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 March 31, 2004

or

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

For the transition period from _________ to _________

Commission File Number 0-50179

ACCREDITED HOME LENDERS HOLDING CO.

(Exact name of registrant as specified in its charter)

Delaware	**04-3669482**
(State or other jurisdiction of	**(I.R.S. Employer**
incorporation or organization)	**Identification No.)**

15090 Avenue of Science

San Diego, California 92128

(Address of principal executive offices) (Zip Code)

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

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

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

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

The number of outstanding shares of the registrant s common stock as of April 30, 2004 was 20,799,250.

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FORWARD-LOOKING STATEMENTS

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

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

- changes in demand for, or value of, mortgage loans due to the attributes of the loans we originate; the characteristics of our borrowers; and fluctuations in the real estate market, interest rates or the market in which we sell or securitize our loans;
- a general deterioration in economic or political conditions;
- our ability to protect and hedge our mortgage loan portfolio against adverse interest rate movements;
- changes in government regulations that affect our ability to originate and service mortgage loans;
- changes in the credit markets, which affect our ability to borrow money to originate mortgage loans;
- the degree and nature of our competition;
- our ability to employ and retain qualified employees; and
- the other factors referenced in this report, including, without limitation, under the section entitled ITEM 2. Management s Discussion and Analysis of Financial Condition and Results of Operations.

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

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

PART I

Item 1. ***Financial Statements***

ACCREDITED HOME LENDERS HOLDING CO. AND SUBSIDIARY

CONDENSED CONSOLIDATED BALANCE SHEETS

(unaudited)

(dollars in thousands)	**December 31, 2003**	**March 31, 2004**
ASSETS		
Cash and cash equivalents	$ 27,119	$ 34,542
Restricted cash	209	5,660
Mortgage loans held for sale, net of market reserve of $12,213 and $12,833, respectively	1,615,994	1,907,341
Securitized loans, net of allowance for loan losses of $19,890 and $24,686, respectively	1,751,318	2,139,009
Mortgage-related securities, at fair value	3,692	4,286
Mortgage servicing rights, net	1,119	812
Furniture, fixtures and equipment, net	20,674	26,310
Other receivables	44,911	57,149
Deferred income tax asset	16,052	18,288
Prepaid expenses and other assets	20,329	22,249
TOTAL	$ 3,501,417	$ 4,215,646
LIABILITIES AND STOCKHOLDERS EQUITY		
LIABILITIES:		
Warehouse facilities	$ 1,515,195	$ 1,816,200
Securitization bond financing	1,724,389	2,094,043
Income taxes payable	2,949	12,266
Accounts payable and accrued liabilities	46,661	54,946
Total liabilities	3,289,194	3,977,455
COMMITMENTS AND CONTINGENCIES (Note 13)		
STOCKHOLDERS EQUITY:		
Preferred stock, $.001 par value; authorized 5,000,000 shares; no shares issued and outstanding		
Common stock, $.001 par value; authorized 40,000,000 shares; issued and outstanding 20,366,314 shares at December 31, 2003 and 20,740,534 shares at March 31, 2004 (including 326,113 and 496,025, respectively, of restricted stock awarded under the deferred compensation plan)	20	21

Additional paid-in capital	61,585	70,444
Note receivable for common stock	(1,250)	(1,250)
Unearned compensation	(5,623)	(11,021)
Retained earnings	157,491	179,997
Total stockholders equity	212,223	238,191
TOTAL	$ 3,501,417	$ $4,215,646

See notes to condensed consolidated financial statements.

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ACCREDITED HOME LENDERS HOLDING CO. AND SUBSIDIARY

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(unaudited)

(dollars and shares outstanding in thousands, except for earnings per share)	Three Months Ended March 31,	
	2003	2004
REVENUES:		
Interest income	$ 32,297	$ 60,626
Gain on sale of loans (including $2,834 and $0, respectively, with a related party)	43,171	54,730
Loan servicing income	1,882	1,563
Net gain on mortgage-related securities and derivatives	1,399	1,842
Other income	391	202
Total revenues	79,140	118,963
EXPENSES:		
Salaries, wages and benefits	23,902	35,394
Interest expense (including $597 and $0, respectively, with a related party)	12,167	20,930
Occupancy	2,402	3,853
Provision for losses	6,508	7,449
Depreciation and amortization	1,117	1,774
General and administrative expenses	8,361	12,053
Total expenses	54,457	81,453
INCOME BEFORE INCOME TAXES	24,683	37,510
INCOME TAXES	9,873	15,004
NET INCOME	$ 14,810	$ 22,506
BASIC EARNINGS PER SHARE	$ 1.19	$ 1.12
DILUTED EARNINGS PER SHARE	$ 0.85	$ 1.05
WEIGHTED AVERAGE SHARES OUTSTANDING:		
BASIC	12,445	20,119
DILUTED	17,419	21,504

See notes to condensed consolidated financial statements.

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ACCREDITED HOME LENDERS HOLDING CO. AND SUBSIDIARY

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(unaudited)

	Three Months Ended March 31,	
(dollars in thousands)	**2003**	**2004**
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	$ 14,810	$ 22,506
Adjustments to reconcile net income to net cash used in operating activities:		
Depreciation and amortization	1,117	1,774
Amortization of unearned compensation	49	777
Loss on disposal of furniture, fixtures, and equipment		4
Mortgage loans originated, net of fees	(1,470,267)	(2,388,770)
Proceeds from sale of mortgage loans held for sale, net of fees	1,075,857	1,582,909
Collection of principal payments on mortgage loans held for sale	4,551	11,274
Net change in fair value hedge basis adjustment on mortgage loans held for sale and securitized loans	(3,200)	(14,933)
Amortization of net deferred origination fees on securitized loans	(125)	(252)
Cash received on mortgage-related securities	3,735	1,407
Net unrealized gain on mortgage-related securities	(1,735)	(2,190)
Accretion of mortgage-related securities	(346)	(108)
Amortization of mortgage servicing rights	565	307
Provision for losses	6,508	7,449
Deferred income taxes	(3,324)	(2,236)
Income tax deduction for disqualifying stock dispositions		2,294
Changes in assets and liabilities:		
Other receivables	(230)	(12,238)
Other assets	1,906	(336)
Accounts payable and accrued liabilities	(6,333)	6,556
Income taxes payable	7,192	9,317
Net cash used in operating activities	(369,270)	(774,489)
CASH FLOWS FROM INVESTING ACTIVITIES:		
Capital expenditures	(2,257)	(7,414)
Principal payments on securitized loans	14,270	123,734
Net cash provided by investing activities	12,013	116,320
CASH FLOWS FROM FINANCING ACTIVITIES:		
Net proceeds from warehouse credit facilities	348,916	301,005
Payments of borrowings on residual interest credit facility	(6,858)	
Proceeds from issuance of securitization bond financing		505,000
Payments of securitization bond financing	(22,817)	(135,346)
Change in restricted cash	(120)	(5,451)
Payments on capital leases	(75)	(7)
Proceeds from exercise of stock options	134	391
Net proceeds from initial public offering and concurrent private placement	38,773	
Net cash provided by financing activities	357,953	665,592

NET INCREASE IN CASH AND CASH EQUIVALENTS		696		7,423
BEGINNING BALANCE, CASH AND CASH EQUIVALENTS		11,300		27,119
ENDING BALANCE, CASH AND CASH EQUIVALENTS	$	11,996	$	34,542
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION:				
Cash paid during the period for:				
Interest	$	9,200	$	18,852
Income taxes	$	6,024	$	5,609
SUPPLEMENTAL DISCLOSURE OF NON-CASH INVESTING AND FINANCING ACTIVITIES:				
Transfer of loans held for sale to securitized loans	$		$	504,925
Transfer of loans held for sale to real estate owned, included in other assets	$	2,172	$	1,584
Transfer of mortgage related securities from other liabilities	$		$	297
Unearned compensation	$	48	$	76
Deferred compensation	$		$	6,023
Conversion of convertible debt to common stock	$	3,000	$	
Conversion of preferred stock to common stock	$	5,113	$	
Conversion of warrants to common stock	$	1	$	

See notes to condensed consolidated financial statements.

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ACCREDITED HOME LENDERS HOLDING CO. AND SUBSIDIARY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

For The Three Months Ended March 31, 2003 and 2004 (Unaudited)

1. THE COMPANY AND A SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation The consolidated financial statements include the accounts of Accredited Home Lenders Holding Co. (AHLHC), a Delaware corporation, and its wholly owned subsidiary Accredited Home Lenders, Inc. (AHL) (collectively the Company). 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 months ended March 31, 2004 are not necessarily indicative of the results that may be expected for the year ending December 31, 2004. All intercompany balances and transactions have been eliminated. The unaudited consolidated financial statements presented herein should be read in conjunction with the audited consolidated financial statements and related notes thereto included in Accredited Home Lenders Holding Co. s Annual Report on Form 10-K for the year ended December 31, 2003.

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

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

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

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

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

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ACCREDITED HOME LENDERS HOLDING CO. AND SUBSIDIARY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

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

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

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

Securitized Loans and Securitization Bond Financing Since July 2002, the Company has completed a total of six securitizations totaling $2.5 billion structured as a financing under Statement of Financial Accounting Standards (SFAS) No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities a replacement of FASB Statement No. 125*.

