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**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION**  
Washington, DC 20549

**FORM 10-Q**

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

**For the quarterly period ended June 30, 2004**

**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: 1-11416**

**CONSUMER PORTFOLIO SERVICES, INC.**

(Exact name of registrant as specified in its charter)

California  
(State or other jurisdiction of  
incorporation or organization)

33-0459135  
(IRS Employer  
Identification No.)

16355 Laguna Canyon Road, Irvine, California  
(Address of principal executive offices)

92618  
(Zip Code)

**Registrant's telephone number: (949) 753-6800**

**Former name, former address and former fiscal year, if changed since last report: N/A**

Indicate by check mark whether the registrant (1) 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  No

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

As of August 12, 2004 the registrant had 21,354,069 common shares outstanding.

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**CONSUMER PORTFOLIO SERVICES, INC. AND SUBSIDIARIES**  
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**Item 1. Financial Statements****CONSUMER PORTFOLIO SERVICES, INC. AND SUBSIDIARIES  
UNAUDITED CONDENSED CONSOLIDATED BALANCE SHEETS  
(In thousands, except share and per share data)**

	<b>June 30, 2004</b>	<b>December 31, 2003</b>
<b>ASSETS</b>		
Cash	\$ 15,292	\$ 33,209
Restricted cash	70,049	67,277
Finance receivables	460,005	302,078
Less: Allowance for finance credit losses	(38,731)	(35,889)
Finance receivables, net	421,274	266,189
Servicing fees receivable	5,573	3,942
Residual interest in securitizations	81,304	111,702
Furniture and equipment, net	1,740	826
Deferred financing costs	4,443	1,529
Other assets	13,925	7,796
	<u>\$ 613,600</u>	<u>\$ 492,470</u>
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
<b>Liabilities</b>		
Accounts payable and accrued expenses	\$ 23,088	\$ 22,920
Warehouse lines of credit	57,114	33,709
Tax liabilities, net	3,083	2,768
Capital lease obligation	424	-
Notes payable	2,132	3,330
Residual interest financing	33,799	-
Securitization trust debt	337,058	245,118
Senior secured debt	59,829	49,965
Subordinated debt	15,000	35,000
Related party debt	-	17,500
	<u>531,527</u>	<u>410,310</u>
<b>Shareholders' Equity</b>		
Preferred stock, \$1 par value; authorized 5,000,000 shares; none issued	-	-
Series A preferred stock, \$1 par value; authorized 5,000,000 shares; 3,415,000 shares issued; none outstanding	-	-
Common stock, no par value; authorized 30,000,000 shares; 21,286,769 and 20,588,924 shares issued and outstanding at June 30, 2004 and December 31, 2003, respectively	65,701	64,397
Retained earnings	19,411	20,992
Comprehensive loss - minimum pension benefit obligation, net	(2,426)	(2,426)
Deferred compensation	(613)	(803)
	<u>82,073</u>	<u>82,160</u>
	<u>\$ 613,600</u>	<u>\$ 492,470</u>

See accompanying Notes to Unaudited Condensed Consolidated Financial Statements.

**CONSUMER PORTFOLIO SERVICES, INC. AND SUBSIDIARIES**  
**UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS**  
(In thousands, except per share data)

