IMPAC MORTGAGE HOLDINGS INC
Form 10-Q/A
September 17, 2008
Table of Contents

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Amendment No. 1

FORM 10-Q/A

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

For the quarterly period ended June 30, 2008 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: 1-14100

IMPAC MORTGAGE HOLDINGS, INC.

(Exact name of registrant as specified in its charter)

Maryland	**33-0675505**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

19500 Jamboree Road, Irvine, California 92612

(Address of principal executive offices)

(949) 475-3600

(Registrant s telephone number, including area code)

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 o No o

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

Large accelerated filer o Accelerated filer x Non-accelerated filer o Smaller reporting company o

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

There were 76,096,392 shares of common stock outstanding as of September 12, 2008.

Table of Contents

EXPLANATORY NOTE

Impac Mortgage Holdings, Inc. (the Company) is filing this Amendment No. 1 to its Quarterly Report on Form 10-Q/A for the quarter ended June 30, 2008 filed with the Securities and Exchange Commission on September 15, 2008 solely for the purpose of correcting a typographical error in Exhibit 32.1 Certifications of Chief Executive Officer and Chief Financial Officer pursuant to 18 U.S.C. Section 1350 as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 regarding the quarter end to which the Certificate applies, which is the quarter ended June 30, 2008.

Except as described above, and except for currently dating the Exhibits attached hereto, this Amendment No. 1 on Form 10-Q/A does not modify or update any information reported in the original Quarterly Report on Form 10-Q for the quarter ended June 30, 2008 and it does not reflect events occurring after the date of the filing of the original Quarterly Report.

IMPAC MORTGAGE HOLDINGS, INC.

FORM 10-Q/A QUARTERLY REPORT

TABLE OF CONTENTS

		Page
	PART I. FINANCIAL INFORMATION	
ITEM 1.	**CONSOLIDATED FINANCIAL STATEMENTS**	
	Consolidated Balance Sheets as of June 30, 2008 and December 31, 2007	1
	Consolidated Statements of Operations and Comprehensive Earnings (Loss) for the Three and Six Months Ended June 30, 2008 and 2007	2
	Consolidated Statements of Cash Flows for the Six Months Ended June 30, 2008 and 2007	4
	Notes to Unaudited Consolidated Financial Statements	6
ITEM 2.	**MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**	23
	Forward-Looking Statements	23
	The Mortgage Banking Industry and Discussion of Relevant Fiscal Periods	24
	Status of Operations, Liquidity and Capital Resources	24
	Market Conditions	26
	Critical Accounting Policies	29
	Fair Value of Financial Instruments	30
	Interest Income and Expense	31
	Selected Financial Results for the Three Months Ended June 30, 2008	32
	Selected Financial Results for the Six Months Ended June 30, 2008	32
	Estimated Taxable Income	32
	Financial Condition and Results of Operations	33

ITEM 3.	QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK	44
ITEM 4.	CONTROLS AND PROCEDURES	44
	PART II. OTHER INFORMATION	
ITEM 1.	LEGAL PROCEEDINGS	45
ITEM 1A.	RISK FACTORS	45
ITEM 2.	UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS	48
ITEM 3.	DEFAULTS UPON SENIOR SECURITIES	48
ITEM 4.	SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS	48
ITEM 5.	OTHER INFORMATION	48
ITEM 6.	EXHIBITS	50
	SIGNATURES	50
	CERTIFICATIONS	

Table of Contents

PART I. FINANCIAL INFORMATION

ITEM 1. CONSOLIDATED FINANCIAL STATEMENTS

IMPAC MORTGAGE HOLDINGS, INC. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

(in thousands, except share data)

	June 30, 2008 (Unaudited)	December 31, 2007
ASSETS		
Cash and cash equivalents	$ 25,971	$ 24,387
Trust assets		
Investment securities available-for-sale	8,644	15,248
Securitized mortgage collateral (at fair value at June 30, 2008)	11,055,382	16,532,633
Derivative assets	109	7,497
Real estate owned (REO) at net realizeable value	621,433	400,863
Total trust assets	11,685,568	16,956,241
Assets of discontinued operations	203,320	353,250
Other assets	48,684	57,194
Total assets	$ 11,963,543	$ 17,391,072
LIABILITIES		
Trust liabilities		
Securitized mortgage borrowings (at fair value at June 30, 2008)	$ 11,497,132	$ 17,780,060
Derivative liabilities	136,580	127,757
Total trust liabilities	11,633,712	17,907,817
Trust preferred securities (at fair value at June 30, 2008)	46,266	98,398
Liabilities of discontinued operations	253,334	405,341
Other liabilities	5,723	57,244
Total liabilities	11,939,035	18,468,800
Commitments and contingencies		
STOCKHOLDERS EQUITY		
Series-A junior participating preferred stock, $0.01 par value; 2,500,000 shares authorized; none issued and outstanding		
Series-B 9.375% cumulative redeemable preferred stock, $0.01 par value; liquidation value $50,000; 2,000,000 shares authorized, issued and outstanding	20	20
Series-C 9.125% cumulative redeemable preferred stock, $0.01 par value; liquidation value $111,765; 5,500,000 shares authorized; 4,470,600 shares issued and outstanding as of June 30, 2008 and December 31, 2007	45	45

Common stock, $0.01 par value; 200,000,000 shares authorized; 76,096,392 shares issued and outstanding as of June 30, 2008 and December 31, 2007		761		761
Additional paid-in capital		1,175,125		1,173,562
Accumulated other comprehensive income				1,028
Net accumulated deficit:				
Cumulative dividends declared		(811,355)		(803,912)
Retained deficit		(340,088)		(1,449,232)
Net accumulated deficit		(1,151,443)		(2,253,144)
Total stockholders equity (deficit)		24,508		(1,077,728)
Total liabilities and stockholders equity	$	11,963,543	$	17,391,072

See accompanying notes to consolidated financial statements.