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

The Company periodically evaluates the need for or the adequacy of the allowance for loan losses on its securitized loans. Provision for loan losses on securitized loans is made in an amount sufficient to maintain credit

ACCREDITED HOME LENDERS HOLDING CO. AND SUBSIDIARY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

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

The Company designates certain derivative financial instruments as hedge instruments under SFAS No. 133, and, at trade date, these instruments and their hedging relationship are identified, designated and documented. For derivative financial instruments designated as hedge instruments, the Company evaluates the effectiveness of these hedges against the mortgage loans being hedged to ensure that there remains adequate correlation in the hedge relationship. To hedge the adverse effect of interest rate changes on the fair market value of mortgage loans held for sale and securitized loans, the Company is using derivatives as fair value hedges under SFAS No. 133. Once the hedge relationship is established, the realized and unrealized changes in fair value of both the hedge instruments and mortgage loans held for sale and securitized loans are recognized in the consolidated statement of operations in the period in which the changes occur. Any change in the fair value of mortgage loans held for sale recognized as a result of hedge accounting is reversed at the time the mortgage loans are sold. This results in a correspondingly higher or lower gain on sale of loans at such time. Any change in the fair value of securitized loans is amortized over the fixed rate period of the loan on a level yield basis. This results in a corresponding adjustment to interest income. The net amount recorded in the consolidated statement of operations is referred to as hedge ineffectiveness.

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

Provision for Losses Market valuation adjustments have been provided on certain nonperforming loans, other loans held for sale and real estate owned. These adjustments are based on the Company s estimate of expected losses, calculated using loss severity and loss frequency rate assumptions, and are based on the value that the Company could reasonably expect to obtain from a sale, that is, other than in a forced or liquidation sale. Provision for losses on securitized loans is recorded in an amount sufficient to maintain the allowance for loan losses at a level considered appropriate to cover probable losses on such loans. Provision for losses also includes net losses on real estate owned. The Company also accrues liabilities associated with loans sold which may be required to be repurchased due to breaches of representations and warranties and early payment defaults. The Company periodically evaluates the estimates used in calculating expected losses and adjustments are reported in earnings. As these estimates are influenced by factors outside of the Company s control and as uncertainty is inherent in these estimates, it is reasonably possible that they could change.

Escrow and Fiduciary Funds The Company maintains segregated bank accounts in trust for investors with respect to payments on securitized loans and mortgage loans serviced for investors, as well as for mortgagors with respect to property tax and hazard insurance premium payments escrowed by mortgagors with

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ACCREDITED HOME LENDERS HOLDING CO. AND SUBSIDIARY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

the Company. Such accounts amounted to $35.4 million and $52.0 million at December 31, 2003 and March 31, 2004, respectively, and are excluded from the Company s assets and liabilities.

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

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

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

	Three Months Ended March 31,	
	2003	**2004**
Net income, as reported	$ 14,810	$ 22,506
Add: Stock-based compensation included in reported net income, net of tax	29	68
Deduct: Stock-based employee compensation expense determined using fair value method, net of tax	(76)	(321)
Pro forma net income	$ 14,763	$ 22,253
Earnings per share:		
Basic as reported	$ 1.19	$ 1.12
Basic pro forma	$ 1.19	$ 1.11
Diluted as reported	$ 0.85	$ 1.05
Diluted pro forma	$ 0.84	$ 1.03

The fair value of each option grant is estimated as of the date of the grant using the Black-Scholes option-pricing model with the following weighted-average assumptions: no dividends, an expected option life of five years, a risk-free rate of 2.9% (three months ended March 31, 2003) and 3.1% (three months ended March 31, 2004) and no volatility (three months ended March 31, 2003) as options were granted prior to the Offering and a 57.3% weighted average volatility (three months ended March 31, 2004), respectively. The Company s volatility is calculated as an average of its own volatility and the mean of its closest competitors volatility for the respective periods due to the limited period of time since the Offering. The weighted average fair value at grant date was $1.08 and $20.78 for options granted during the three months ended March 31, 2003 and 2004, respectively.

Segment Reporting While the Company s management monitors the revenue streams through wholesale and retail loan originations, operations are managed and financial performance is evaluated by the Company s chief operating decision-maker on a company-wide basis. Accordingly, the Company operates in one reportable operating segment.

Use of Estimates in the Preparation of Financial Statements The preparation of these consolidated financial statements in conformity with accounting principles generally accepted in the United States of America

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ACCREDITED HOME LENDERS HOLDING CO. AND SUBSIDIARY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Material estimates that are particularly susceptible to significant change in the near term relate to the valuation of the mortgage-related securities, mortgage servicing rights, derivative financial instruments and hedged assets, the determination of the market reserve on loans and the allowance for loan losses on securitized loans, and the determination of the reserves for repurchases.

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

2. CONCENTRATIONS OF RISK

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

Geographical Concentration Properties securing the mortgage loans in the Company s servicing portfolio, including loans subserviced, are geographically dispersed throughout the United States. At March 31, 2003 and 2004, approximately 37% and 35%, respectively, of the properties were located in California. The remaining properties securing mortgage loans serviced did not exceed 10% in any other state at any period end.

Loan originations are geographically dispersed throughout the United States. During the three months ended March 31, 2003 and 2004, approximately 36% and 31%, respectively, of the principal balance of loans originated were collateralized by properties located in California. The remaining originations did not exceed 10% in any other state during any of such periods.

3. MORTGAGE LOANS

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

	December 31,	March 31,

	2003	2004
Mortgage loans held for sale principal balance	$ 1,622,896	$ 1,910,768
Basis adjustment for fair value hedge accounting	3,487	6,946
Net deferred origination costs	1,824	2,460
Market reserve	(12,213)	(12,833)
Mortgage loans held for sale, net	$ 1,615,994	$ 1,907,341

At March 31, 2004, mortgage loans held for sale included $418.2 million in loans held for a securitization.

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ACCREDITED HOME LENDERS HOLDING CO. AND SUBSIDIARY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Securitized loans Securitized loans were as follows (dollars in thousands):

	December 31, 2003	March 31, 2004
Securitized loans principal balance	$ 1,761,132	$ 2,142,323
Basis adjustment for fair value hedge accounting	12,447	23,921
Net deferred origination fees	(2,371)	(2,549)
Allowance for loan losses	(19,890)	(24,686)
Securitized loans, net	$ 1,751,318	$ 2,139,009

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

	Three Months Ended March 31, 2003	Three Months Ended March 31, 2004
Balance, beginning of period	$ 6,885	$ 12,213
Provision for losses	4,437	2,094
Chargeoffs, net	(1,162)	(1,474)
Balance, end of period	$ 10,160	$ 12,833
Reserve % of loans held for sale	0.74%	0.67%

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

Three Months Ended

March 31,

	2003	2004
Balance, beginning of period	$ 4,550	$ 19,890
Provision for losses	1,884	5,057
Chargeoffs, net		(261)
Balance, end of period	$ 6,434	$ 24,686
Allowance % of securitized loans	0.89%	1.15%

As of December 31, 2003 and March 31, 2004, $7.5 million and $8.7 million of securitized loans were 90 days or more delinquent under their payment terms, respectively. This increase results from the increased age and size of the Company s securitized loan portfolio.

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ACCREDITED HOME LENDERS HOLDING CO. AND SUBSIDIARY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

As of December 31, 2003 and March 31, 2004, $4.2 million and $2.5 million of real estate owned, net of the reserve for losses on real estate owned of $1.7 million and $1.0 million, respectively, is included in other assets. Activity in the reserve for losses on real estate owned was as follows (dollars in thousands):

	Three Months Ended March 31, 2003	Three Months Ended March 31, 2004
Balance, beginning of period	$ 2,092	$ 1,684
Provision for losses	(90)	(188)
Chargeoffs, net	(337)	(514)
Balance, end of period	$ 1,665	$ 982

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

	Three Months Ended March 31, 2003	Three Months Ended March 31, 2004
Provision market reserve on loans	$ 4,437	$ 2,094
Provision allowance for losses on securitized loans	1,884	5,057
Recovery reserve for real estate owned	(90)	(188)
Provision (recovery) reserve for repurchases	(31)	407
Net losses on real estate owned	308	79
	$ 6,508	$ 7,449

4. MORTGAGE-RELATED SECURITIES

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

	Three Months ended March 31,	
	2003	2004
Balance, beginning of period	$ 8,356	$ 3,692
Net unrealized gains	1,735	2,190
Interest accretion	346	108
Cash collected	(3,735)	(1,407)
Reclassification from other liabilities		(297)
Balance, end of period	$ 6,702	$ 4,286

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ACCREDITED HOME LENDERS HOLDING CO. AND SUBSIDIARY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

	December 31, 2003	March 31, 2004
Annual prepayment speeds	20.0% to 67.5%	20.0% to 67.5%
Discount rate	15%	15%
Expected cumulative credit losses	4.2%	4.2%
Interest rates on adjustable rate loans	Forward LIBOR curve	Forward LIBOR curve
Fair value at period end	$(297)	$159

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

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

	December 31, 2003	March 31, 2004
Annual prepayment speeds	22.0% to 55.2%	22.0% to 43.3%
Discount rate	15%	15%
Expected cumulative credit losses	4.9%	4.6%
Interest rates on adjustable rate loans	Forward LIBOR curve	Forward LIBOR curve
Fair value at period end	$3,692	$4,127

5. MORTGAGE SERVICING RIGHTS

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

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

	Three Months ended March 31,	
	2003	**2004**
Balance, beginning of period	$ 3,116	$ 1,119
Amortization	(565)	(307)
Balance, end of period	$ 2,551	$ 812

The fair value of mortgage servicing rights at March 31, 2003 and March 31, 2004 was $3.1 million and $915,000, respectively.

