

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

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

(Mark One)

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended June 30, 2006

or

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

Commission File Number 001-32275

ACCREDITED HOME LENDERS HOLDING CO.

(Exact name of registrant as specified in its charter)

Delaware
(State or other jurisdiction of
incorporation or organization)

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

15090 Avenue of Science

San Diego, California 92128

(Address of principal executive offices) (Zip Code)

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

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

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

Large accelerated filer Accelerated filer Non-accelerated filer

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

The number of outstanding shares of the registrant's common stock as of August 4, 2006 was 21,582,082.

Table of Contents

TABLE OF CONTENTS

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

Table of Contents

SERVICE MARKS AND TRADE NAMES

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

InzuraSM and Common Sense for Uncommon Loans are service trademarks of AHL, and Informed Broker is a trademark of AHL.

FORWARD-LOOKING STATEMENTS

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

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

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

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

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

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

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

our ability to employ and retain qualified employees;

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

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

our ability to adapt to and implement technological changes; and

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

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

Table of Contents

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

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

(Dollars in thousands, except par value)

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

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

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

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

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

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

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

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Ending balance, cash and cash equivalents	\$ 63,842	\$ 79,739
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The accompanying notes are an integral part of these financial statements.

Table of Contents

ACCREDITED HOME LENDERS HOLDING CO. AND SUBSIDIARIES

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

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

1. ORGANIZATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation

The consolidated financial statements include the accounts of Accredited Home Lenders Holding Co. (AHLHC), a Delaware corporation, and its wholly owned subsidiaries Accredited Home Lenders, Inc. (AHL), Accredited Home Lenders Canada, Inc. (AHLCA) and Vendor Management Services, LLC d/b/a Inzura Settlement Services (ISS), AHL's wholly owned subsidiaries Accredited Mortgage Loan REIT Trust herein reported separately (the REIT), and Inzura Insurance Services (IIS), (collectively referred to as Accredited).

The accompanying unaudited consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America for interim financial information. Accordingly, they do not include all of the information and footnotes required by accounting principles generally accepted in the United States of America for complete financial statements. In the opinion of management, all adjustments, consisting of normal recurring accruals, considered necessary for a fair presentation have been included. Operating results for the three and six months ended June 30, 2006 are not necessarily indicative of the results that may be expected for the year ending December 31, 2006. All intercompany balances and transactions are eliminated in consolidation. The unaudited consolidated financial statements presented herein should be read in conjunction with the audited consolidated financial statements and related notes thereto included in AHLHC's Annual Report on Form 10-K for the year ended December 31, 2005.

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

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

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

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

Acquisitions

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

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

Table of Contents

ACCREDITED HOME LENDERS HOLDING CO. AND SUBSIDIARIES

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

Use of Estimates

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

lower of cost or market valuation allowance

provisions for losses and repurchase

interest rate risk, market valuation on derivatives and hedging strategies

stock-based compensation expense

income taxes

Cash and Cash Equivalents

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

Mortgage Banking Activities

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

Mortgage Loans Held for Sale

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

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

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

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

Certain whole loan sale contracts include provisions requiring Accredited to repurchase a loan if a borrower fails to make one or more of the first loan payments due on the loan. In addition, an investor may request that Accredited refund a portion of the premium paid on the sale of mortgage loans if a loan is prepaid in full within a certain amount of time from the date of sale. Accredited records a provision for estimated repurchases and premium recapture on loans sold, which is charged to gain on sale of loans.

Loans Held for Investment, Securitization Financing and Provision for Losses

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

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

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

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

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

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

Derivative Financial Instruments

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

Fair Value Hedges

Accredited designates certain derivative financial instruments as hedge instruments under SFAS No. 133, and, at trade date, these instruments and their hedging relationship are identified, designated and documented. Accredited has implemented fair value hedge accounting on its mortgage loans held for sale, whereby certain derivatives are designated as a hedge of the fair value of mortgage loans held for sale. This process includes linking derivatives to specific assets or liabilities on the balance sheet. Accredited also assesses, both at the hedge's inception and on an ongoing basis, whether the derivatives used in hedge transactions are highly effective in offsetting changes in fair values of hedged items.