1

Table of Contents

IMPAC MORTGAGE HOLDINGS, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF OPERATIONS

AND COMPREHENSIVE EARNINGS (LOSS)

(in thousands, except per share data)

(Unaudited)

	For the Three Months Ended June 30, 2008	For the Three Months Ended June 30, 2007	For the Six Months Ended June 30, 2008	For the Six Months Ended June 30, 2007
INTEREST INCOME:				
Total interest income	$ 407,855	$ 316,443	$ 679,811	$ 621,191
INTEREST EXPENSE:				
Total interest expense	403,599	308,569	668,206	605,374
Net interest income	4,256	7,874	11,605	15,817
Provision for loan losses		161,163		190,295
Net interest income (expense) after provision for loan losses	4,256	(153,289)	11,605	(174,478)
NON-INTEREST INCOME:				
Change in fair value of derivative instruments		91,670		73,672
Change in fair value of net trust assets, excluding REO	(11,161)		(7,633)	
Change in fair value of trust preferred securities	(997)		(5,020)	
Losses from real estate owned	(4,830)	(19,328)	(9,086)	(29,220)
Real estate advisory fees	4,696		8,540	
Other	1,544	(1,538)	3,442	3,749
Total non-interest (expense) income	(10,748)	70,804	(9,757)	48,201
NON-INTEREST EXPENSE:				
General and administrative	4,925	4,451	8,912	9,960
Personnel expense	2,820	1,620	5,150	2,464
Total non-interest expense	7,745	6,071	14,062	12,424
Net loss from continuing operations	(14,237)	(88,556)	(12,214)	(138,701)
Income tax expense from continuing operations	2,202	4,969	8,728	8,956
Net loss from continuing operations	(16,439)	(93,525)	(20,942)	(147,657)
Net loss from discontinued operations, net of tax	(11,048)	(59,022)	(10,360)	(126,558)
Net loss	(27,487)	(152,547)	(31,302)	(274,215)
Cash dividends on cumulative redeemable preferred stock	(3,722)	(3,722)	(7,443)	(7,443)
Net loss available to common stockholders	$ (31,209)	$ (156,269)	$ (38,745)	$ (281,658)

See accompanying notes to consolidated financial statements.

Table of Contents

	For the Three Months Ended June 30,		For the Six Months Ended June 30,	
	2008	2007	2008	2007
Net loss	$ (27,487)	$ (152,547)	$ (31,302)	$ (274,215)
Net unrealized losses on securities:				
Unrealized holding losses arising during year		(1,656)		(2,718)
Reclassification of losses included in net earnings		1,596		1,596
Net unrealized losses		(60)		(1,122)
Comprehensive loss	$ (27,487)	$ (152,607)	$ (31,302)	$ (275,337)
Net loss per common share - Basic:				
Loss from continuing operations	$ (0.26)	$ (1.28)	$ (0.37)	$ (2.04)
Loss from discontinued operations	(0.15)	(0.78)	(0.14)	(1.66)
Net loss per share	$ (0.41)	$ (2.05)	$ (0.51)	$ (3.70)
Net loss per common share - Diluted:				
Loss from continuing operations	$ (0.26)	$ (1.28)	$ (0.37)	$ (2.04)
Loss from discontinued operations	(0.15)	(0.78)	(0.14)	(1.66)
Net loss per share	$ (0.41)	$ (2.05)	$ (0.51)	$ (3.70)
Dividends declared per common share	$	$	$	$ 0.10

See accompanying notes to consolidated financial statements.

Table of Contents

IMPAC MORTGAGE HOLDINGS, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS

(in thousands)

(Unaudited)

	For the Six Months Ended June 30, 2008	For the Six Months Ended June 30, 2007
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net loss from continuing operations	$ (20,942)	$ (147,657)
Provision for loan losses		190,295
Provision for REO losses	14,323	28,074
Loss (gain) on sale of REO	(5,237)	1,145
Amortization of deferred charge, net	8,728	9,069
Amortization of debt issuance costs and mortgage servicing rights	948	807
Amortization of premiums and securitization costs		84,863
Change in fair value of derivative instruments	12,144	1,354
Change in fair value of net trust assets, excluding REO and derivatives	(75,878)	
Change in fair value of trust preferred securities	5,020	
Accretion of interest income and expense	(25,191)	
Stock-based compensation	653	812
Net change in accrued interest receivable		(547)
Net cash provided by (used in) operating activities of discontinued operations	91,219	(3,157,915)
Net change in other assets and liabilities	(41,444)	(8,968)
Net cash used in operating activities	**(35,657)**	**(2,998,668)**
CASH FLOWS FROM INVESTING ACTIVITIES:		
Securitized mortgage collateral	1,342,015	3,468,817
Mortgages held-for-investment	22	(3,229)
Purchase of premises and equipment	386	(873)
Principal change on investment securities available-for-sale	1,196	6,404
Proceeds from the sale of real estate owned	197,796	76,532
Net cash provided by (used in) investing activities of discontinued operations	11,805	191,664
Net cash provided by investing activities	**1,553,220**	**3,739,315**
CASH FLOWS FROM FINANCING ACTIVITIES:		
Cash disbursements under reverse repurchase agreements		(90,642)
Cash receipts from reverse repurchase agreements		92,392
Proceeds from securitized mortgage borrowings		3,858,143
Repayment of securitized mortgage borrowings	(1,393,987)	(4,323,044)
Common stock dividends paid		(30,326)
Preferred stock dividends paid	(7,443)	(7,443)
Proceeds from sale of cumulative redeemable preferred stock		608
Net cash (used in) povided by investing activities of discontinued operations	(116,465)	(306,831)
Net cash used in financing activities	**(1,517,895)**	**(807,143)**
Net change in cash and cash equivalents	(332)	(66,496)
Cash and cash equivalents at beginning of period	26,462	179,677
Cash and cash equivalents at end of period - Continuing Operations	25,971	107,083