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

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ACCREDITED HOME LENDERS HOLDING CO. AND SUBSIDIARY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The Company is the master servicer of 20,567 and 32,404 loans with an outstanding balance of $2.6 billion and $4.3 billion as of March 31, 2003 and 2004, respectively. Losses on our servicing portfolio, defined as loans held for sale, securitized loans and loans held in off balance sheet securitizations, were $3.9 million for both the three months ended March 31, 2003 and 2004, respectively, resulting in annualized losses of 0.7% and 0.4% for the comparable periods. As of March 31, 2003 and 2004, the unpaid principal balance of loans sold servicing retained was $430.3 million and $236.5 million, respectively.

6. DERIVATIVE FINANCIAL INSTRUMENTS

Derivative Financial Instruments and Hedged Instrument Activity The Company uses hedge accounting as defined by SFAS No. 133 for certain derivative financial instruments used to hedge its mortgage loans held for sale. At December 31, 2003 and March 31, 2004, fair value hedge basis adjustments of $3.5 million and $6.9 million, respectively, are included in mortgage loans held for sale related to the $960.8 million and $1.1 billion, respectively, of such loans designated as hedged assets. Hedge ineffectiveness associated with fair value hedges of $401,000 was recorded in earnings during the three months ended March 31, 2004 and is included as an addition to gain on sale of loans in the consolidated statements of operations.

The Company uses hedge accounting as defined by SFAS No. 133 for certain derivative financial instruments used to hedge its securitized loans. At December 31, 2003 and March 31, 2004, fair value hedge basis adjustments of $12.4 million and $23.9 million, respectively, are included in securitized loans related to the $1.0 billion and $1.4 billion, respectively, of such loans designated as hedged assets. Hedge ineffectiveness associated with fair value hedges of ($105,000) was recorded in earnings during the three months ended March 31, 2004 and is included as a reduction in interest income in the consolidated statements of operations.

At March 31, 2004, the Company had outstanding futures contracts with a fair value of ($17.9) million included in accrued liabilities of which contracts with a fair value of ($17.3) million are designated as hedge instruments. The Company is required to maintain a cash deposit in a margin account with its broker related to these derivative transactions. At March 31, 2004, approximately $27.1 million was on deposit in such margin account, which is included in other receivables. Accordingly, the net liquidation value of the Company s derivative financial instruments and related margin account is $9.2 million at March 31, 2004. In addition, the Company had option contracts and interest rate cap agreements with a fair value of $228,000 and $394,000, respectively, included in other assets at March 31, 2004.

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

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ACCREDITED HOME LENDERS HOLDING CO. AND SUBSIDIARY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

	Three Months Ended March 31, 2004			
	Interest Income	**Gain on Sale**	**Net Gain on MRS**	**Total**
Net unrealized gain (loss)	$ 1,319	$ 7,287	$ (19)	$ 8,587
Net realized gain (loss)	(4,616)	(12,675)	(329)	(17,620)
Total	$ (3,297)	$ (5,388)	$ (348)	$ (9,033)

	Three Months Ended March 31, 2003			
	Interest Income	**Gain on Sale**	**Net Gain on MRS**	**Total**
Net unrealized gain (loss)	$ (138)	$ 3,584	$ 2,622	$ 6,068
Net realized gain (loss)	(1,119)	(4,918)	(2,958)	(8,995)
Total	$ (1,257)	$ (1,334)	$ (336)	$ (2,927)

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ACCREDITED HOME LENDERS HOLDING CO. AND SUBSIDIARY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

7. CREDIT FACILITIES

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

	Amount Outstanding	
	December 31, 2003	March 31, 2004
A $500 million warehouse credit facility expiring July 30, 2005, collateralized by performing loans, bearing interest based on one-month LIBOR (rate was 2.3% to 2.8% at March 31, 2004). This line also includes a $15 million sublimit collateralized by aged and delinquent loans with interest based on one-month LIBOR (rate was 4.6% at March 31, 2004). Outstanding borrowings on this sublimit is included in the amount outstanding and totaled $6.6 million and $2.6 million at December 31, 2003 and March 31, 2004, respectively.	$ 387.9 million	$ 357.8 million
A $500 million warehouse credit facility expiring May 1, 2004, collateralized by performing and delinquent loans, bearing interest based on one-month LIBOR (rate was 2.4% to 2.7% at March 31, 2004). In April 2004, the expiration date was changed to May 31, 2004.	$ 190.3 million	$ 351.8 million
A $40 million warehouse credit facility expiring July 31, 2004, collateralized by performing loans, bearing interest based on the prime rate (rate was 4.50% at March 31, 2004).	$ 11.0 million	$ 10.2 million
A $325 million warehouse credit facility expiring October 6, 2004, collateralized by performing, aged and delinquent loans, bearing interest based on one-month LIBOR (rate was 2.3% to 3.3% at March 31, 2004). In April 2004, this facility was amended and restated whereby the maximum borrowings were increased to $450 million and the expiration date was changed to April 18, 2005.	$ 152.4 million	$ 210.0 million
A $150 million non-discretionary; $150 million discretionary warehouse credit facility expiring November 12, 2004, collateralized by performing and delinquent loans, bearing interest based on one-month LIBOR (rate was 2.2% to 3.8% at March 31, 2004).	$ 168.4 million	$ 240.3 million
A $400 million warehouse credit facility expiring April 21, 2004, collateralized by performing, aged and delinquent loans, bearing interest based on one-month LIBOR (rate was 2.3% to 3.6% at March 31, 2004). In April 2004, the expiration date was changed to April 20, 2005.	$ 175.0 million	$ 233.0 million
A $300 million warehouse credit facility expiring October 8, 2004, collateralized by performing, aged and delinquent loans, bearing interest based on one-month LIBOR (rate was 2.0% to 2.6% at March 31, 2004).	$ 214.7 million	$ 211.3 million
A $300 million warehouse credit facility expiring January 31, 2005, collateralized by performing, aged and delinquent loans, bearing interest based on one-month LIBOR (rate was 2.3% at March 31, 2004). This line also included a $7 million sublimit collateralized by seasoned loans with interest based on one-month LIBOR (rate was 3.6% at March 31, 2004) with no outstanding borrowings at December 31, 2003 and March 31,	$ 215.5 million	$ 201.8 million
An $8 million warehouse credit facility expiring January 31, 2005, collateralized by real estate owned (properties acquired through foreclosure of defaulted mortgage loans or through deeds in		

lieu of foreclosure) and loans 60 days or more delinquent, bearing interest based on one-month LIBOR (rate was 4.1% at March 31, 2004).		
Total warehouse credit facilities	$ 1,515.2 million	$ 1,816.2 million

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ACCREDITED HOME LENDERS HOLDING CO. AND SUBSIDIARY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

As of March 31, 2004, the Company was in compliance with all covenant requirements for each of the facilities. The Company s warehouse and other credit facilities contain customary covenants including minimum liquidity, profitability and net worth requirements and limitations on other indebtedness. If the Company fails to comply with any of these covenants or otherwise defaults under a facility, the lender has the right to terminate the facility and require immediate repayment that may require sale of the collateral at less than optimal terms. In addition, if the Company defaults under one facility, it would generally trigger a default under the Company s other facilities.

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

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ACCREDITED HOME LENDERS HOLDING CO. AND SUBSIDIARY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

8. SECURITIZATION BOND FINANCING

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

	December 31, 2003	March 31, 2004		
	Amount	Amount	Interest Rate	Stated Maturity Date
Series 2002-1:				
Class A-1	$ 41,668	$ 36,985	4.93% *	July 25, 2032
Class A-2	80,849	69,271	One-month LIBOR + 0.32%	July 25, 2032
	122,517	106,256		
Unamortized bond discount	(9)	(8)		
Series 2002-1, net	$ 122,508	$ 106,248		
Series 2002-2				
Class A-1	$ 141,027	$ 126,054	4.48% *	January 25, 2033
Class A-2	184,892	162,101	One-month LIBOR + 0.49%	February 25, 2033
Class A-3	85,972	76,444	One-month LIBOR + 0.50%	January 25, 2033
	411,891	364,599		
Unamortized bond discount	(39)	(35)		
Series 2002-2, net	$ 411,852	$ 364,564		
Series 2003-1				
Class A-1	$ 95,244	$ 88,248	3.58% *	June 25, 2033
Class A-2	99,095	90,016	One-month LIBOR + 0.35%	June 25, 2033
Class A-3	78,916	68,213	One-month LIBOR + 0.38%	June 25, 2033
	273,255	246,477		
Unamortized bond discount	(4)	(4)		
Series 2003-1, net	$ 273,251	$ 246,473		
Series 2003-2				
Class A-1	$ 115,132	$ 111,268	4.23% *	October 25, 2033
Class A-2	193,938	183,936	One-month LIBOR + 0.35%	October 25, 2033

Class A-3	97,323	91,116	One-month LIBOR + 0.37%	October 25, 2033
	406,393	386,320		
Unamortized bond discount	(34)	(31)		
Series 2003-2, net	$ 406,359	$ 386,289		
Series 2003-3				
Class A-1	$ 192,888	$ 187,579	4.46% *	January 25, 2034
Class A-2	208,048	199,755	One-month LIBOR + 0.38%	January 25, 2034
Class A-3	109,483	103,405	One-month LIBOR + 0.38%	January 25, 2034
Series 2003-3, net	$ 510,419	$ 490,739		
Series 2004-1				
Class A-1		$ 246,938	One-month LIBOR + 0.30%	April 25, 2034
Class A-2		252,792	One-month LIBOR + 0.30%	April 25, 2034
Series 2004-1, net		$ 499,730		
Total securitization bond financing, net	$ 1,724,389	$ 2,094,043		

* The interest rates for the A-1 classes are a result of swap rates plus a spread of 1.02%, 1.30%, 1.32%, 1.25% and 1.35%, respectively.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The bonds are collateralized by securitized loans with an aggregate outstanding principal balance of $1.8 billion and $2.1 billion as of December 31, 2003 and March 31, 2004, respectively. Unamortized debt issuance costs, included in other assets, are approximately $7.7 million and $8.9 million at December 31, 2003 and March 31, 2004, respectively.