	<u>Three Months Ended</u> <u>June 30,</u>		<u>Six Months Ended</u> <u>June 30,</u>	
	<u>2004</u>	<u>2003</u>	<u>2004</u>	<u>2003</u>
<b>Revenues:</b>				
Gain on sale of contracts, net	\$ -	\$ 4,109	\$ -	\$ 8,664
Interest income	25,722	11,442	46,145	20,770
Servicing fees	3,507	4,463	6,831	9,065
Other income	3,458	4,333	7,233	8,763
	<u>32,687</u>	<u>24,347</u>	<u>60,209</u>	<u>47,262</u>
<b>Expenses:</b>				
Employee costs	9,794	9,442	19,447	17,889
General and administrative	6,466	4,049	10,433	8,081
Interest	7,500	5,086	13,412	10,617
Provision for credit losses	6,300	-	13,050	-
Marketing	1,784	1,395	3,317	2,728
Occupancy	808	1,004	1,751	1,984
Depreciation and amortization	209	239	380	477
	<u>32,861</u>	<u>21,215</u>	<u>61,790</u>	<u>41,776</u>
Income (loss) before income tax expense (benefit)	(174)	3,132	(1,581)	5,486
Income tax expense (benefit)	-	490	-	(3,434)
Net income (loss)	<u>\$ (174)</u>	<u>\$ 2,642</u>	<u>\$ (1,581)</u>	<u>\$ 8,920</u>
Earnings (loss) per share:				
Basic	\$ (0.01)	\$ 0.13	\$ (0.08)	\$ 0.44
Diluted	(0.01)	0.12	(0.08)	0.41
Number of shares used in computing earnings (loss) per share:				
Basic	21,016	20,209	20,827	20,239
Diluted	21,016	21,565	20,827	22,160

See accompanying Notes to Unaudited Condensed Consolidated Financial Statements.

**CONSUMER PORTFOLIO SERVICES, INC.**  
**UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**  
(In thousands)

	Six Months Ended	
	June 30,	
	2004	2003
<i>Cash flows from operating activities:</i>		
Net income (loss)	\$ (1,581)	\$ 8,920
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Depreciation and amortization	380	477
Amortization of deferred financing costs	1,206	1,413
Provision for credit losses	13,050	526
NIR gains recognized	-	(6,676)
Loss on sale of furniture and equipment	8	-
Stock-based compensation expense	148	447
Releases of cash from Trusts to Company	12,140	13,859
Initial deposits to Trusts	-	(17,299)
Net deposits to Trusts to increase Credit Enhancement	(1,344)	(1,325)
Decrease in receivables from Trusts and investment in subordinated certificates	19,602	7,769
Changes in assets and liabilities:		
Restricted cash	(2,772)	2,819
Purchases of contracts held for sale	-	(182,045)
Amortization and liquidation of contracts held for sale	-	216,769
Servicing fees receivable and other assets	(7,825)	3,885
Accounts payable and accrued expenses	168	(1,299)
Tax liabilities, net	315	(1,348)
Net cash provided by operating activities	<u>33,495</u>	<u>46,892</u>
<i>Cash flows from investing activities:</i>		
Purchases of contracts held for investment	(255,422)	-
Amortization of contracts held for investment	87,287	-
Purchase of furniture and equipment	(758)	(67)
Purchase of subsidiary, net of cash acquired	-	(10,181)
Net cash used in investing activities	<u>(168,893)</u>	<u>(10,248)</u>
<i>Cash flows from financing activities:</i>		
Proceeds from issuance of senior secured debt	25,000	25,000
Proceeds from issuance of securitization trust debt	160,728	-
Proceeds from issuance of residual financing debt	44,000	-
Net proceeds from warehouse lines of credit	23,405	2,188
Repayment of residual interest financing debt	(10,201)	-
Repayment of securitization trust debt	(68,788)	(37,205)
Repayment of senior secured debt	(15,136)	(22,576)
Repayment of subordinated debt	(20,000)	(34)
Repayment of capital lease obligations	(56)	(51)
Repayment of notes payable	(1,198)	(1,058)
Repayment of related party debt	(16,500)	-
Payment of financing costs	(4,120)	(1,300)
Purchase of common stock	(25)	(1,116)
Exercise of options and warrants	372	172
Net cash provided by (used in) financing activities	<u>117,481</u>	<u>(35,980)</u>
Increase (decrease) in cash	(17,917)	664
Cash at beginning of period	33,209	32,947
Cash at end of period	<u>\$ 15,292</u>	<u>\$ 33,611</u>
<i>Supplemental disclosure of cash flow information:</i>		
Cash paid (received) during the period for:		
Interest	\$ 12,425	\$ 7,849
Income taxes	831	(2,085)
<i>Supplemental disclosure of non-cash investing and financing activities:</i>		
Stock compensation	\$ 42	\$ 447
Conversion of related party debt to common stock	1,000	-
Furniture and equipment acquired through capital leases	480	-

See accompanying Notes to Unaudited Condensed Consolidated Financial Statements.