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

Table of Contents

ACCREDITED HOME LENDERS HOLDING CO. AND SUBSIDIARIES

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

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

Cash Flow Hedges

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

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

Loan Origination Costs and Fees

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

Interest Income

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

Loan Servicing and Other Fees

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

Escrow and Fiduciary Funds

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

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

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

Real Estate Owned

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

Share-Based Payments

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

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

Other Comprehensive Income

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

Comprehensive income is determined as follows:

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

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

Segment Reporting

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

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

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

Reclassifications

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

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

Recently Issued Accounting Pronouncements

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

2. RESTRICTED CASH

Restricted cash consisted of the following deposits:

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

3. CONCENTRATIONS OF RISK**Significant Customers**

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

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

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

Credit Repurchase Risk

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

Table of Contents

ACCREDITED HOME LENDERS HOLDING CO. AND SUBSIDIARIES

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

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

Loan Products

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

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

Geographical Concentration

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

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

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

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

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

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

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

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

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

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

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

2005:

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

Total	\$ 75,694	\$ 18,100	\$ (2,556)	\$ 91,238
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Six Months Ended June 30,:

2006:

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

Total	\$ 116,742	\$ 29,599	\$ (8,168)	\$ 138,173
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2005:

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

Total	\$ 64,543	\$ 30,950	\$ (4,255)	\$ 91,238
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Table of Contents**ACCREDITED HOME LENDERS HOLDING CO. AND SUBSIDIARIES****NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****For the Three and Six Months Ended June 30, 2006 and 2005**

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

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

(1) Includes loans repurchased.

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

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

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

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

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

Cash Flow Hedges

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

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

At June 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

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

contracts, 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:

	June 30, 2006	December 31, 2005
	(In thousands)	
Options contracts	\$ 6,892	\$ 4,739
Interest rate swap agreements	23,060	14,684
Futures contracts	36,960	8,099
Interest rate cap agreements	26	53
Total fair value of derivatives	66,938	27,575
Margin account balances	40,810	61,834
Derivative assets, including margin account	\$ 107,748	\$ 89,409
Futures contracts(1)	\$	\$ (1,815)

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

A gain of \$357 thousand and loss of \$23 thousand on derivative instruments not designated for SFAS No. 133 hedge accounting treatment was recorded in interest expense on the statement of operations during the three months ended June 30, 2006 and 2005, respectively, relating to the gain in value of interest rate cap agreements and interest rate swap agreements. A gain of \$359 thousand and \$1.7 million on derivative instruments not designated for SFAS No. 133 hedge accounting treatment was recorded in interest expense on the statement of operations during the six months ended June 30, 2006 and 2005, respectively, relating to the gain in value of interest rate cap agreements and interest rate swap agreements. The change in the fair value of derivative financial instruments and the related hedged asset or liability recorded in the statements of operations was as follows:

	Interest Income	Interest Expense	Gain on Sale (In thousands)	Other Income	Total
Three Months Ended June 30, 2006:					
Net unrealized gain (loss)	\$ 1,304	\$ (9,450)	\$ (8,113)	\$	\$ (16,259)
Net realized gain (loss)		19,339	20,430		39,769
Total	\$ 1,304	\$ 9,889	\$ 12,317	\$	\$ 23,510
2005:					
Net unrealized gain (loss)	\$ (1,683)	\$ (1,981)	\$ 5,785	\$ (38)	\$ 2,083
Net realized gain (loss)		5,077	(6,784)	19	(1,688)

