UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended September 30, 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 incorporation or organization)	**(I.R.S. Employer Identification No.)**

15090 Avenue of Science

San Diego, California 92128

(Address of principal executive offices) (Zip Code)

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

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

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes 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 October 29, 2004 was 21,199,728.

TABLE OF CONTENTS

Table of Contents

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.

Table of Contents

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

PART I

Item 1. ***Financial Statements***

ACCREDITED HOME LENDERS HOLDING CO. AND SUBSIDIARIES

CONDENSED CONSOLIDATED BALANCE SHEETS

(unaudited)

(dollars in thousands)	December 31, 2003	September 30, 2004
ASSETS		
Cash and cash equivalents	$ 27,119	$ 73,469
Restricted cash	209	5,690
Mortgage loans held for sale, net of market reserve of $12,213 and $14,372, respectively	1,277,075	1,848,376
Mortgage loans held for investment, net of allowance for loan losses of $19,890 and $51,328, respectively	2,090,237	4,047,046
Mortgage-related securities, at fair value	3,692	3,754
Mortgage servicing rights, net	1,119	331
Furniture, fixtures and equipment, net	20,674	32,653
Other receivables	44,911	60,570
Prepaid income taxes		19,878
Deferred income tax asset	16,052	17,214
Prepaid expenses and other assets	20,329	27,693
TOTAL	$ 3,501,417	$ 6,136,674
LIABILITIES AND STOCKHOLDERS EQUITY		
LIABILITIES:		
Warehouse facilities	$ 1,515,195	$ 2,411,415
Securitization bond financing	1,724,389	3,275,887
Income taxes payable	2,949	
Accounts payable and accrued liabilities	46,661	50,975
Total liabilities	3,289,194	5,738,277
COMMITMENTS AND CONTINGENCIES (Note 14)		
MINORITY INTEREST IN SUBSIDIARY		84,094
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 21,161,641 shares at September 30, 2004 (including 326,113 and 563,767, respectively, of restricted stock awarded under the deferred compensation plan)	20	21
Additional paid-in capital	61,585	78,970
Note receivable for common stock	(1,250)	(1,250)
Unearned compensation	(5,623)	(11,685)
Other comprehensive loss		(1,921)
Retained earnings	157,491	250,168
Total stockholders equity	212,223	314,303
TOTAL	$ 3,501,417	$ 6,136,674

See notes to condensed consolidated financial statements.

2

Table of Contents

ACCREDITED HOME LENDERS HOLDING CO. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(unaudited)

(dollars and shares outstanding in thousands, except for earnings per share)	Three Months Ended September 30,		Nine Months Ended September 30,	
	2003	2004	2003	2004
REVENUES:				
Interest income	$ 47,870	$ 97,493	$ 120,484	$ 242,792
Gain on sale of loans (including $0, $0, $2,834 and $0, respectively, with a related party)	65,237	77,993	171,317	210,342
Loan servicing income	1,979	1,996	5,789	5,205
Net gain on mortgage-related securities and derivatives	1,051	309	5,439	2,083
Other income	98	283	583	413
Total revenues	116,235	178,074	303,612	460,835
EXPENSES:				
Salaries, wages and benefits	28,700	42,674	79,523	117,775
Interest expense (including $0, $0, $597 and $0, respectively, with a related party)	16,616	37,114	43,628	86,137
Occupancy	3,449	4,810	8,448	13,341
Provision for losses	6,537	14,416	22,916	39,708
Depreciation and amortization	1,260	2,911	3,343	6,934
General and administrative expenses	10,590	15,878	29,019	42,002
Total expenses	67,152	117,803	186,877	305,897
INCOME BEFORE INCOME TAXES	49,083	60,271	116,735	154,938
INCOME TAXES	19,634	23,234	46,694	61,101
MINORITY INTEREST DIVIDENDS ON PREFFERED STOCK OF SUBSIDIARY		1,160		1,160
NET INCOME	$ 29,449	$ 35,877	$ 70,041	$ 92,677
BASIC EARNINGS PER SHARE	$ 1.50	$ 1.75	$ 4.09	$ 4.57
DILUTED EARNINGS PER SHARE	$ 1.40	$ 1.66	$ 3.56	$ 4.31
WEIGHTED AVERAGE SHARES OUTSTANDING:				
BASIC	19,651	20,470	17,139	20,287
DILUTED	21,046	21,580	19,687	21,516

See notes to condensed consolidated financial statements.