Cash and cash equivalents at end of period - Discontinued Operations		159		6,098
Cash and cash equivalents at end of period	$	26,130	$	113,181

See accompanying notes to consolidated financial statements.

4

Table of Contents

	For the Six Months Ended June 30, 2008			2007
SUPPLEMENTARY INFORMATION (Continuing and Discontinued Operations):				
Interest paid	$	315,545	$	651,736
Taxes paid				116
NON-CASH TRANSACTIONS (Continuing and Discontinued Operations):				
Accumulated other comprehensive loss	$		$	(1,122)
Transfer of loans held-for-sale and held-for-investment to real estate owned				20,872
Transfer of securitized mortgage collateral to real estate owned		435,038		255,051
Transfer of loans held-for-sale to securitized mortgage collateral				3,245,500
Transfer of securitized mortgage collateral to loans held-for-sale				27,040

See accompanying notes to consolidated financial statements.

Table of Contents

IMPAC MORTGAGE HOLDINGS, INC. AND SUBSIDIARIES

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

(dollars in thousands, except per share data or as otherwise indicated)

Note A Summary of Business and Significant Accounting Policies

1. Business Summary and Financial Statement Presentation

Business Summary

Impac Mortgage Holdings, Inc. (the Company or IMH) is a Maryland corporation incorporated in August 1995 and has the following subsidiaries: IMH Assets Corp. (IMH Assets), Impac Warehouse Lending Group, Inc. (IWLG), and Impac Funding Corporation (IFC), together with its wholly-owned subsidiaries Impac Secured Assets Corp. (ISAC), Impac Commercial Capital Corporation (ICCC).

During late 2007, the Company s board of directors elected to discontinue the non-conforming mortgage operations conducted by IFC, commercial operations conducted by ICCC, retail mortgage operations conducted by IHL, and warehouse lending operations conducted by IWLG.

The Company consists of the continuing operations which includes the long-term mortgage portfolio (residual interests in securitizations) conducted by IMH and IMH Assets, master servicing portfolio conducted by IFC and real estate advisory fees from IMH s advisory services agreement with a real estate marketing company.

The information contained throughout this document is presented on a continuing basis, unless otherwise stated.

Financial Statement Presentation

The accompanying unaudited consolidated financial statements of IMH and its subsidiaries (as defined above) have been prepared in accordance with Accounting Principles Generally Accepted in the United States of America (GAAP) for interim financial information and with the instructions to Form 10-Q and Rule 10-01 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by GAAP for complete financial statements. In the opinion of management, all adjustments, consisting of normal recurring adjustments considered necessary for a fair presentation, have been included. Operating results for the three-month and six month periods ended June 30, 2008 are not

necessarily indicative of the results that may be expected for the year ending December 31, 2008.

All significant inter-company balances and transactions have been eliminated in consolidation. In addition, certain amounts in the prior periods consolidated financial statements have been reclassified to conform to the current year presentation.

Management has made a number of estimates and assumptions relating to the reporting of assets and liabilities, the 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 to prepare these consolidated financial statements in conformity with GAAP. The items affected by management s estimates and assumptions include the valuation of trust assets and liabilities (including investment securities available-for-sale), the valuation of repurchase liabilities related to sold loans, the valuation of trust preferred securities, and the valuation of loans held-for-sale. Actual results could differ from those estimates.

Market Conditions, Status of Operations, Liquidity and Capital Resources

In 2007 and 2008, management has been seriously challenged by the unprecedented turmoil in the mortgage market, including the following: significant increases in delinquencies and foreclosures; significant increases in credit-related losses; decline in originations; tightening of warehouse credit and the virtual elimination of the market for loan securitizations. As a result, the Company discontinued certain operations, resolved and terminated all but one of the Company s reverse repurchase facilities and settled a portion of its outstanding repurchase claims, while also reducing its operating costs and liabilities. In the first quarter of 2008, the Company also entered into an agreement with a real estate marketing company to generate advisory fees.

Table of Contents

As describes in Note L, in September 2008, the Company executed definitive agreements, which require scheduled principal paydowns and remove any and all technical defaults that existed under the previous reverse repurchase facility.

In order to reduce dividend payments on its preferred stock, the Company is considering exchanging the preferred stock for common stock. In July 2008, the Company s stockholders approved the potential issuance of common shares in excess of 20 percent of the existing common shares.

The Company earns advisory fees from a real estate marketing company specializing in the marketing and disposition of foreclosed properties. During the three and six months ended June 30, 2008, the Company earned $4.7 million and $8.5 million, respectively, from this relationship. The amount of real estate advisory fees the Company receives from this relationship are based on numerous factors, including real estate market conditions, the level of foreclosure activity, the ability of the marketing company to attract new business, and the Company retaining its CEO and avoiding liquidation. The agreement terminates in 2010 with the Company having an option to extend the agreement for an additional three years.