Amounts collected by the Company as servicer of the mortgage loans are remitted to the trustee, who in turn distributes such amounts each month to the bondholders, together with other amounts received with respect to the mortgage loans, net of fees payable to the Company, trustee and insurer of the bonds. Interest collected each month on the mortgage loans will generally exceed the amount of interest accrued on the bonds. A portion of such excess interest will initially be distributed as principal to the bonds. As a result of such principal distributions, the excess of the unpaid principal balance of the loans over the unpaid principal balance of the bonds (overcollateralization) will increase. The securitization agreements require that a certain level of overcollateralization be maintained. Once a required level has been reached, excess interest will no longer be used to accelerate the amortization of the bonds. Whenever the level of overcollateralization falls below the required level, excess interest will again be paid as principal to the bonds until the required level has been reached. Excess interest that is not paid to the bonds in order to create or maintain the required overcollateralization level, or used to make certain other payments, will be passed through to the Company. The securitization agreements provide that if delinquencies or losses on the underlying mortgage loans exceed certain maximums, the required levels of credit enhancement would be increased. During the three months ended March 31, 2004, the Company received $12.0 million of excess interest from these securitizations. Therefore, the bonds are not necessarily expected to be outstanding through the stated maturity date set forth above.

The following table summarizes the expected repayment requirements relating to the securitization bond financing at March 31, 2004. Amounts listed as bond payments are based on anticipated receipts of principal and interest on underlying mortgage loan collateral using historical prepayment speeds:

	March 31, 2004 (dollars in thousands)
Nine months ending December 31:	
2004	$ 310,576
Years ending December 31:	
2005	580,914
2006	514,539
2007	271,967
2008	113,139
2009	71,356
Thereafter	231,629
Discount	(77)
Total	$ 2,094,043

9. INCOME TAXES

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

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ACCREDITED HOME LENDERS HOLDING CO. AND SUBSIDIARY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

	December 31, 2003	March 31, 2004
Loans held for sale	$ 11,408	$ 14,702
Market reserve on loans held for sale	5,627	5,591
Loan securitizations	4,403	5,907
State taxes	3,419	1,549
Other reserves and accruals	1,712	2,057
Deferred tax assets	26,569	29,806
Mortgage-related securities	(10,517)	(11,518)
Deferred tax liabilities	(10,517)	(11,518)
Net deferred tax asset	$ 16,052	$ 18,288

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

	Three Months Ended March 31, 2003	Three Months Ended March 31, 2004
Federal:		
Current	$ 10,657	$ 13,542
Deferred	(2,684)	(1,372)
	7,973	12,170
State:		
Current	2,540	3,698
Deferred	(640)	(864)

	1,900	2,834
Total	$ 9,873	$ 15,004

The deferred income tax expense resulted from temporary differences in the recognition of revenues and expenses for tax and financial statement purposes. The primary sources of these differences were the origination and reversal of the following: mortgage securitizations where book income has been recognized in excess of taxable income, loans held for sale at period end where taxable income has been recognized in excess of book income and various reserves and accruals in which book deductions exceed tax deductions.

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

	Three Months Ended March 31,	
	2003	**2004**
Federal income tax at statutory rate	$ 8,638	$ 13,128
State income tax, net of federal effects	1,235	1,842
Other		34
Total	$ 9,873	$ 15,004

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

During the three months ended March 31, 2004, the Company recorded a $2.3 million reduction in income taxes payable and a corresponding increase to additional paid in capital related to corporate tax deductions arising from the sale by employees of common stock they acquired from the stock option plans and the ESPP prior to the fulfillment of required tax holding periods for such stock.

10. ACCOUNTS PAYABLE AND ACCRUED LIABILITIES

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

	December 31, 2003	March 31, 2004
Accrued liabilities payroll	$ 16,884	$ 16,194
Accrued liabilities general	12,106	12,376
Futures contracts	9,359	17,868
Reserve for repurchases	5,445	5,785
Reserve for premium recapture	2,470	2,305
Accounts payable trade	385	413
Capital leases	12	5
Total	$ 46,661	$ 54,946

11. STOCKHOLDERS EQUITY

A summary of the changes in options outstanding under the Company s Stock Option Plans for the three months ended March 31, 2004 follows:

	Number of Options	Weighted Average Exercise Price
Balance, January 1, 2004	1,699,619	$ 5.80
Options granted	213,650	40.08
Options exercised	(204,308)	1.91
Options cancelled	(79,210)	18.40
Balance, March 31, 2004	1,629,751	$ 10.17

2002 Employee Stock Purchase Plan The Company s 2002 Employee Stock Purchase Plan (the 2002 ESPP) was adopted effective as of the closing of the Offering by the board of directors and approved by the stockholders in 2002. A total of 1,500,000 shares of common stock are currently authorized and reserved for issuance under the plan, which provides that the plan be cumulatively increased each January 1 through January) 1, 2013 according to the formula specified by the 2002 ESPP. Employees, including officers and employee directors, are eligible to participate in the 2002 ESPP if they are employed for more than 20 hours per week and more than five months in any calendar year. The 2002 ESPP permits participants to purchase common stock through payroll deductions of up to 15% of the participant s compensation. Such amounts are applied to the purchase of shares of the Company s common stock at a price of 85% of the fair market value of the common stock as defined in the 2002 ESPP. As of March 31, 2004, employees have contributed $1.3 million to the 2002 ESPP for future purchases of stock.

Deferred Compensation Plan The Company s Deferred Compensation Plan (the Plan) was adopted by the board of directors and approved by the stockholders in 2002. The Plan is effective as of January 1, 2003. A total of 2,000,000 shares of the Company s common stock is authorized and reserved for issuance under the Plan. The Plan is an unfunded, nonqualified deferred compensation plan that benefits directors, certain designated key members of management and highly compensated employees. Under the Plan, an employee may defer up to

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

100% of his or her base salary, director fee, bonus and/or commissions on a pre-tax basis. The Company may make both voluntary and/or matching contributions to the Plan on behalf of Plan participants and may make voluntary and/or matching contributions in the form of common stock. All Plan assets are corporate assets rather than individual property and are therefore subject to creditors claims against the Company. As of March 31, 2004, employees had voluntarily contributed $1.0 million to the Plan. In January 2004, the Company awarded 158,538 shares, net of forfeitures, of restricted common stock under the Plan that vest 50% two years from the date of grant and 25% each year thereafter until fully vested. In March 2004, the Company granted 9,876 shares of restricted common stock under the Plan to its independent, outside directors and an additional 1,498 shares of restricted common stock to a member of its advisory board of directors, which vest in full two years from the date of grant.

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

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

	Three Months Ended March 31, 2003		
	Net Income (numerator)	Shares (denominator)	Per Share Amount
Basic EPS	$ 14,810	12,445	$ 1.19
Plus effect of income of assumed conversions			
Interest on convertible debt, net of tax	16		
Effect of dilutive shares			
Warrants *		206	
Stock options		1,243	
Convertible preferred stock *		2,500	
Convertible debt *		1,025	
Diluted EPS	$ 14,826	17,419	$ 0.85

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

Three Months Ended March 31, 2004

	Net Income (numerator)	Shares (denominator)	Per Share Amount
Basic EPS	$ 22,506	20,119	$ 1.12
Effect of dilutive shares			
Stock options		1,213	
Restricted stock		172	
Diluted EPS	$ 22,506	21,504	$ 1.05

13. COMMITMENTS AND CONTINGENCIES

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

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ACCREDITED HOME LENDERS HOLDING CO. AND SUBSIDIARY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

At March 31, 2004, the minimum future lease payments under non-cancelable operating leases were as follows (dollars in thousands):

Nine Months Ending:	
2004	$ 6,473
Years ending:	
2005	9,032
2006	7,520
2007	5,577
2008	4,070
2009	2,387
Thereafter	1,711
Total	$ 36,770

Other The Company is party to financial instruments with off-balance sheet risk in the normal course of business to meet the financing needs of its borrowers. These financial instruments primarily represent commitments to fund loans. These instruments involve, to varying degrees, elements of interest rate risk and credit risk in excess of the amount recognized in the statement of financial position. The credit risk is mitigated by the Company s evaluation of the creditworthiness of potential mortgage loan borrowers on a case-by-case basis. The Company does not guarantee interest rates to potential borrowers when an application is received. Interest rates conditionally approved following the initial underwriting of applications are subject to adjustment if any conditions are not satisfied. The Company commits to originate loans, in many cases dependent on the borrower s satisfying various terms and conditions. These commitments totaled $177.3 million and $238.3 million as of December 31, 2003 and March 31, 2004, respectively.

Commitments to sell loans generally have fixed expiration dates or other termination clauses and may require payment of a commitment or a non-delivery fee. The Company periodically enters into other loan sale commitments. Loan sale commitments totaled $447.2 million and $129.2 million at December 31, 2003 and March 31, 2004, respectively.

In connection with various regulatory lending requirements, the Company is required to maintain certain minimum levels of net worth. The Company was in compliance with these requirements at March 31, 2004.