Table of Contents

ACCREDITED HOME LENDERS HOLDING CO. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(unaudited)

	Nine Months Ended September 30,	
(dollars in thousands)	**2003**	**2004**
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	$ 70,041	$ 92,677
Adjustments to reconcile net income to net cash used in operating activities:		
Depreciation and amortization	3,343	6,934
Amortization of unearned compensation	406	2,473
Loss on disposal of furniture, fixtures, and equipment	120	39
Mortgage loans held for sale originated, net of fees	(4,467,876)	(6,076,570)
Proceeds from sale of mortgage loans held for sale, net of fees	4,223,016	5,789,582
Collection of principal payments on mortgage loans held for sale	22,902	52,405
Net change in fair value hedge basis adjustment on mortgage loans held for sale and securitized loans	(10,769)	(16,910)
Amortization of net deferred origination fees on securitized loans	(447)	1,972
Cash received on mortgage-related securities	11,205	2,419
Net unrealized gain on mortgage-related securities	(6,513)	(2,086)
Accretion of mortgage-related securities	(671)	(380)
Amortization of mortgage servicing rights	1,598	788
Provision for losses	22,916	39,708
Deferred income taxes	(2,743)	(1,162)
Income tax deduction for disqualifying stock dispositions		5,625
Changes in assets and liabilities:		
Other receivables	(15,510)	(15,659)
Prepaid income taxes		(19,878)
Other assets	2,442	(2,642)
Accounts payable and accrued liabilities	10,262	3,691
Income taxes payable	(998)	(2,949)
Net cash used in operating activities	(137,276)	(139,923)
CASH FLOWS FROM INVESTING ACTIVITIES:		
Capital expenditures	(11,398)	(18,952)
Mortgage loans held for investment originated	(1,140,347)	(2,905,882)
Principal payments on securitized loans	119,857	581,562
Net cash used in investing activities	(1,031,888)	(2,343,272)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Net proceeds from warehouse credit facilities	569,573	896,220
Payments of borrowings on residual interest credit facility	(6,859)	
Proceeds from issuance of securitization bond financing	719,847	2,167,569
Payments of securitization bond financing.	(141,289)	(616,071)
Change in restricted cash	(1,367)	(5,481)
Payments on capital leases	(208)	(12)
Proceeds from exercise of stock options	547	1,123
Proceeds from issuance of stock under ESPP	1,873	2,103
Net proceeds from initial public offering and concurrent private placement	38,294	
Proceeds from preferred stock offering of consolidated subsidiary		84,094

Net cash provided by financing activities		1,180,411		2,529,545
NET INCREASE IN CASH AND CASH EQUIVALENTS		11,247		46,350
BEGINNING BALANCE, CASH AND CASH EQUIVALENTS		11,300		27,119
ENDING BALANCE, CASH AND CASH EQUIVALENTS	$	22,547	$	73,469
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION:				
Cash paid during the period for:				
Interest	$	38,960	$	74,772
Income taxes	$	50,359	$	78,194
SUPPLEMENTAL DISCLOSURE OF NON-CASH INVESTING AND FINANCING ACTIVITIES:				
Transfer of loans held for sale to loans held for investment	$	720,940	$	2,570,380
Transfer of loans held for sale to real estate owned, included in other assets	$	7,347	$	4,721
Transfer of mortgage related securities from other liabilities	$		$	16
Unearned compensation	$	284	$	129
Deferred compensation	$		$	8,406
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.

Table of Contents

ACCREDITED HOME LENDERS HOLDING CO. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF STOCKHOLDERS EQUITY

(unaudited)