In July 2008, the Company executed a letter of intent, subject to execution of definitive agreements, to acquire a special servicing platform, whereby the seller will contribute specified balances of loans (mostly distressed) to the platform in order to provide sufficient cash flows to maintain the business during its initial operations.

There can be no assurance that the Company will be successful in executing the agreements outlined above. Also, there can be no assurance that the restructuring of the trust preferred securities or the preferred stock will occur. In this event, the Company intends to reduce operating expenses to a level that is supportable by the revenues from the existing long-term mortgage portfolio (residual interests in securitizations), master servicing portfolio and real estate advisory fees. Nevertheless, if the Company is not successful in completing the objectives outlined above, it may not be able to meet its contractual obligations for the next year, including repayment of the reverse repurchase line, interest payments on trust preferred securities and preferred stock dividends.

2. Adoption of New Accounting Standards

Adoption of SFAS 157 Fair Value Measurements

The Company prospectively adopted the provisions of Financial Accounting Standards Board (FASB) Statement No. 157 Fair Value Measurements (SFAS 157), as of January 1, 2008. SFAS 157 defines fair value, expands disclosure requirements around fair value and specifies a hierarchy of valuation techniques based on whether the inputs to those valuation techniques are observable or unobservable. Observable inputs reflect market data obtained from independent sources, while unobservable inputs reflect the Company s market assumptions. These two types of inputs create the following fair value hierarchy:

- Level 1 Quoted prices for identical instruments in active markets.

- Level 2 Quoted prices for similar instruments in active markets; quoted prices for identical or similar instruments in markets that are not active; and model-derived valuations in which all significant inputs and significant value drivers are observable in active markets.

- Level 3 Valuations derived from valuation techniques in which one or more significant inputs or significant value drivers are unobservable.

This hierarchy requires the Company to use observable market data, when available, and to minimize the use of unobservable inputs when determining fair value.

For some products or in certain market conditions, observable inputs may not always be available. Through the second quarter of 2008, certain markets remained illiquid, and some key observable inputs used in valuing certain exposures were unavailable. When and if these markets are liquid, the Company will use the related observable inputs available at that time from these markets.

Table of Contents

Under fair value accounting, the Company is required to take into account its own credit risk when measuring the fair value of assets and liabilities.

Adoption of SFAS 159 - Fair Value Option

The adoption of Statement No. 159 The Fair Value Option for Financial Assets and Financial Liabilities (SFAS 159) has also resulted in new valuation techniques used by the Company when determining fair value, most notably to value its securitized mortgage collateral and borrowings and trust preferred securities, which had not previously been carried at fair value. The Company prospectively adopted SFAS 159 as of January 1, 2008. SFAS 159 provides an option on an instrument-by-instrument basis for most financial assets and liabilities to be reported at fair value with changes in fair value reported in earnings. After the initial adoption, the election is made at the acquisition of a financial asset, financial liability, or a firm commitment and it may not be revoked. Management believes that the adoption of SFAS 159 provides an opportunity to mitigate volatility in reported earnings and provides a better representation of the economics of the trust assets and liabilities.

Under the SFAS 159 transition provisions, the Company elected to apply fair value accounting to certain financial instruments (certain trust assets, trust liabilities and trust preferred securities) held at January 1, 2008. Differences between the December 31, 2007 carrying values and the January 1, 2008 fair values were recognized as an adjustment to retained deficit. The adoption of SFAS 159 resulted in a $1.1 billion decrease to retained deficit on January 1, 2008 from $(1.4) billion at December 31, 2007 to $(308.8) million at January 1, 2008.

As a result of deterioration in the real estate market since the second half of 2007, the Company significantly added to its allowance for loan losses during the third and fourth quarters of 2007. Principally, because of the increase in the allowance for loan losses, the Company reported a stockholders deficit as of December 31, 2007. This stockholders deficit was created primarily because the Company was required under GAAP to record an allowance for loan losses that reduced securitized mortgage collateral in its consolidated trusts below the balance of the related securitized mortgage borrowings, resulting in a negative investment in certain consolidated trusts, even though the related trust agreements are nonrecourse to the Company. However, with the adoption of SFAS 159, the Company s net investment position is unable to go below zero since the related trust liabilities are also recorded at fair value. Therefore the difference between the fair value of the trust assets and trust liabilities represents the net investment interests (residual interests in securitizations) in the trust at fair value.

The following table summarizes the initial retained earnings charge related to the prospective adoption SFAS 159 as of January 1, 2008 and the related fair value balances as of January 1, 2008.

	Ending Balance as of December 31,2007 (Prior to Adoption)	Adoption Net Gain/(Loss)	Fair Value Balance as of January 1, 2008 (After Adoption) (5)
Impact of electingthe fair value option under SFAS 159:			
Investment securities available-for-sale	$ 15,248	$ 1,028(1)	$ 15,248
Securitized mortgage collateral (2)	16,532,633	(821,311)	15,711,322
Securitized mortgage borrowings (3)	(17,780,060)	1,903,283	(15,876,777)
Trust preferred securities	(98,398)	57,446	(40,952)
Cumulative-effect adjustment (pre-tax)		1,140,446	
Tax impact (4)			
Cumulative-effect adjustment to reduce retained deficit		**$ 1,140,446**	

Total retained deficit as of December 31, 2007		(1,449,232)
Cumulative-effect adjustment to reduce retained deficit	$	1,140,446
Total retained deficit as of January 1, 2008 (6)	**$**	**(308,786)**

(1) Investment securities available-for-sale are recorded at fair value at December 31, 2007, with a corresponding $1,028 thousand unrealized gain included in accumulated other comprehensive income. Included in the cumulative-effect adjustment was $1,028 thousand in unrealized holding gains that were reclassified from accumulated other comprehensive income to retained deficit. Due to the effect of reclassifying the $1,028 thousand from accumulated other comprehensive income to retained deficit, the investment securities available-for-sale balances do not add across.