## CONSUMER PORTFOLIO SERVICES, INC.

### NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

#### (1) Summary of Significant Accounting Policies

##### *Description of Business*

Consumer Portfolio Services, Inc. (“CPS”) was incorporated in California on March 8, 1991. CPS and its subsidiaries (collectively, the “Company”) specialize primarily in purchasing, selling and servicing retail automobile installment sale contracts (“Contracts” or “finance receivables”) originated by licensed motor vehicle dealers (“Dealers”) located throughout the United States. The Company purchases Contracts with obligors who generally would not be expected to qualify for traditional financing, such as that provided by commercial banks or automobile manufacturers’ captive finance companies.

##### *Acquisition of MFN Financial Corporation*

On March 8, 2002, CPS acquired 100% of MFN Financial Corporation, a Delaware corporation (“MFN”) and its subsidiaries, by the merger (the “MFN Merger”) of a direct wholly-owned subsidiary of CPS with and into MFN. MFN thus became a wholly-owned subsidiary of CPS, and CPS thus acquired the assets of MFN, which consisted principally of interests in automobile installment sales finance Contracts and the facilities for originating and servicing such Contracts. The MFN Merger was accounted for as a purchase.

MFN, through its primary operating subsidiary, Mercury Finance Company LLC, was in the business of purchasing automobile installment sales finance Contracts from Dealers, and securitizing and servicing such Contracts. CPS continues to use the assets acquired in the MFN Merger in the automobile finance business, but has disposed of a portion of such assets. MFN has ceased to purchase automobile installment sales finance Contracts, and does not anticipate recommencing such purchasing. In connection with the termination of MFN origination activities and the integration and consolidation of certain activities, the Company has recognized certain liabilities related to the costs to exit these activities and terminate the affected employees of MFN. These activities include service departments such as accounting, finance, human resources, information technology, administration, payroll and executive management. These costs include the following:

	<b>June 30, 2004(1)</b>	<b>Activity</b>	<b>December 31, 2003</b>	<b>Activity</b>	<b>March 8, 2002</b>
	<b>(In thousands)</b>				
Sevrence payments and consulting contracts.....	\$ -	\$ -	\$ -	\$ 3,215	\$ 3,215
Facilities closures.....	1,551	338	1,889	263	2,152
Termination of conratcs, leases, services and other obligations.....	-	-	-	597	597
Acquisition expenses accrued but unpaid.....	-	-	-	250	250
Total liabilities assumed.....	\$ 1,551	\$ 338	\$ 1,889	\$ 4,325	\$ 6,214

(1) The initial accrual amount recorded was \$6.2 million on March 8, 2002 and the remaining accrual recorded in the Condensed Consolidated Balance Sheet of the Company is approximately \$1.6 million, \$1.9 million, and \$2.9 million as of June 30, 2004, December 31, 2003 and December 31, 2002, respectively. The Company believes that this amount provides adequately for anticipated remaining costs related to exiting certain activities of MFN, and that amounts indicated above are reasonably allocated.

The Company’s Condensed Consolidated Balance Sheet and Condensed Consolidated Statements of Operations as of and for the three and six months ended June 30, 2004 and 2003, include the balance sheet accounts and results of operations of MFN Financial Corporation.

The following table summarizes the estimated fair value of the assets acquired and liabilities assumed at the date of acquisition.