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Total	\$ (1,683)	\$ 3,096	\$ (999)	\$ (19)	\$ 395
Six Months Ended June 30,					
2006:					
Net unrealized gain (loss)	\$ 1,977	\$ (15,395)	\$ (12,541)	\$	\$ (25,959)
Net realized gain (loss)		32,801	28,863		61,664
Total	\$ 1,977	\$ 17,406	\$ 16,322	\$	\$ 35,705
2005:					
Net unrealized gain (loss)	\$ (3,461)	\$ (7,333)	\$ 2,774	\$	\$ (8,020)
Net realized gain		15,292	2,990	46	18,328
Total	\$ (3,461)	\$ 7,959	\$ 5,764	\$ 46	\$ 10,308

Table of Contents**ACCREDITED HOME LENDERS HOLDING CO. AND SUBSIDIARIES****NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****For the Three and Six Months Ended June 30, 2006 and 2005****6. CREDIT FACILITIES**

Credit facilities consisted of the following:

	June 30, 2006	December 31, 2005
	(In thousands)	
A \$660 million warehouse credit facility expiring December 2007	\$ 399,802	\$ 281,428
A \$650 million warehouse credit facility expiring February 2007	304,341	472,457
A \$500 million warehouse credit facility expiring June 2007	166,442	385,317
A \$650 million warehouse credit facility expiring July 2007	118,090	315,812
A \$200 million CAD warehouse credit facility expiring June 2007	117,815	127,826
A \$300 million warehouse credit facility expiring January 2007	47,827	5,923
A \$600 million warehouse credit facility expiring August 2006	31,830	135,353
A \$600 million warehouse credit facility expiring December 2006	27,868	303,953
A \$40 million warehouse credit facility expiring November 2006	3,473	9,513
A \$1 billion asset-backed commercial paper facility	339,621	767,537
Total credit facilities	\$ 1,557,109	\$ 2,805,119

Outstanding credit facilities consist of committed warehouse lines and asset-backed commercial paper (ABCP). 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. The weighted average interest rate as of June 30, 2006 was 5.8%.

Starting in the second quarter of 2005, Accredited began issuing commercial paper under the ABCP in the form of short-term secured liquidity notes (SLNs) with initial maturities ranging from one to 180 days and also issued \$40.0 million of subordinated notes maturing on May 25, 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 (5.4% at June 30, 2006), which vary depending on the prevailing market conditions.

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

At June 30, 2006 and December 31, 2005, 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 of loans and other assets, cash flows from operations, or from refinancing the borrowings.

Table of Contents**ACCREDITED HOME LENDERS HOLDING CO. AND SUBSIDIARIES****NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****For the Three and Six Months Ended June 30, 2006 and 2005****7. SECURITIZATION FINANCING**

Securitization financing consisted of the following:

	Balance		Interest Rate Range		Final Stated Maturity
	June 30, 2006	December 31, 2005	Fixed	Variable (LIBOR+)	
Bond financing:					
2002 two securitizations	\$ 95,411	\$ 136,634	4.48% - 4.93%	.32% - .50%	2033
2003 three securitizations	315,129	406,650	3.58% - 4.46%	.35% - .38%	2034
2004 four securitizations	1,484,103	1,882,537	2.90% - 5.25%	.15% - 2.50%	2035
2005 four securitizations	3,193,832	3,747,597	N/A	.08% - 2.50%	2035
2006 two securitizations	2,333,917		N/A	.04% - 2.10%	2036
Total bond financing(a)	7,422,392	6,173,418			
Other:					
2005 Private placement Canadian mortgages(b)	66,564	70,934	N/A	CP rate + .27%	None
2006 Private placement Canadian mortgages(b)	157,606		N/A	4.68%	None
	7,646,562	6,244,352			
Unamortized debt discounts	(3,096)	(3,532)			
Total securitization financing, net	\$ 7,643,466	\$ 6,240,820			

(a) Collateralized by U.S. loans securitized with an aggregate outstanding balance of \$7.5 billion and \$6.4 billion at June 30, 2006 and December 31, 2005, respectively. In addition, \$352.3 million of restricted cash at June 30, 2006 is pledged as collateral in connection with the securitization closed in June 2006.