Table of Contents

(2) Components of securitized mortgage collateral at December 31, 2007 include the allowance for loan loss of $1.2 billion, accrued interest of $99.7 million and premiums of $183.1 million, which were part of its fair value for the adoption of SFAS 159. At June 30, 2008 and December 31, 2007, securitized mortgage collateral included $10.1 million and $9.1 million, respectively in master servicing rights, recorded at the lower of cost or market, related to consolidated securitizations and recorded at the lower of cost or market.
(3) Components of securitized mortgage borrowings at December 31, 2007 include accrued interest of $17.1 million and securitization costs of $37.5 million, which were part of its fair value for the adoption of SFAS 159.
(4) There was no tax effect of the adoption of SFAS 159 as the Company qualifies as a REIT for federal income tax purposes and its tax liabilities are only related to it deferred charges associated with previous inter-company loan sales.
(5) The securitized mortgage collateral and securitized mortgage borrowings include the mortgage insurance and bond insurance proceeds to be received from third parties.
(6) As of January 1, 2008, after adoption of SFAS 159, total stockholder s equity was $61.7 million

Changes in Significant Accounting Policies

Investment Securities Available-for-Sale

The Company elected to continue to account for all of its existing investment securities available-for-sale at fair value. Interest income is recorded based on the effective yield for the period based on the valuation of the previous quarter. Net gains and losses resulting from changes in fair value of investment securities available-for-sale are recorded within change in fair value of net trust assets in the Company s consolidated statement of operations.

The Company s election to account for its investment securities available-for-sale at fair value was based on the Company s overall objective of moving toward fair value accounting for significant financial assets and liabilities. The election of SFAS 159 for these investment securities results in increased volatility within net earnings as a result of the recognition of fair value changes with no offsetting amounts that would result if these assets were economically hedged. However, management believes that electing fair value accounting for its investment securities results in a stronger reflection of the value, while furthering its objective of migrating toward fair value accounting.

Securitized Mortgage Collateral and Borrowings

The Company elected to account for certain of its securitized assets at fair value. Interest income on securitized mortgage collateral and interest expense on securitized mortgage borrowings, respectively, is recorded based on the effective yield for the period based on the previous quarter s valuation resulting in interest income and expense accretion. Net gains (losses) resulting from the changes in fair value of these items, are included in non-interest income in the Company s consolidated statement of operations. Electing the fair value option allows the Company to avoid the burden of recording losses on collateral for which the Company will not ultimately bare the loss. In addition, recording the collateral and borrowings at fair value will help to reflect the true economics of the transactions within the consolidated statement of operations. Upon the adoption of SFAS 159, all deferred costs associated with securitized mortgage collateral and borrowings have been recognized as a cumulative effect of a change in accounting principle within retained deficit as of January 1, 2008.

Trust Preferred Securities

The Company elected to account for all of its trust preferred securities at fair value. Interest expense on these items is recorded based on the effective yield for the period. Gains and losses resulting from the changes in fair value of these items are recorded within change in fair value of trust preferred securities in the Company s consolidated statement of operations.

The Company s election to account for its trust preferred securities at fair value was based on the Company s overall objective of moving toward fair value accounting for significant financial assets and liabilities. The election of SFAS 159 for these liabilities results in increased volatility within net earnings as a result of the recognition of fair value changes with no offsetting amounts that would result if these liabilities were economically hedged. However, management believes that electing fair value accounting for its trust preferred securities results in a stronger reflection of the value, while furthering its objective to migrate toward fair value accounting.

3. Recent Accounting Pronouncements

In March 2008, the FASB issued Statement No. 161, Disclosures about Derivative Instruments and Hedging Activities (SFAS 161), an amendment of FASB Statement No. 133, Accounting for Derivative Instruments and Hedging Activities (SFAS 133), to expand disclosure requirements for an entity s derivative and hedging activities. Under SFAS 161, entities are required to provide enhanced disclosures about how and why an entity uses derivative instruments, how derivative

Table of Contents

instruments and related hedged items are accounted for under SFAS 133 and its related interpretations, and how derivative instruments and related hedged items affect an entity s financial position, financial performance, and cash flows. In order to meet these requirements, entities shall include qualitative disclosures about objectives and strategies for using derivatives, quantitative disclosures about fair value amounts of and gains and losses on derivative instruments, and disclosures about credit-risk-related contingent features in derivative agreements. SFAS 161 is effective for fiscal years and interim periods beginning after November 15, 2008 with early adoption encouraged. The Company plans to adopt this Statement on January 1, 2009, and there should be no impact on the consolidated financial statements as this Statement only addresses disclosures.

In April 2008, the FASB voted to eliminate qualifying special purpose entities (QSPEs) from the guidance in FASB Statement No. 140 Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities (SFAS 140). While the revised standard has not been finalized and the FASB s proposals will be subject to a public comment period, this change may have a significant impact on the Company s consolidated financial statements as it may lose sales treatment for assets previously sold to a QSPE, as well as for future sales. An effective date for any proposed revisions has not been determined by the FASB. As of June 30, 2008, the current principal balance of QSPEs to which the Company, acting as principal, has transferred assets and received sales treatment were $727.1 million. The Company s investment in these QSPE s consists of residual interests accounted for as investment securities available-for-sale in its consolidated balance sheets.