From time to time, the Company enters into certain types of contracts that contingently require the Company to indemnify parties against third party claims and other obligations customarily indemnified in the ordinary course of the Company s business. The terms of such obligations vary and, generally, a maximum obligation is not explicitly stated. Therefore, the overall maximum amount of the obligations cannot be reasonably estimated. Historically, the Company has not been obligated to make significant payments for these obligations and no liabilities have been recorded for these obligations on its balance sheet as of March 31, 2004.

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

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The Company previously disclosed a suit that was outside of the ordinary course of business, *Zimmerman et al. v. Accredited Home Lenders, Inc.*, filed in Los Angeles County, California, Superior Court in July 2001. The plaintiffs were individuals who sold a retail mortgage loan business to a purchaser pursuant to a contract which provided for future payments to plaintiffs over a period of years based upon future mortgage loans originated by the business. The contract provided that, in the event control of the business was transferred by the purchaser, the purchaser s obligations under the contract, including the future payments, either must be assumed by the transferee or the purchaser must make a lump sum payment to the plaintiffs in accordance with a formula set forth in the contract. The Company subsequently acquired some furniture, fixtures and equipment, assumed lease liabilities on some office branches and office equipment, and hired a number of employees of the business. The Company expressly did not assume liability for the future payments that were part of the original purchase transaction, nor did the Company hire all of the persons employed by the business, acquire all of the assets or assume all of the liabilities. The plaintiffs claimed that the future payments they negotiated with the original purchaser were assumed by the Company as a result of the transaction between the Company and the original purchaser. The action was dismissed with prejudice on March 29, 2002, and, on July 29, 2003, the appellate court affirmed the trial court s dismissal of the action. The time for further appeal expired without further action on the part of the plaintiffs, and this matter is now resolved.

In December 2002, the Company was served with a complaint and motion for class certification in a class action lawsuit alleging that the Company misrepresents and inflates the amounts it charges its borrowers for third-party fees in violation of state laws, which prohibit unfair and deceptive trade practices. The Company filed an answer to the complaint in January 2003, but a schedule for briefing and hearing the motion for class certification has not yet been established. There has been no ruling on the merits of either the plaintiffs individual claims or the claims of the class. At the present time, the ultimate outcome of this matter and the amount of liability, if any, that may result is not determinable and no amounts have been accrued in the Company s financial statements. The Company intends to vigorously defend this matter and does not believe it will have a material adverse affect on its business with respect to this matter.

In December 2003, the Company was served with a class action complaint, *Silva v. Accredited Home Finance, et al.,* alleging that the Company violated a California statute restricting prepayment charges, breached the covenant of good faith and fair dealing, and constituted an unfair business practice. In April 2004, the Company s demurrer to the complaint was sustained without leave to amend and the action was dismissed with prejudice. The plaintiff subsequently agreed to waive his right to appeal in exchange for the Company s agreement to waive its rights to costs and fees. This matter is now finally resolved.

In January 2004, the Company was served with a complaint, alleging that the Company violated California and federal law by misclassifying the plaintiff, a commissioned loan officer, as an exempt employee and failing to pay the plaintiff on an hourly basis and for overtime worked. The plaintiff seeks to recover, on behalf of himself and all of the Company s other similarly situated current and former employees, lost wages and benefits, general damages, multiple statutory penalties and interest, attorneys fees and costs of suit, and also seeks to enjoin further violations of wage and overtime laws and retaliation against employees who complain about such violations. The Company has removed the case to federal court and has filed an answer to the complaint. The Company does not believe this matter will have a material adverse effect on its business and is pursuing settlement discussions. At the present time, the ultimate outcome of this matter and the amount of liability, if any that may result is not determinable and no amounts have been accrued in the Company s financial statements with respect to this matter.

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

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

General

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

Revenue Model

Our operations generate revenues in three ways:

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

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

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

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

Critical Accounting Policies

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

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

- Fair value of mortgage-related securities;

- Mortgage servicing rights valuation;

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- Provision for losses; and

- Interest rate risk, derivatives and hedging strategies.

Fair Value of Mortgage-Related Securities

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

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

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

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

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

Accounting for Mortgage-Related Securities

We measure our mortgage-related securities like debt securities classified as trading securities under Statement of Financial Accounting Standards (SFAS) No. 115*, Accounting for Certain Investments in Debt and Equity Securities*. When we enter into a loan sale transaction that generates a mortgage-related security, we record the fair value of that security as an asset on our balance sheet. Thereafter, we measure the fair value of the mortgage-related securities at each reporting date. Any change in fair value since the end of the prior period is recorded in our results of operations as an unrealized gain or loss. The carrying value of mortgage-related securities on our balance sheet is also increased or decreased accordingly.

How We Determine Fair Value of Mortgage-Related Securities

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

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

Securitizations Structured as Financings

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

Mortgage Servicing Rights Valuations

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

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

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

Provisions for Losses

We have provided market valuation adjustments on certain nonperforming loans, other loans we hold for sale and real estate owned. These adjustments are based upon our estimate of expected losses, calculated using 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 securitized loans is recorded in an amount sufficient to maintain appropriate coverage for probable losses on such loans. The provision for losses also includes net losses on real estate owned. We also accrue for liabilities associated with loans sold, which we may be requested to repurchase due to breaches of representations and warranties and early payment defaults. We periodically evaluate the estimates used in calculating expected losses, and adjustments are reported in earnings. As these estimates are influenced by factors outside of our control and as uncertainty is inherent in these estimates, it is reasonably possible that they could change.

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

Interest Rate Risk, Derivatives and Hedging

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

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

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

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

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During 2002, we began using hedge accounting as defined by SFAS No. 133 for certain derivative financial instruments used to hedge our mortgage loans held for sale and securitized loans to reduce the volatility in revenues due to fluctuations in interest rates. We designate certain derivative financial instruments as hedge instruments under SFAS No. 133, and at trade date, these instruments and their hedging relationship are identified, designated and documented. For derivative financial instruments designated as hedge instruments, we evaluate the effectiveness of these hedges against the mortgage loans being hedged to ensure there remains a highly effective correlation in the hedge relationship. To hedge the effect of interest rate changes on the fair value of mortgage loans held for sale and securitized loans, we are using derivatives as fair value hedges under SFAS No. 133. Once the hedge relationship is established, the realized and unrealized changes in fair value of both the hedge instrument and mortgage loans are recognized in the period in which the changes occur. Any change in the fair value of mortgage loans held for sale recognized as a result of hedge accounting is reversed at the time we sell the mortgage loans. This results in a correspondingly higher or lower gain on sale revenue at such time. Any change in the fair value of securitized loans is amortized over the fixed rate period of the loan on a level yield basis. This results in a corresponding adjustment to interest income. The net amount recorded in the consolidated statements of operations is referred to as hedge ineffectiveness. For derivative financial instruments not designated as hedge instruments, realized and unrealized changes in fair value are recognized in the period in which the changes occur or when such instruments are settled.

Results Of Operations

Three Months Ended March 31, 2003 Compared to Three Months Ended March 31, 2004

Executive Summary

Net income was $22.5 million, or $1.05 per diluted share, an increase of 52% from the prior year.

This was driven by a 63% growth in origination volume, to $2.4 billion, and a 68% growth in our serviced loans to $4.3 billion.

Growth was achieved by increasing offices by 15 locations, and penetrating new and existing markets through 610 new employees.

Whole loan sales of $1.6 billion resulted in gains recorded of $54.7 million, representing an average premium of 3.7%, versus 4.0% in 2003.

Origination costs net of points and fees improved from 2.3% in the three months ended March 31, 2003 to 2.2% in the comparable period in 2004.

Portfolio income (interest income less interest expense and provision for losses) of $32.2 million, compared to $13.6 million in the first quarter of 2003, an increase of 137%. As a percentage of total revenue less interest expense and provision for losses, portfolio income increased from 23% in the first quarter of 2003, to 36% in 2004.

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

Revenues

Total Revenues. Total revenues increased 50.3% from $79.1 million for the three months ended March 31, 2003 to $119.0 million for the comparable period in 2004. This increase was due to increases in interest income of $28.3 million and gain on sale of loans of $11.6 million.

Interest Income. Interest income represents the interest earned on our mortgage loans held for sale during the period prior to their sale or securitization, interest earned on securitized loans subject to portfolio-based accounting, prepayment penalty income from the on balance sheet portfolio, the realized and unrealized gain (loss) on derivatives purchased to manage our interest rate risk associated with securitized loans, net of the

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related fair value basis adjustments recorded due to the use of hedge accounting and, to a lesser extent, interest accreted on our mortgage-related securities. We do not accrue interest for mortgage loans that are 90 days or more delinquent. Interest income increased 87.7% from $32.3 million for the three months ended March 31, 2003 to $60.6 million for the comparable period in 2004. The increase in interest income was due to an increase in the average inventory of loans held for sale and securitized loans from $1.7 billion during the three months ended March 31, 2003 to $3.3 billion during the comparable period in 2004. Our average inventory of mortgage loans increased as we increased loan production volume, completed six securitizations of $2.5 billion of mortgage loans since June of 2002 that are accounted for as financings and intentionally extended the holding period, which was partially offset by a decrease in weighted average interest rate on the inventory of mortgage loans. Interest income of $13.5 million and $35.3 million was recognized on the securitized loans for the three months ended March 31, 2003 and March 31, 2004, respectively. In the future, to the extent we continue to complete these types of securitizations, our gain on sale revenue will be lower and our interest income will be higher than it would have been otherwise.