	Common Stock		Additional Paid-in	Note Receivable for Common	Unearned	Other Comprehensive	Retained	
	Shares	Amount	Capital	Stock	Compensation	Loss	Earnings	Total
				(dollars in thousands)				
BALANCE, JANUARY 1, 2003	5,833,873	$ 6	$ 2,351	$ (1,250)	$ (574)	$	$ 57,476	$ 58,009
Issuance of common stock for options exercised	517,546	1	864					865
Issuance of common stock in initial public offering and concurrent private placement, net of offering costs	5,653,712	6	38,288					38,294
Conversion of preferred stock, convertible debt and warrants to common stock	7,631,191	7	8,106					8,113
Issuance of common stock in the employee stock purchase plan	403,879		4,045					4,045
Stock compensation related to non-employee stock options			434		(434)			
Amortization of unearned compensation					282			282
Issuance and amortization of restricted stock net of forfeited shares	326,113		5,415		(4,897)			518
Tax benefit for disqualifying stock dispositions			2,082					2,082
Net income							100,015	100,015
BALANCE, DECEMBER 31, 2003	20,366,314	$ 20	$ 61,585	$ (1,250)	$ (5,623)		$ 157,491	$ 212,223
Issuance of common stock for options exercised	469,797	1	1,122					1,123
Issuance of common stock in the employee stock purchase plan	87,876		2,103					2,103
Stock compensation related to non-employee stock options			129		(129)			
Amortization of unearned compensation					274			274
Issuance and amortization of restricted stock net of forfeited shares	237,654		8,406		(6,207)			2,199
Tax benefit for disqualifying stock dispositions			5,625					5,625
Other comprehensive loss, net of tax						(1,921)		(1,921)
Net income							92,677	92,677
BALANCE, September 30, 2004	21,161,641	$ 21	$ 78,970	$ (1,250)	$ (11,685)	$ (1,921)	$ 250,168	$ 314,303

See notes to condensed consolidated financial statements.

ACCREDITED HOME LENDERS HOLDING CO. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

For The Nine Months Ended September 30, 2003 and 2004 (Unaudited)

1. THE COMPANY AND A SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation The consolidated financial statements include the accounts of Accredited Home Lenders Holding Co. (AHLHC), a Delaware corporation, and its wholly owned subsidiaries Accredited Home Lenders, Inc. (AHL), AHL s wholly owned subsidiary Accredited Mortgage Loan REIT Trust (REIT) and the recently formed subsidiary Accredited Home Lenders Canada, Inc. (collectively the Company). REIT was formed in May 2004 as a Maryland real estate investment trust for the purpose of acquiring, holding and managing real estate assets. 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 nine months ended September 30, 2004 are not necessarily indicative of the results that may be expected for the year ending December 31, 2004. All intercompany balances and transactions have been eliminated. The unaudited consolidated financial statements presented herein should be read in conjunction with the audited consolidated financial statements and related notes thereto included in AHLHC 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.

In August 2004, REIT completed a public offering of 3,400,000 Series A Preferred Shares, and in September 2004 sold an additional 100,000 Series A Preferred Shares pursuant to the exercise of the underwriters over-allotment option. The sale of the 3,500,000 Series A Preferred Shares resulted in gross proceeds of $87.5 million to REIT. In October 2004, REIT closed the public offering of 593,678 additional Series A Preferred Shares. The sale resulted in an additional $15.0 million of gross proceeds to REIT.

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

Table of Contents

ACCREDITED HOME LENDERS HOLDING CO. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

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 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 eight securitizations totaling $ 4.2 billion structured as a financing under Statement of Financial Accounting Standards (SFAS) No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities a replacement of FASB Statement No. 125*.

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

Table of Contents

ACCREDITED HOME LENDERS HOLDING CO. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

the securitized loans. The Company records interest income on securitized loans and interest expense on the bonds issued in the securitizations over the life of the securitizations. Deferred debt issuance costs and discount related to the bonds are amortized on a level yield basis over the estimated life of the bonds.

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

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

Derivative Financial Instruments As part of the Company s interest rate management process, the Company uses derivative financial instruments such as Eurodollar futures and options. In connection with five 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, the Company is using derivatives as fair value hedges under SFAS No. 133. Once the hedge relationship is established, the realized and unrealized changes in fair value of both the hedge instruments and mortgage loans are recognized in the consolidated statement of operations in the period in which the changes occur. Any change in the fair value of mortgage loans held for sale recognized as a result of hedge accounting is reversed at the time the mortgage loans are sold. The net amount recorded in the consolidated statement of operations is referred to as hedge ineffectiveness. During the third quarter 2004, the Company implemented the use of cash flow hedging on its securitized loans under SFAS No. 133. Pursuant to SFAS No. 133 hedge instruments have been designated as hedging the exposure to variability of cash flows from our securitized loans attributable to interest rate risk. Cash flow hedge accounting requires that the effective portion of the gain or loss in the fair value of a derivative instrument designated as a hedge be reported as a component of other comprehensive income in stockholders equity, and reclassified into earnings in the period during which the hedged transaction affects earnings pursuant to SFAS No. 133. The ineffective portion on the derivative instrument is reported in current earnings as a component of interest expense.