(b) Collateralized by Canadian loans with an aggregate outstanding balance of \$232.5 million and \$70.9 million at June 30, 2006 and December 31, 2005, respectively. In addition, \$13.7 million and \$8.2 million of restricted cash at June 30, 2006 and December 31, 2005, respectively, are pledged as collateral in connection with this debt.

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.

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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.

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

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

	(In thousands)
Six months ending December 31, 2006	\$ 1,238,392
Year Ending December 31:	
2007	2,387,767
2008	1,476,398
2009	824,424
2010	541,631
2011	347,773
Thereafter	830,177
Discount	(3,096)
Total	\$ 7,643,466

8. INCOME TAXES

The income tax provision consists of the following:

	Three Months Ended June 30		Six Months Ended June 30	
	2006	2005	2006	2005
	(In thousands)			
Current:				
Federal	\$ 37,380	\$ 11,674	\$ 61,267	\$ 16,524
State	8,073	2,054	14,202	3,578
Total current provision	45,453	13,728	75,469	20,102
Deferred:				
Federal	(14,364)	9,910	(18,061)	22,216
State	(2,817)	2,861	(4,418)	5,383
Total deferred provision (benefit)	(17,181)	12,771	(22,479)	27,599
Total provision	\$ 28,272	\$ 26,499	\$ 52,990	\$ 47,701

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

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	Three Months Ended June 30		Six Months Ended June 30,	
	2006	2005	2006	2005
	(In thousands)			
Federal income tax at statutory rate	\$ 25,206	\$ 23,998	\$ 47,268	\$ 43,242
State income tax, net of federal effects	3,417	3,194	6,360	5,824
REIT dividends on preferred stock	(873)	(873)	(1,746)	(1,746)
Other	522	180	1,108	381
Total provision	\$ 28,272	\$ 26,499	\$ 52,990	\$ 47,701

Accredited recorded \$1.1 million and \$1.2 million during the three months ending June 30, 2006 and 2005, respectively, and \$3.8 million and \$2.9 million, during the six months ending June 30, 2006 and 2005, respectively, as a reduction in income taxes payable for corporate tax deductions arising from the sale by employees of common stock they acquired from employee stock plans prior to the fulfillment of the required tax holding periods for such stock and the issuance of stock that employees were awarded through employee incentive compensation plans. These benefits have been reflected as additional paid in capital.

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

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

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.

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

	June 30, 2006	December 31, 2005
	(In thousands)	
Deferred tax assets:		
Loans held for sale	\$ 9,769	\$ 6,303
Market reserve on loans held for sale	8,341	8,639
Loan securitizations	72,405	54,991
State taxes	3,280	6,151
Other reserves and accruals	17,104	12,289
Total deferred tax assets	110,899	88,373
Deferred tax liabilities:		
Mortgage-related securities	(10,847)	(10,800)
Cash flow hedging	(22,717)	(9,549)
Total deferred tax liabilities	(33,564)	(20,349)
Net deferred tax asset	\$ 77,335	\$ 68,024

9. ACCOUNTS PAYABLE AND ACCRUED LIABILITIES

Accounts payable and accrued liabilities were as follows:

	June 30, 2006	December 31, 2005
	(In thousands)	
Accrued liabilities payroll	\$ 22,778	\$ 28,116
Accrued liabilities general	37,513	34,627
Reserve for repurchases and premium recapture	12,562	10,751
Total	\$ 72,853	\$ 73,494