	Three Months Ended March 31,			
	2003		2004	
	(dollars in thousands)			
Interest income	$ 32,297	7.50%	$ 60,626	7.27%
Interest expense	12,167	2.83%	20,930	2.51%
Net interest income	$ 20,130	4.67%	$ 39,696	4.76%
Average mortgage loans outstanding	$ 1,721,588		$ 3,334,863	

Gain on Sale of Loans. Total gain on sale of loans increased 26.8% from $43.2 million for the three months ended March 31, 2003 to $54.7 million for the comparable period in 2004.

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

	Three Months Ended March 31,	
	2003	2004
	(dollars in thousands)	
Gain on whole loan sales	$ 43,885	$ 63,267
Provision for premium recapture	(530)	(606)
Net loss on derivatives	(1,334)	(5,388)
Net origination points and fees	7,117	7,832
Direct loan origination expenses	(5,967)	(10,375)
Gain on sale of loans	$ 43,171	$ 54,730

Gain on whole loan sales increased 44.2% from $43.9 million for the three months ended March 31, 2003 to $63.3 million for the comparable period in 2004 due to higher sales volume in 2004. Total whole loan sales increased 47.2% from $1.1 billion for the three months ended March 31, 2003 to $1.6 billion for the comparable period in 2004. This increase was due to an increase in loan originations of 63.1% from $1.5 billion for the three months ended March 31, 2003 to $2.4 billion in the comparable period of 2004, partially offset by holding $418.2 million of mortgage loans at March 31, 2004 for future securitizations. The average whole loan sales premium, net of losses on related derivatives, was 4.0% for the three months ended March 31, 2003 and 3.7% for the comparable period in 2004. Our top ten loan purchasers during the three months ended March 31, 2004, were as follows in descending order: Household Mortgage Services, Morgan Stanley Mortgage Capital Inc., DLJ Mortgage Capital, Inc. (Credit Suisse First Boston), Chase Manhattan, Lehman Brothers Bank, FSB, Wintergroup, Bank of America, N.A., Residential Funding Corporation, Goldman Sachs, and Greenwich.

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

	Three Months Ended March 31,	
	2003	**2004**
Gain on whole loan sales (1)(2)	4.09%	4.00%
Net loss on derivatives (2)	(0.13%)	(0.34%)
Net gain on whole loan sales (1)(2)	3.96%	3.66%
Net origination points and fees	0.63%	0.44%
Loan origination expenses	(2.95%)	(2.66%)
Net cost to originate (3)	(2.32%)	(2.22%)
Net profit margin on whole loan sales	1.64%	1.44%

(1) Excludes the provision for premium recapture.

(2) The percentages hereon are calculated based upon the respective amounts presented in the table above divided by our total whole loan sales of $1.1 billion and $1.6 billion for the three months ended March 31, 2003 and 2004, respectively.

(3) Net cost to originate loans is defined as total operating expenses (total expenses less interest expense and provision for losses), less allocated loan servicing related costs, plus yield spread premiums, less points and fees collected, all prior to any deferrals of origination costs for accounting purposes. This total is divided by total originations of $1.5 billion and $2.4 billion for the three months ended March 31, 2003 and 2004, respectively.

Provision for premium recapture represents our estimate of the potential refunds of premium received on loan sales during the period based upon our historical experience. Provision for premium recapture increased 14.3% from $530,000 for the three months ended March 31, 2003 to $606,000 for the comparable period in 2004. This increase results from the increase in whole loan sales of 47.2% from $1.1 billion for the three months ended March 31, 2003 to $1.6 billion for the comparable period in 2004 slightly offset by the recovery of $178,000 of prior year reserves no longer needed.

Net loss on derivatives represents the realized and unrealized gain (loss) on the derivatives purchased to manage our interest rate risk associated with our mortgage loans held for sale from the time of funding commitment to sale commitment, net of the related fair value basis adjustments recorded due to the use of hedge accounting. We enter into these transactions to offset fluctuations in interest rates that affect our premiums earned on the sale of these loans. The net loss on derivatives increased 303.9% from a $1.3 million loss for the three months ended March 31, 2003 to a $5.4 million loss for the comparable period in 2004. This increase results from a higher rate of decline in LIBOR rates, as well as an increase in derivative volume during the three months ended March 31, 2004 as compared to the comparable period in 2003.

Net origination points and fees represent the revenue earned from the origination of mortgage loans held for sale, net of broker rebates paid, which are deferred and recognized in the consolidated statement of operations when the related loans are sold. Net origination points and fees increased from $7.1 million for the three months ended March 31, 2003 to $7.8 million for the comparable period in 2004. This increase results from a 47.2% increase in whole loan sales offset by an increase in broker fees paid per loan for the three months ended March 31, 2004 as compared to the comparable period in 2003.

Direct loan origination expenses represent the costs incurred to originate mortgage loans held for sale that are deferred and recognized in the consolidated statement of operations when the related loans are sold. Direct loan origination expenses increased from $6.0 million for the three months ended March 31, 2003 to $10.4 million for the comparable period in 2004. The increase results from the 47.2% increase in whole loan sales and the increase in our standard origination expense per loan for the three months ended March 31, 2004 as compared to the comparable period in 2003.

Loan Servicing Income. Loan servicing income represents all contractual and ancilliary servicing revenue for loans we service for others, net of subservicing costs, certain of our own servicing costs and amortization of mortgage servicing rights. Subservicing costs are the amounts we pay to others to service loans on our behalf. Loan servicing income decreased 17.0% from $1.9 million for the three months ended March 31, 2003 to $1.6 million for the comparable period in 2004. This decrease results from the decrease in prepayment penalties on the off balance sheet portfolio collected during the three months ended March 31, 2004 as compared to the three months ended March 31, 2003.

Net Gain (Loss) on Mortgage-Related Securities and Derivatives. Net gain on mortgage-related securities and derivatives increased 31.7% from $1.4 million for the three months ended March 31, 2003 to $1.8 million for the comparable period in 2004.

Net gain on mortgage-related securities increased 26.2% from $1.7 million for the three months ended March 31, 2003 to $2.2 million for the comparable period in 2004. This gain represents the increase in fair value of the residual income from these securities. The increase for both years was due to declining interest rates and stronger cash flow received than anticipated, primarily from lower losses.

Net gain (loss) on derivatives represents the realized and unrealized gain (loss) on the derivatives purchased to manage the interest rate risk associated with our mortgage-related securities. The risk arises because the cash we receive from our mortgage-related securities is dependent on the difference between the interest rates on the underlying loans and the yield payable to the senior security holders, or payable to the purchaser of the loans in the case of a sale with retained interests. The majority of the loans underlying our mortgage-related securities have interest rates which are fixed for the first two or three years, while the yield payable to the senior interests or purchaser changes monthly based upon short-term LIBOR. Net loss on derivatives increased 3.3% from $336,000 for the three months ended March 31, 2003, to $347,000 for the comparable period in 2004 due to a higher rate of decline in LIBOR rates which was partially offset by a lower mortgage related securities balance during the three months ended March 31, 2004 as compared to the comparable period in 2003.

Expenses

Total Expenses. Total expenses increased 49.6% from $54.5 million for the three months ended March 31, 2003 to $81.5 million for the comparable period in 2004. The increase was the result of higher salaries, wages, and benefits expense of $11.5 million, an increase in interest expense of $8.8 million, an increase in the provision for losses of $941,000 and increases in other variable operating expenses associated with growth in loans originated and serviced.

Salaries, Wages and Benefits. Salaries, wages and benefits increased 48.1% from $23.9 million for the three months ended March 31, 2003 to $35.4 million for the comparable period in 2004. The increase was due to growth in the number of employees, as well as higher commission and bonus expenses that are variable expenses dependent upon loan production volume and profits. The total number of employees increased by 41.5% from 1,471 at March 31, 2003 to 2,081 at March 31, 2004.

Interest Expense. Interest expense represents the interest incurred on all outstanding debt and securitization bond financing, as well as the amortization of bond issue costs on the securitization bond financing and other costs associated with accessing our credit facilities. Interest expense increased 72.0% from $12.2 million for the three months ended March 31, 2003, to $20.9 million for the comparable period in 2004. Our average outstanding borrowings, excluding securitization bond financing, increased from $1.1 billion to $1.4 billion consistent with the increase in the average inventory of loans held for sale; however our average borrowing rate, excluding securitization bond financing, decreased from 2.6% for the three months ended March 31, 2003, to 2.3% for the comparable period in 2004. Our average securitization bond financing increased from $718.1 million for the three months ended March 31, 2003 to $2.0 billion for the comparable period in 2004; however our average borrowing rate on the securitization bond financing decreased from 2.8% for the three months ended March 31, 2003, to 2.6% for the comparable period in 2004. For the three months ended March 31, 2003 and

March 31, 2004, interest expense of $5.2 million and $12.0 million, respectively, was recognized on the securitization bond financing. As we increase the number of loans we securitize in transactions structured as financings, our related bond debt will increase, which will result in an increase in our interest expense.

Occupancy. Occupancy expense increased 60.4% from $2.4 million for the three months ended March 31, 2003 to $3.9 million for the comparable period in 2004. The increase resulted from growth in the total number of office sites leased from 35 at March 31, 2003 to 50 at March 31, 2004 due to our penetration in new geographic markets, as well as an increase in square footage in some existing sites.