In connection with the proposed changes to SFAS 140, the FASB also is proposing three key changes to the consolidation model in FASB Interpretation No. 46(R), Consolidation of Variable Interest Entities (revised December 2003) an interpretation of ARB No. 51 (FIN 46(R)). First, the FASB will now include former QSPEs in the scope of FIN 46(R). In addition, the FASB supports amending FIN 46(R) to change the method of analyzing which party to a variable interest entity (VIE) should consolidate the VIE to a primarily qualitative determination of control instead of today s risks and rewards model. Finally, the proposed amendment is expected to require all VIEs and their primary beneficiaries to be reevaluated quarterly. The previous rules required reconsideration only when specified reconsideration events occurred. As of June 30, 2008, the current principal balance of significant unconsolidated VIEs with which the Company is involved were approximately $727.1 million.

The Company will be evaluating the impact of these changes on the Company s consolidated financial statements once the standard is approved and issued.

4. Legal Proceedings

The Company is party to litigation and claims which are normal in the course of its operations. While the results of such litigation and claims cannot be predicted with certainty, the Company believes the final outcome of such matters will not have a material adverse effect on the Company s financial condition or results of operations.

On November 9, 2007, and separately on August 25, 2008, two matters were filed against IFC in Orange County in the Superior Court of California, as case nos. 07CC11612 and 00110553, respectively, by Citimortgage, Inc., alleging claims for breach of contract and damages based upon representations and warranties made in conjunction with whole loan sales. These actions seek combined damages in excess of $4.2 million.

On June 28, 2008 a matter was filed against IFC in the Circuit Court of the Eighteenth Judicial District, Dupage County in Illinois, as case no. 2008L000721, by TR Mid America Plaza Corp., seeking damages for breach of contract (a lease agreement) in excess of $0.6 million plus such

amount as determined through the date of judgment and payment of attorneys fees and costs.

The Company believes that it has meritorious defenses to the above claims and intends to defend these claims vigorously. Nevertheless, litigation is uncertain and the Company may not prevail in the lawsuits and can express no opinion as to their ultimate resolution. An adverse judgment in any of these matters could have a material adverse effect on the Company.

Please refer to IMH s report on Form 10-K for the year ended December 31, 2007 for a description of other litigation and claims.

Table of Contents

5. Income Taxes and Deferred Charge

In accordance with Accounting Research Bulletin No. 51, Consolidated Financial Statements, the Company records a deferred charge representing the deferral of income tax expense on inter-company profits that resulted from the sale of mortgages from taxable subsidiaries to IMH in prior years. The deferred charge is included in other assets in the accompanying consolidated balance sheets and is amortized as a component of income tax expense in the accompanying consolidated statements of operations over the estimated life of the mortgages retained in the securitized mortgage collateral. The Company recorded a tax provision of $2.2 million and $8.7 million for the three and six months ending June 30, 2008 and $5.0 million and $9.0 million for the three and six months ending June 30, 2007, respectively. The net provision is predominately the result of the amount of the deferred charge amortized and/or impaired resulting from credit losses, which does not result in any tax liability required to be paid.

Note B Fair Value of Financial Instruments

The Company s consolidated financial statements include financial assets and liabilities that are measured based on their estimated fair values. The use of fair value to measure the Company s financial instruments is fundamental to its consolidated financial statements and is a critical accounting estimate because a substantial portion of its assets and liabilities are recorded at estimated fair value.

The application of fair value estimates may be on a recurring or nonrecurring basis depending on the accounting principles applicable to the specific asset or liability or whether management has elected to carry the item at its estimated fair value as discussed previously.

Effective January 1, 2008, the Company adopted two pronouncements affecting its fair value measurements and accounting: SFAS 157 and SFAS 159.

SFAS 157 defines fair value as the price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. SFAS 157 establishes a three-tiered fair value hierarchy that prioritizes the inputs used to estimate fair value into three broad levels, considering the relative reliability of the inputs:

- Level 1 Quoted prices in active markets for identical assets or liabilities. Level 1 assets and liabilities include debt and equity securities and derivative contracts that are traded in an active exchange market, as well as certain U.S. treasury, other U.S. Government and agency mortgage-backed debt securities that are highly liquid and are actively traded in over-the-counter markets.

- Level 2 Observable inputs other than Level 1 prices, such as quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable

market data for substantially the full term of the assets or liabilities. Level 2 assets and liabilities include securities with quoted prices that are traded less frequently than exchange-traded instruments, securities and derivative contracts and financial liabilities whose value is determined using a pricing model with inputs that are observable in the market or can be derived principally from or corroborated by observable market data. This category generally includes trust assets or liabilities where more than a significant percentage of the fair values were derived using a pricing process that was based upon observable inputs.

- Level 3 Unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities. Level 3 assets and liabilities include financial instruments whose value is determined using pricing models, discounted cash flow methodologies, or similar techniques, as well as instruments for which the determination of fair value requires significant management judgment or estimation. This category includes those assets and liabilities that were not included in Level 1 or Level 2.

Table of Contents

The following table presents for each of these hierarchy levels, the Company s assets and liabilities that are measured at fair value on a recurring basis, including financial instruments for which the Company has elected the fair value option at June 30, 2008.