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

Table of Contents

ACCREDITED HOME LENDERS HOLDING CO. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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 the Company. Such accounts amounted to $35.4 million and $78.4 million at December 31, 2003 and September 30, 2004, respectively, and are excluded from the Company s assets and liabilities.

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

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

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

	Three Months Ended September 30,	
	2003	**2004**
Net income, as reported	$ 29,449	$ 35,877
Add: Stock-based compensation included in reported net income, net of tax		85
Deduct: Stock-based employee compensation expense determined using fair value method, net of tax	(85)	(491)
Pro forma net income	$ 29,364	$ 35,471

Earnings per share:		
Basic as reported	$ 1.50	$ 1.75
Basic pro forma	$ 1.49	$ 1.73
Diluted as reported	$ 1.40	$ 1.66
Diluted pro forma	$ 1.40	$ 1.64

Table of Contents

ACCREDITED HOME LENDERS HOLDING CO. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

	Nine Months Ended September 30,	
	2003	2004
Net income, as reported	$ 70,041	$ 92,677
Add: Stock-based compensation included in reported net income, net of tax		164
Deduct: Stock-based employee compensation expense determined using fair value method, net of tax	(187)	(1,473)
Pro forma net income	$ 69,854	$ 91,368
Earnings per share:		
Basic as reported	$ 4.09	$ 4.57
Basic pro forma	$ 4.08	$ 4.50
Diluted as reported	$ 3.56	$ 4.31
Diluted pro forma	$ 3.55	$ 4.25

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 3.0% and 3.4% (nine months ended September 30, 2003 and 2004, respectively) and a 48.8% and 54.5% weighted average volatility (nine months ended September 30, 2003 and 2004, respectively). The Company s volatility is calculated as an average of its own volatility and the mean of its closest competitors volatility for the respective periods due to the limited period of time since the Offering. The weighted average fair value at grant date was $6.81 and $17.98 for options granted during the nine months ended September 30, 2003 and 2004, respectively.

Segment Reporting While the Company s management monitors the revenue streams through wholesale and retail loan originations, operations are managed and financial performance is evaluated by the Company s chief operating decision-maker on a company-wide basis. The Company has identified REIT and AHL as separate operating segments, however they are aggregated to a single reporting segment for financial reporting due to commonality and similarity of operations. See Note 15 for supplemental condensed consolidating financial information.

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

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

Recent Accounting Developments In March 2004, the Securities and Exchange Commission issued Staffing Accounting Bulletin No. 105 (SAB No. 105). SAB No. 105 contains specific guidance that significantly limits opportunities for registrants to recognize an asset related to a commitment to originate a mortgage loan that will be held for sale prior to funding the loan, which differs from the current accounting guidance provided by Statement of Financial Accounting Standards No. 149 (SFAS No. 149). SFAS No. 149 requires that the entity that makes the mortgage loan commitment record the commitment on its balance sheet at

Table of Contents

ACCREDITED HOME LENDERS HOLDING CO. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

fair value, but does not address how to measure the fair value of the loan commitment. SAB No. 105 requires that fair value measurement of loan commitments include only differences between the guaranteed interest rate in the loan commitment and a market interest rate, excluding any expected cash flows related to the customer relationship or loan servicing. SAB No. 105 is effective for new loan commitments accounted for as derivatives entered into after March 31, 2004. SAB No.105 permits registrants to continue to use previously applied accounting policies to commitments entered into on or before March 31, 2004. We quote interest rates to borrowers, which are generally subject to change by us. Although we typically honor such interest rate quotes, the quotes do not constitute interest rate locks, minimizing the potential interest rate exposure. We do not account for our interest rate quotes as derivatives. We do not expect that the application of SAB No. 105 will have a material impact on our consolidated financial statements.

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 September 30, 2003 and 2004, approximately 34% and 33%, 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 nine months ended September 30, 2003 and 2004, approximately 33% and 29%, respectively, of the principal balance of loans originated were collateralized by properties located in California. The remaining originations did not exceed 10% in any other state during any of such periods.

3. MORTGAGE LOANS

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

	December 31, 2003	September 30, 2004
Mortgage loans held for sale principal balance	$ 1,288,630	$ 1,853,673

Basis adjustment for fair value hedge accounting	(1,368)	6,791
Net deferred origination costs	2,026	2,284
Market reserve	(12,213)	(14,372)