Provision for Losses. Provision for losses increased 14.5% from $6.5 million for the three months ended March 31, 2003 to $7.4 million for the comparable period in 2004. The increases in our provisions for losses were as follows: allowances for losses on securitized loans of $3.2 million, and reserve for repurchases of $438,000, offset by decreases in our market reserve on loans of $2.3 million, our reserve for real estate owned of $98,000 and in the net losses on real estate owned of $229,000. The increase in our allowance for losses on securitized loans results from the increase in our securitized loan balance from $723 million at March 31, 2003 to $2.1 billion at March 31, 2004. The increase in our reserve for repurchases results from a refinement to our reserve methodology to better incorporate estimated losses on loans sold, based upon historical data, for which no repurchase request has yet been received. The decrease in our market reserve on loans results from a decrease in delinquencies at March 31, 2004 compared to March 31, 2003 slightly offset by an increase in the loans held for sale balance.

Depreciation and Amortization. Depreciation and amortization increased 58.8% from $1.1 million for the three months ended March 31, 2003 to $1.8 million for the comparable period in 2004. The increase results from our investment in technology and infrastructure resulting from the increase in the number of employees and offices during the three months ended March 31, 2004 as compared to the comparable period in 2003.

General and Administrative. General and administrative expenses increased 44.2% from $8.4 million for the three months ended March 31, 2003 to $12.1 million for the comparable period in 2004. This increase resulted from an increase in loan origination volume, an increase in our servicing portfolio, an increase in our number of leased locations and an increase in the number of employees as compared to 2003. Loan originations increased 63.1% from $1.5 billion for the three months ended March 31, 2003 to $2.4 billion in the comparable period of 2004. Additionally, the total number of employees increased by 41.5% from 1,471 at March 31, 2003 to 2,081 at March 31, 2004.

Income Taxes. Income taxes increased 52.0% from $9.9 million for the three months ended March 31, 2003 to $15.0 million for the comparable period in 2004. This increase was a result of a 52.0% increase in income before taxes from the three months ended March 31, 2003 to the comparable period in 2004. The two major components of our effective tax rate are the federal corporate tax rate of 35.0% and the effective state income tax rates. We operate and pay tax in nearly every state. As our operations and profits have expanded in various states, it has created changes in our effective tax rate depending upon each particular state s tax structure and rate.

Liquidity And Capital Resources

As a mortgage banking company, our primary cash requirements include the funding of (1) mortgage loan originations, including principal, as well as origination costs such as commissions and broker premiums, (2) interest expense on and repayment of principal on warehouse credit facilities and securitization bond financing, (3) operational expenses, (4) servicing advances, (5) hedging margin requirements, and (6) tax payments. We fund these cash requirements with cash received from (1) loan sales, (2) borrowings under warehouse credit facilities and securitization bond financing secured by mortgage loans, (3) cash distributions from our mortgage-related securities, (4) interest collections on mortgage loans, (5) servicing fees and other servicing income, and (6) points and fees collected from the origination of loans.

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Our liquidity strategy is to maintain sufficient and diversified warehouse 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 the ability to finance our growing origination operations and to maximize our realization of the value of loans we originate. During the three months ended March 31, 2003 and 2004, we had negative operating cash flows of approximately $369.3 million and $774.5 million, respectively, which resulted from more new loan originations than sales and securitizations. More specifically, during the three months ended March 31, 2003 and 2004, we used approximately $1.5 billion and $2.4 billion, respectively, of cash for new loan originations and purchases offset by cash proceeds from the sale of loans of $1.1 billion and $1.6 billion, respectively. In total, there was an increase in cash and cash equivalents during the three months ended March 31, 2003 and 2004.

We use our various warehouse credit facilities to finance the actual funding of our loan originations. We then sell or securitize our mortgage loans within three or four months of origination and pay down the warehouse credit facilities with the proceeds. At March 31, 2004, we had voluntary and recoverable warehouse line paydowns of $74.5 million that increased our warehouse line availability by a corresponding amount. These voluntary and recoverable warehouse line paydowns of $74.5 million plus cash of $34.5 million brought our total liquidity to $109.0 million at March 31, 2004. The majority of our current warehouse credit facilities are committed lines, which means that the lender is obligated to fund up to the committed amount subject to our meeting various financial and other covenants. One of our warehouse lines is, and in the future some may be, uncommitted, which means that the lender may fund the uncommitted amount at its discretion. 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. Our warehouse facilities generally have a one-year term.

Except as otherwise noted below, all of our warehouse credit facilities accrue interest at a rate based upon one-month LIBOR plus a specified spread and as of April 30, 2004 have other material terms and features as follows:

(in millions) Warehouse Lender	Inception Date	Committed Amount	Uncommitted Amount	Total Facility Amount	Portion Available for Wet Funding	Expiration Date
Lehman Brothers Bank, FSB and Affiliate	1997	$ 500	$	$ 500	$ 110	July 30, 2005
Residential Funding Corporation	1999	$ 300	$	$ 300	$ 150	January 31, 2005
Morgan Stanley Mortgage Capital Inc.	2001	$ 500	$	$ 500	$ 100	May 31, 2004
Household Commercial Financial Services, Inc.	2001	$ 40	$	$ 40	$ 40	July 31, 2004
CDC Mortgage Capital, Inc.	2002	$ 450	$	$ 450	$ 180	April 18, 2005
Credit Suisse First Boston Mortgage Capital LLC	2002	$ 150	$ 150	$ 300	$ 60	November 12, 2004
Goldman Sachs Mortgage Company	2003	$ 400	$	$ 400	$	April 20, 2005
Merrill Lynch Mortgage Company	2003	$ 300	$	$ 300	$ 120	October 8, 2004
Total		$ 2,640	$ 150	$ 2,790	$ 760	

Most of our credit facilities include sublimits for aged and delinquent loans, as well as for REO (properties acquired through foreclosure of defaulted mortgage loans or through deeds in lieu of foreclosure).

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Our warehouse and other credit facilities contain customary covenants including 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.

We are currently working on implementing an asset-backed commercial paper facility which, if consummated, we expect to provide us with warehouse financing at a significantly lower cost than, and otherwise on terms and conditions generally as favorable as or better than, under our current warehouse credit facilities. We cannot predict when or guarantee that this facility will be implemented.

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.

Contractual Obligations

The following table summarizes our contractual obligations at March 31, 2004 and the effect such obligations are expected to have on our liquidity and cash flows in future periods:

	Payments Due by Period				
(*in thousands*)	Total	Less than 1 year	1-3 years	3-5 years	More than 5 years
Securitization bond financing	$ 2,094,120	$ 310,576	$ 1,095,453	$ 456,462	$ 231,629
Warehouse and residual interest credit facilities	1,816,200	1,816,200			
Capital lease obligations	5	5			
Operating lease obligations	36,770	6,473	16,552	12,034	1,711
Purchase obligations					
Other long-term liability reflected on the registrant s balance sheet under GAAP					
Total	$ 3,947,095	$ 2,133,254	$ 1,112,005	$ 468,496	$ 233,340

Off-Balance Sheet Financing Arrangements

We are a party to financial instruments with off-balance sheet risk in the normal course of business to meet the financing needs of our borrowers. 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 statement of financial position. 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. 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 terms and conditions. These commitments totaled $177.3 million and $238.3 million as of December 31, 2003 and March 31, 2004, respectively.

Inflation

Inflation affects us most significantly in the area of loan originations by affecting interest rates. Interest rates normally increase during periods of high inflation (or in periods when the Federal Reserve Bank attempts to prevent inflation) and decrease during periods of low inflation.

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Risk Factors That May Affect Future Results

You should carefully consider the following risks, together with other matters described in this Form 10-Q in evaluating our business and prospects. 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 1 of this Form 10-Q.

Risks Related to Our Business

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 and, to a lesser extent, 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, the greater the chance that the loans may become delinquent before we have the opportunity to dispose of them. 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. At March 31, 2004, mortgage loans held for sale included approximately $8.1 million of loans repurchased. Our total provision for losses was $7.4 million for the three months ended March 31, 2004. 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 (including loans in foreclosure and converted into real estate owned) for our servicing portfolio was 1.4% at March 31, 2004. Historically, our delinquency rate has increased, and may increase in the future, as the mortgage loans in our portfolio age.

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 an increased rate 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

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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.

Our business may be significantly harmed by a slowdown in the economy of California, where we conduct a significant amount of business.

Since inception, a significant portion of the mortgage loans we have originated, purchased or serviced has been secured by property in California. For the three months ended March 31, 2004, approximately 31% of the unpaid principal balance of the loans we originated were collateralized by properties located in California. As of March 31, 2004, approximately 35% of the unpaid principal balance of loans we serviced were collateralized by properties located in California. 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 or wildfire, in California could decrease the value of mortgaged properties in California. 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.

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 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 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 trends.

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Competition in the industry can take many forms, including interest rates and costs of a loan, less stringent underwriting standards, 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.

An 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 may incur higher monthly payments as the interest rate increases, which may lead to 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 two or three 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 2.3% for the three months ended March 31, 2004.

When we securitize loans or sell loans with retained interests, the value of and the income we receive from the securitized loans 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 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.

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, securitized loans subject to portfolio-based accounting and mortgage-related securities, as reflected in the Interest Rate Simulation

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Sensitivity Analysis in the section entitled ITEM 3. Quantitative and Qualitative Disclosures About Market Risk. 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 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 ITEM 2. Management s Discussion and Analysis of Financial Condition and Results of Operations Newly Issued Accounting Pronouncements and ITEM 3. Quantitative and Qualitative Disclosures About Market Risk.

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 and the proceeds from the sales and securitizations of our loans. We require substantial cash to fund our loan 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 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 March 31, 2004, we financed substantially all of our loans through eight separate warehouse lenders. 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 warehouse credit facilities contain covenants that restrict our operations and may inhibit our ability to grow our business and increase revenues.

Our warehouse credit facilities contain extensive restrictions and covenants that, among other things, require us to satisfy specified financial, asset quality and loan performance tests. 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.