	Recurring Fair Value Measurements At June 30, 2008			
	Level 1	Level 2	Level 3	Total
Assets				
Investment securities available-for-sale	$	$	$ 8,644	$ 8,644
Securitized mortgage collateral (1)		10,747,133	298,189	11,045,322
Total Assets at Fair Value	**$**	**$ 10,747,133**	**$ 306,833**	**$ 11,053,966**
Liabilities				
Securitized mortgage borrowings	$	$ 11,180,164	$ 316,968	$ 11,497,132
Derivative liabilities, net (2)		136,471		136,471
Trust preferred securities			46,266	46,266
Total Liabilities at Fair Value	**$**	**$ 11,316,635**	**$ 363,234**	**$ 11,679,869**

(1) Excluded from securitized mortgage collateral above is $10.1 million in master servicing rights related to consolidated securitizations and recorded at the lower of cost or market.
(2) Derivative liabilities, net includes $109 thousand in derivative assets and $136.6 million in derivative liabilities, included within trust assets and trust liabilities, respectively.

Level 3 assets and liabilities were 2.6 percent and 3.0 percent of total assets at fair value and total liabilities at fair value, respectively.

The following tables present a reconciliation for all assets and liabilities measured at fair value on a recurring basis using significant unobservable inputs (Level 3) for the three and six months ended June 30, 2008:

	Level 3 Recurring Fair Value Measurements Three Months Ended June 30, 2008					
	Fair Value -March 31, 2008	Total Gains (Losses) Included in Earnings	Transfers in and/or out of Level 3	Purchases, issuances and settlements	Fair Value - June 30, 2008	Unrealized gains (losses) still held (1)
Investment securities available-for-sale	$ 10,621	$ (1,318)	$	$ (659)	$ 8,644	$ (1,977)
Securitized mortgage collateral	966,958	12,581	(645,986)	(35,364)	298,189	(22,783)
Securitized mortgage borrowings	(998,395)	(12,388)	661,157	32,658	(316,968)	20,270
Trust preferred securities	(45,129)	(1,137)			(46,266)	(1,137)

	Level 3 Recurring Fair Value Measurements Six Months Ended June 30, 2008					
	Fair Value - January 1, 2008	Total Gains (Losses) Included in	Transfers in and/or out of Level 3	Purchases, issuances and settlements	Fair Value - June 30, 2008	Unrealized gains (losses) still held (1)

		Earnings				
Investment securities available-for-sale	$ 15,248	$ (5,408)	$	$ (1,196)	$ 8,644	$ (5,006)
Securitized mortgage collateral	782,574	(236,490)	(119,516)	(128,379)	298,189	(189,290)
Securitized mortgage borrowings	(767,704)	265,815	98,688	86,233	(316,968)	183,216
Trust preferred securities	(40,952)	(5,314)			(46,266)	(5,020)

(1) Represents the amount of total gains or losses for the period, included in earnings, attributable to the change in unrealized gains (losses) relating to assets and liabilities classified as Level 3 that are still held at June 30, 2008.

Table of Contents

The tables below summarize gains and losses due to changes in fair value, including both realized and unrealized gains and losses, recorded in earnings for Level 3 assets and liabilities for the three and six months ended June 30, 2008.

	Recurring Fair Value Measurements Level 3 - Total Gains (Losses) Included in Net Loss Three Months Ended June 30, 2008			
	Investment Securities Available-for-Sale	**Securitized Mortgage Collateral**	**Securitized Mortgage Borrowings**	**Trust Preferred Securities**
Interest income	$ 199	$ 10,306	$	$
Interest expense			(6,275)	(140)
Change in fair value of net trust assets, excluding REO	(1,517)	2,275	(6,113)	
Change in fair value of trust preferred securities				(997)
Total	**$ (1,318)**	**$ 12,581**	**$ (12,388)**	**$ (1,137)**

	Recurring Fair Value Measurements Level 3 - Total Gains (Losses) Included in Net Loss Six Months Ended June 30, 2008			
	Investment Securities Available-for-Sale	**Securitized Mortgage Collateral**	**Securitized Mortgage Borrowings**	**Trust Preferred Securities**
Interest income	$ 399	$ 10,217	$	$
Interest expense			(15,176)	(294)
Change in fair value of net trust assets, excluding REO	(5,807)	(246,707)	280,991	
Change in fair value of trust preferred securities				(5,020)
Total	**$ (5,408)**	**$ (236,490)**	**$ 265,815**	**$ (5,314)**

SFAS 159 permits fair value accounting to be elected for certain assets and liabilities on an individual contract basis at the time of acquisition or under certain other circumstances referred to as remeasurement event dates. For those items for which fair value accounting is elected, changes in fair value will be recognized in earnings, and fees and costs associated with the origination or acquisition of such items will be recognized as incurred rather than deferred. In addition, SFAS 159 allows application of the Statement s provisions to eligible items existing at the effective date and management has elected to apply SFAS 159 to certain of those items as discussed below.

The following is a description of the measurement techniques for items recorded at fair value on a recurring basis and a non-recurring basis.

Recurring basis

Investment Securities Available-for-Sale. Pursuant to the Company s adoption of SFAS 159, the Company elected to carry all of its investment securities available-for-sale at fair value. These investment securities are recorded at fair value and consist primarily of non-investment grade mortgage-backed securities. The fair value of the investment securities are measured based upon the Company s expectation of inputs that other market participants would use. Such assumptions include judgments about the underlying collateral, prepayment speeds, credit losses, and certain other factors. Given

the market disruption and lack of observable market data as of June 30, 2008, the fair value of the investment securities available-for-sale were measured using significant internal expectations of market participants assumptions. At June 30, 2008, investment securities available-for-sale were classified as Level 3 fair value measurements.