Table of Contents

ACCREDITED HOME LENDERS HOLDING CO. AND SUBSIDIARIES
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

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

	Balance at Beginning of Period	Provision (1)	Chargeoffs, net	Balance at End of Period
	(In thousands)			
Three Months Ended June 30,:				
2006:				
Reserve for repurchases	\$ 8,042	\$ 1,864	\$ (1,220)	\$ 8,686
Reserve for premium recapture	3,588	2,125	(1,837)	3,876
Total	\$ 11,630	\$ 3,989	\$ (3,057)	\$ 12,562
2005:				
Reserve for repurchases	\$ 5,461	\$ 1,302	\$ (435)	\$ 6,328
Reserve for premium recapture	2,149	1,409	(1,933)	1,625
Total	\$ 7,610	\$ 2,711	\$ (2,368)	\$ 7,953
Six Months Ended June 30,:				
2006:				
Reserve for repurchases	\$ 7,434	\$ 2,913	\$ (1,661)	\$ 8,686
Reserve for premium recapture	3,317	4,230	(3,671)	3,876
Total	\$ 10,751	\$ 7,143	\$ (5,332)	\$ 12,562
2005:				
Reserve for repurchases	\$ 5,126	\$ 2,004	\$ (802)	\$ 6,328
Reserve for premium recapture	2,410	2,463	(3,248)	1,625
Total	\$ 7,536	\$ 4,467	\$ (4,050)	\$ 7,953

(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.

Table of Contents**ACCREDITED HOME LENDERS HOLDING CO. AND SUBSIDIARIES****NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****For the Three and Six Months Ended June 30, 2006 and 2005****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 six months ended June 30, 2006 and 2005, and the related tax benefit is shown in the following table:

	Three Months Ended June 30, 2006		Six Months Ended June 30, 2005	
	2006	2005	2006	2005
	(In thousands, except per share amounts)			
Stock options	\$ 1,402	\$ 242	\$ 2,381	\$ 289
Restricted stock units (Deferred Compensation Plan)	1,351	2,206	2,394	3,262
Restricted stock awards	119	38	238	38
Total share-based compensation expense	2,872	2,486	5,013	3,589
Income tax benefit recognized	(948)	(994)	(1,675)	(1,435)
Compensation expense, net of tax benefit	\$ 1,924	\$ 1,492	\$ 3,338	\$ 2,154
Change in the following due to the adoption of SFAS 123R:				
Net income	\$ (1,038)		\$ (1,738)	
Basic earnings per share	\$ (0.05)		\$ (0.08)	
Diluted earnings per share	\$ (0.05)		\$ (0.08)	

For the three and six months ended June 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 six months ended June 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 six months ended June 30, 2006 are noted in the following table.

Three Months Ended**Six Months Ended**

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	June 30, 2006	June 30, 2006
Weighted-average risk-free rate	4.96 %	4.74 %
Weighted-average expected life	3.9 yrs	3.9 yrs
Expected Volatility	43%	43%
Dividend Yield	0%	0%
Weighted-average grant date fair value	\$ 21.13	\$ 19.77

In determining the expected volatility, we reviewed historical and implied volatility. 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. We applied the change in computation of volatility and weighted-average expected life on a prospective basis beginning with awards granted after December 31, 2005. A summary

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

of the change in options outstanding under Accredited's Stock Option Plans during the six months ended June 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	457	\$ 51.24		
Options exercised	(157)	\$ 17.09		
Options cancelled	(161)	\$ 42.25		
Outstanding at June 30, 2006	1,537	\$ 32.96	7.93 yrs	\$ 24,296
Options vested and expected to vest at June 30, 2006	1,316	\$ 30.83	7.93 yrs	\$ 23,373
Options exercisable at June 30, 2006	578	\$ 16.47	6.25 yrs	\$ 18,118
Shares authorized for issuance	2,485			
Shares available for grant	948			

Aggregate intrinsic value disclosed above represents the difference between Accredited's closing stock price of \$47.81 on June 30, 2006, and the exercise price multiplied by the number of options. The actual intrinsic value of options exercised was \$1.8 million and \$5.5 million for the three and six-month periods ended June 30, 2006, respectively, and \$2.8 million and \$6.6 million for the three and six-month periods ended June 30, 2005, respectively. At June 30, 2006, Accredited had \$12.1 million of gross unrecognized compensation expense related to stock option plans that will be recognized over the weighted-average period of 1.9 years. Cash received from stock option exercises was \$2.7 million during the quarter ended June 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 \$57.79 and \$52.30 for the three and six-month periods ended June 30, 2006, respectively, and \$39.00 and \$41.37 for the three and six-month periods ended June 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 the Company's common stock upon distribution. RSUs granted to directors cliff vest two years from the date of grant.