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The covenants and restrictions in our warehouse 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
- hold 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.

Our rights to cash flow from our mortgage-related securities and securitized loans subject to portfolio-based accounting are subordinate to senior interests and may fail to generate any revenues for us if the revenue stream only generates enough revenues to pay the senior interest holders.

As part of the credit enhancement for our securitizations and loan sales with retained interests, the net cash flow that we receive from the securitized loans and the mortgage-related securities 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 is also 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 securitized loans and mortgage-related securities. If a gain has been recorded at the time of a sale or securitization based upon assumptions as to the levels of future income streams, and actual income streams are less than assumed or if we change our assumptions based upon our actual loss and delinquency experience, we may be required to record a charge against our earnings.

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, 1998, we had approximately 340 employees and by March 31, 2004, we had more than 2,080 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

incorporate effectively 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.

The 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. 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.

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

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 or interruption or breach in security of our information systems or the third-party information systems on which we rely could cause underwriting or other delays 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.

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 process status updates instantly and other customer-expected conveniences that are cost-efficient to our process. 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 months ended March 31, 2004, 90.2% 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.

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 come from the gain 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 of which may be frequent, repeat purchasers, and others of which may make only one or a few purchases from us. There can be no assurance 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, 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 previously securitized loans.

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. If our results of operations do not meet the expectations of our stockholders and securities analysts, then the price of our common stock may decrease.

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.

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Defective 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, 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. 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.

If the prepayment rates for our mortgage loans are higher 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 with a retained interest, we lose the future income from that loan, and if we recorded a gain at the time of such securitization or sale, we may be required to record a charge against our earnings if actual prepayment rates for the related pool of loans are higher than the prepayment rates assumed in recording the gain at the time of sale or securitization.

Prepayment rates on mortgage loans vary from time to time and tend to increase during periods of declining interest rates. Of the securitized loans we serviced during the three months ended March 31, 2004, 21.7% (annualized) 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

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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 nationwide 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 and in the District of Columbia, 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 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 NASDAQ 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 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 which we obtain loans have parallel and separate legal obligations to which they are subject. While these laws may not explicitly hold the originating lenders responsible for the legal violations of mortgage brokers, increasingly federal and state agencies have sought to impose such assignee liability.

Recently, for example, the United States Federal Trade Commission (FTC) entered into a settlement agreement with a mortgage lender where 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. 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 no longer 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. 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 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.

In addition, on April 24, 2003, a New Jersey state appellate court relied on the new OTS rule to find that the Parity Act does not preempt New Jersey state law restrictions on prepayment penalties. This ruling is contrary to previous published court opinions which have upheld such preemption under the Parity Act, including a May 8, 2000 decision by the United States District Court in New Jersey which upheld such preemption with respect to New Jersey state law. Nonetheless, if the New Jersey state court s decision were followed by other courts, it might call into question the validity of prepayment penalty provisions under which we have previously collected prepayment penalties and which we continued to include in our loan documentation prior to July 1, 2003 on the basis of the Parity Act exemption.

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

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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 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.

Risks Related to Our Capital Structure

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.

For example, our board of directors is divided into three classes. The term of the first class expires at the 2004 annual meeting of stockholders, the term of the second class expires in 2005, and the term of the third class expires in 2006. 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. 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 discourage hostile takeover bids.

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, thereby preserving the current stockholders control.

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, 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***

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 affects 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 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 the mortgage-related securities and the market value of mortgage loans due to changes in the current market rate of interest.

We use several tools and risk management strategies to monitor and address interest rate risk. Such tools allow us to monitor and evaluate our exposure to these and to manage the risk profile to 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 our loan portfolio.

As part of our interest rate management process, we may use derivative financial instruments such as financial futures and options, interest rate caps and swaps and financial forwards. We designate certain derivative financial instruments used to hedge our mortgage loans held for sale and securitized loans subject to portfolio-based accounting as hedge instruments under SFAS No. 133. At trade date, these instruments and their hedge 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 a highly effective correlation in the hedge relationship. Since our concern with interest rates is the

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potential change in fair market value of the loans, we treat these 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 statements of operations in the period in which the changes occur. The net amount recorded in the consolidated statements of operations is referred to as hedge ineffectiveness.

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

Interest Rate Simulation Sensitivity Analysis

Changes in market interest rates affect our estimations of the fair value of our mortgage loans held for sale and the fair value of our mortgage-related securities and 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. The base or current interest rate curve is adjusted by the levels shown below:

As of March 31, 2004:

	+50 bp	+100 bp	-50 bp	-100 bp
Change in fair value of mortgage loans committed and held for sale	$ (14,743,954)	$ (29,203,372)	$ 15,038,110	$ 30,381,009
Change in fair value of derivatives related to mortgage loans committed and held for sale	11,905,000	23,780,000	(11,885,000)	(23,800,000)
Change in fair value of mortgage-related securities and securitized loans subject to portfolio-based accounting	(13,555,487)	(26,843,184)	13,823,761	27,921,686
Change in fair value of derivatives related to mortgage-related securities and securitized loans subject to portfolio-based accounting	12,929,358	25,987,918	(12,786,838)	(25,460,609)
Net change	$ (3,465,083)	$ (6,278,638)	$ 4,190,033	$ 9,042,086

As of December 31, 2003:

	+50 bp	+100 bp	-50 bp	-100 bp
Change in fair value of mortgage loans committed and held for sale	$ (13,995,717)	$ (27,736,463)	$ 14,258,696	$ 28,789,178
Change in fair value of derivatives related to mortgage loans committed and held for sale	11,358,750	22,667,500	(11,338,750)	(22,727,500)
Change in fair value of mortgage-related securities and securitized loans subject to portfolio-based accounting	(9,684,342)	(19,165,169)	9,881,263	19,954,655

Change in fair value of derivatives related to mortgage-related securities and securitized loans subject to portfolio-based accounting	9,092,413	18,306,260	(8,973,079)	(17,833,194)
Net change	$ (3,228,896)	$ (5,927,872)	$ 3,828,130	$ 8,183,139

The simulation analysis reflects our efforts to balance the repricing characteristics of our interest-earning assets and supporting funds.

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Item 4. ***Controls and Procedures***

Under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, we evaluated the effectiveness of our disclosure controls and procedures, as such term is defined under Rule 13a-15(e) promulgated under the Securities Exchange Act of 1934, as amended. Based on this evaluation, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures were effective as of the end of the period covered by this quarterly report. There was no change in our internal control over financial reporting during the three months ended March 31, 2004 that materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

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PART II

Item 1. ***Legal Proceedings***

In December 2003, the Company was served with a class action complaint, *Silva v. Accredited Home Finance, et al.,* alleging that the Company violated a California statute restricting prepayment charges, breached the covenant of good faith and fair dealing, and constituted an unfair business practice. In April 2004, the Company s demurrer to the complaint was sustained without leave to amend and the action was dismissed with prejudice. The plaintiff subsequently agreed to waive his right to appeal in exchange for the Company s agreement to waive its rights to costs and fees. This matter is now finally resolved.

Please also see our Report on Form 10-K filed for the fiscal year ended December 31, 2003.

Item 2. ***Changes in Securities and Use of Proceeds***

Concurrently with the Company s initial public offering, on February 20, 2003, the Company sold 510,697 shares of common stock to an affiliate of one of its underwriters, FBR Asset Investment Corporation, at a price equal to $7.44 per share, or gross proceeds of approximately $3.8 million. There were no underwriters used in connection with this transaction. The Company relied on Section 4(2) of the Securities Act of 1933, as amended, based on the fact that it only offered the shares to one accredited investor in a transaction not involving a public offering.

Item 3. ***Defaults Upon Senior Securities***

None.

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

There were no matters submitted to a vote of security holders during the three month period ended March 31, 2004.

Item 5. ***Other Information***

During the first quarter 2004, the Company adopted a Director Nominations Policy, which can be found on the Company s website, **www.accredhome.com** under the Corporate Governance section of the Investors/Shareholders link.

Item 6. ***Exhibits and Reports on Form 8-K***

(a) Exhibits

For a list of exhibits filed with this Quarterly Report on Form 10-Q, refer to the Exhibit Index beginning on page Ex-1.

(b) Reports on Form 8-K

Report on Form 8-K dated January 28, 2004 attaching the Company s January 28, 2004 press release regarding the Company s financial results for the fiscal quarter and year ended December 31, 2003.

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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.

Date: May 14, 2004

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/ JOHN S. BUCHANAN

John S. Buchanan

Chief Financial Officer

(Principal Financial and Accounting Officer)

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EXHIBIT INDEX

2.1[(1)]	Agreement and Plan of Merger
3.1[(2)]	Amended and Restated Certificate of Incorporation of the Company.
3.2[(2)]	Bylaws of the Company.
4.1[(2)]	Specimen Common Stock Certificate.
4.2[(3)]	Second Amended and Restated Investors Rights Agreement.
31.1	Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1[(4)]	Certification of Chief Executive Officer.
32.2[(4)]	Certification of Chief Financial Officer.

(1) Incorporated by reference to the Company s Annual Report on Form 10-K for the fiscal year ended December 31, 2002, filed March 28, 2003.

(2) Incorporated by reference to amendment number 3 to the Company s Registration Statement on Form S-1 (File No. 333-91644) dated November 12, 2002.

(3) Incorporated by reference to amendment number 1 to the Company s Registration Statement on Form S-1 (File No. 333-91644) dated August 20, 2002.

(4) The information contained in these certifications is furnished to the Securities and Exchange Commission pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 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.