Securitized Mortgage Collateral Pursuant to the Company s adoption of SFAS 159, the Company elected to carry all of its securitized mortgage collateral at fair value. These assets consist primarily of Alt-A mortgage loans securitized between 2002 and 2007. Fair value measurements are based on the Company s estimated cash flow models, which incorporate assumptions, inputs of other market participants and quoted prices for the underlying bonds. The Company s assumptions include its expectations of inputs that other market participants would use. These assumptions include judgments about the underlying collateral, prepayment speeds, credit losses, and certain other factors. At June 30, 2008, securitized mortgage collateral was classified as Level 2 or Level 3 measurements depending on the observability of significant inputs to the model. As of June 30, 2008, the unpaid principal balance and fair values of loans 90 days or more past due was $2.7 billion and estimated at $1.6 billion, respectively. The aggregate unpaid principal balances exceed the fair value by $1.1 billion at June 30, 2008.

Table of Contents

Securitized Mortgage Borrowings - Pursuant to the Company s adoption of SFAS 159, the Company elected to carry all of its securitized mortgage borrowings at fair value. These borrowings consist of individual tranches of bonds issued by securitization trusts and are primarily backed by Alt-A mortgage loans. Fair value measurements include the Company s judgments about the underlying collateral assumptions such as prepayment speeds, credit losses, and certain other factors and are based upon quoted prices for the individual tranches of bonds, if available. At June 30, 2008, securitized mortgage borrowings were classified as Level 2 or Level 3 measurements depending on the observability of significant inputs to the model. As of June 30, 2008, the unpaid principal balance and fair value of securitized mortgage borrowings was $16.5 billion and estimated at $11.5 billion, respectively. The aggregate unpaid principal balance exceeds the fair value by $5 billion at June 30, 2008.

Trust Preferred Securities - Pursuant to the Company s adoption of SFAS 159, the Company elected to carry all of its trust preferred securities at fair value. These securities were measured based upon using other preferred stock issued by the Company adjusted for differences between the securities. The fair value of the trust preferred securities resulted in adjustments to reduce the par value for the following factors:

- Stated interest rate adjustments to account for the stated yield difference between the trust preferred securities and the preferred stock issued by the Company,
- Liquidity adjustments to reflect the presence of a lack of an actively traded market for these securities.
- Preference adjustments to reflect the rights of the trust preferred securities as compared to the preferred securities.

At June 30, 2008 trust preferred securities were classified as Level 3 measurements. As of June 30, 2008, the unpaid principal balance and fair value of trust preferred securities was $99.2 million and $46.3 million, respectively. The aggregate unpaid principal balance exceeds the fair value by $52.9 million at June 30, 2008.

Derivative Assets and Liabilities. For non-exchange traded contracts, fair value is based on the amounts that would be required to settle the positions with the related counterparties as of the valuation date. Valuations of derivative assets and liabilities reflect the value of the instruments, including the values associated with counterparty risk. With the issuance of SFAS 157, these values must also take into account the Company s own credit standing, to the extent applicable, thus included in the valuation of the derivative instrument is the value of the net credit differential between the counterparties to the derivative contract. At June 30, 2008, derivative assets and liabilities were classified as Level 2 measurements.

Non-recurring basis

The Company is required to measure certain assets at fair value from time-to-time. These fair value measurements typically result from the application of specific accounting pronouncements under GAAP. The fair value measurements are considered non-recurring fair value measurements under SFAS 157.

Loans Held-for-Sale - Loans held-for-sale for which the fair value option was not elected are carried at lower of cost or market (LOCOM). When available, such measurements are based upon what secondary markets offer for portfolios with similar characteristics, and are considered Level 2 measurements. If market pricing is not available, such measurements are significantly impacted by the Company s expectations of other market participants assumptions, and are considered Level 3 measurements. The Company utilizes internal pricing processes to estimate the fair value of loans held-for-sale, which is based on recent loan sales and estimates of the fair value of the underlying collateral. Loans held-for-sale, which are primarily included in assets of discontinued operations, are considered Level 3 measurements at June 30, 2008.

Mortgage Servicing Rights - Mortgage servicing rights (MSRs) for which the fair value option was not elected are carried at LOCOM. MSRs are not traded in an active market with observable prices. The Company utilizes internal pricing processes to estimate the fair value of MSRs, which are based on assumptions the Company believes would be used by market participants, including market discount rates, float, prepayment speeds and master servicing fees. MSRs, which are included in other assets, are considered Level 3 measurements at June 30, 2008.

Table of Contents

The following table presents the fair values of those financial assets measured at fair value on a non-recurring basis at June 30, 2008.

	Non-recurring Fair Value Measurements As of June 30, 2008				Total Gains (Losses) For the Periods Ended June 30, 2008	
	Level 1	Level 2	Level 3	Total	Three Months	Six Months
Loans held-for-sale (1)	$	$	$ 167,420	$ 167,420	$ (7,885)	$ (16,249)
Mortgage servicing rights	$	$	$ 1,677	$ 1,677	$ (301)	$ (948)

(1) Includes $1.8 million and $165.6 million of loans held-for-sale within continuing and discontinued operations, respectively at June 30, 2008.

The following table represents changes in fair value of recurring fair value measurements for the three and six months ended June 30, 2008.

	Recurring Fair Value Measurements Changes in Fair Value Included in Net Loss Three Months Ended June 30, 2008				
			Change in Fair Value of		
	Interest Income	Interest Expense	Net Trust Assets	Trust Preferred Securities	Total
Investment securities available-for-sale	$ 687	$	$ (1,517)	$	$ (830)
Securitized mortgage collateral	406,988		(19,062)		387,926
Securitized mortgage borrowings		(401,431)	(88,886)		(490,317)
Trust preferred securities		(2,168)		(997)	(3,165)
Derivative instruments					