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

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

	Units (In thousands)	Aggregate Intrinsic Value (In thousands)
Outstanding at December 31, 2005	774	
Awarded	94	
Released	(126)	
Forfeited	(49)	
Outstanding at June 30, 2006	693	
Authorized and outstanding		
Authorized	1,864	
Total outstanding	(693)	\$ 33,137
Available for grant	1,171	
Units vested not released	146	\$ 6,952
Units vested and expected to vest at June 30, 2006	611	\$ 29,233

The aggregate intrinsic value of restricted stock units is calculated based on the number of units and the quoted market price of \$47.81 at June 30, 2006. The total intrinsic value of net units released was \$1.9 million and \$7.0 million for the three and six-month periods ended June 30, 2006, respectively, and \$0 and \$25,000 for the three and six-month periods ended June 30, 2005, respectively. At June 30, 2006, there was approximately \$14.4 million in gross unrecognized compensation expense related to the nonvested units, which is expected to be recognized over 2.6 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. The expense for these shares is recognized over the awards' service period of approximately five-years. As of June 30, 2006, none of the awards had vested, and unrecognized compensation related to these stock awards totaled \$1 million.

Table of Contents**ACCREDITED HOME LENDERS HOLDING CO. AND SUBSIDIARIES****NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****For the Three and Six Months Ended June 30, 2006 and 2005****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 the Company'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 six months ended June 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	Six Months Ended
	June 30, 2005	June 30, 2005
	(In thousands, except for per share amounts)	
Net income, as reported	\$ 39,572	\$ 70,859
Add: Stock option compensation included in reported net income, net of tax	145	174
Deduct: Stock option compensation expense determined using fair value method, net of tax	(882)	(1,640)
Pro forma net income	\$ 38,835	\$ 69,393
Earnings per share:		
Basic as reported	\$ 1.89	\$ 3.39
Basic pro forma	\$ 1.85	\$ 3.32
Diluted as reported	\$ 1.81	\$ 3.24
Diluted pro forma	\$ 1.78	\$ 3.17

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	Six Months Ended
	June 30, 2005	June 30, 2005
Weighted-average risk-free rate	3.65%	3.44%
Weighted-average expected life	2.7 yrs	2.6 years
Volatility	45%	45%
Dividend Yield	0%	0%
Weighted-average grant date fair value	\$ 12.42	\$ 13.67

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

	Net Income (numerator) (In thousands, except per share amounts)	Shares (denominator)	Per Share Amount
Three Months Ended June 30, 2006:			
Basic earnings per share	\$ 41,250	21,676	\$ 1.90
Effect of dilutive shares:			
Stock options		462	
Restricted stock units		220	
Diluted earnings per share	\$ 41,250	22,358	\$ 1.84
Potentially dilutive stock options not included above since they are antidilutive		521	
Three Months Ended June 30, 2005:			
	\$ 39,572	20,982	\$ 1.89
Effect of dilutive shares:			
Stock options		654	
Restricted stock units		236	
Diluted earnings per share	\$ 39,572	21,872	\$ 1.81
Potentially dilutive stock options not included above since they are antidilutive		275	
Six Months Ended June 30, 2006:			
Basic earnings per share	\$ 77,073	21,615	\$ 3.57
Effect of dilutive shares:			
Stock options		480	
Restricted stock units		241	

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Diluted earnings per share	\$ 77,073	22,336	\$ 3.45
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Potentially dilutive stock options not included above since they are antidilutive		372	
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Six Months Ended June 30, 2005:

Basic earnings per share	\$ 70,859	20,917	\$ 3.39
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Effect of dilutive shares:

Stock options		708	
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Restricted stock units		235	
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Diluted earnings per share	\$		
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