**CONSUMER PORTFOLIO SERVICES, INC.**

**NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

	<b>March 8, 2002</b>
	<b>(In thousands)</b>
Cash.....	\$ 93,782
Restricted cash.....	25,499
Finance Contracts, net.....	186,554
Residual interest in securitizations.....	32,485
Other assets.....	12,006
Total assets acquired.....	<u>350,326</u>
Securitization trust debt.....	156,923
Subordinated debt.....	22,500
Accounts payable and other liabilities.....	30,242
Total liabilities assumed.....	<u>209,665</u>
Net assets acquired.....	140,661
Less: purchase price.....	123,249
Excess of net assets acquired over purchase price.....	<u>\$ 17,412</u>

*Acquisition of TFC Enterprises, Inc.*

On May 20, 2003, CPS acquired TFC Enterprises, Inc., a Delaware corporation (“TFC”) and its subsidiaries, by the merger (the “TFC Merger”) of a direct, wholly-owned subsidiary of CPS, with and into TFC. In the TFC Merger, TFC became a wholly-owned subsidiary of CPS. CPS thus acquired the assets of TFC and its subsidiaries, which consisted principally of interests in motor vehicle installment sales finance Contracts, interests in securitized pools of such Contracts, and the facilities for originating and servicing such Contracts. The TFC Merger was accounted for as a purchase.

TFC, through its primary operating subsidiary, “The Finance Company,” purchases motor vehicle installment sales finance Contracts from automobile Dealers, and securitizes and services such Contracts. CPS has continued to use the assets acquired in the TFC Merger in the automobile finance business.

In connection with the integration and consolidation of certain activities between CPS and TFC, the Company has recognized certain liabilities related to the costs to integrate certain activities and terminate the affected employees of TFC. These activities include service departments such as accounting, finance, human resources, information technology, administration, payroll and executive management. The total of these liabilities recognized by the Company at the time of the merger was \$4.5 million. These costs include the following:

	<b>June 30,</b>		<b>December 31,</b>
	<b>2004(1)</b>	<b>Activity</b>	<b>2003</b>
		<b>(In thousands)</b>	
Severance payments and consulting contracts.....	\$ 1,860	\$ 466	\$ 2,326
Facilities closures.....	1,006	225	1,231
Other obligations.....	75	159	234
Total liabilities assumed.....	<u>\$ 2,941</u>	<u>\$ 850</u>	<u>\$ 3,791</u>

(1) The initial accrual amount recorded was \$4.5 million on May 20, 2003 and the remaining accrual recorded in the Condensed Consolidated Balance Sheet of the Company is approximately \$2.9 million and \$3.8 million as of June 30, 2004 and December 31, 2003, respectively. The Company believes that this amount provides adequately for anticipated remaining costs related to exiting certain activities of TFC, and that amounts indicated above are reasonably allocated.

At the closing of the TFC Merger, each outstanding share of common stock of TFC became a right to receive \$1.87 per share in cash. The total merger consideration paid to stockholders of TFC was approximately \$21.6 million. The recipients of the total merger consideration had no material relationship

## CONSUMER PORTFOLIO SERVICES, INC.

### NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

with CPS, its directors, its officers or any associates of such directors or officers, to the best of CPS's knowledge. The merger consideration was paid with existing cash of CPS. The aggregate purchase price, including expenses related to the transaction, was approximately \$23.7 million.

The Company's Condensed Consolidated Balance Sheet and Condensed Consolidated Statements of Operations as of and for the three and six months ended June 30, 2004, include the balance sheet accounts of TFC Enterprises, Inc. as of June 30, 2004 and the results of operations subsequent to May 20, 2003, the merger date. The Company has recorded certain purchase accounting adjustments on its Condensed Consolidated Balance Sheet, which are estimates based on available information.

The following table summarizes the recorded amounts of the assets acquired and liabilities assumed at the date of acquisition.

	<b>May 20, 2003</b>
	<b>(In thousands)</b>
Cash.....	\$ 13,545
Restricted cash.....	17,723
Finance Contracts, net.....	125,108
Other assets.....	502
Total assets acquired.....	156,878
Securitization trust debt.....	115,597
Subordinated debt.....	6,321
Capital lease obligations.....	17
Accounts payable and other liabilities.....	11,217
Total liabilities assumed.....	133,152
Purchase price.....	\$ 23,726

#### *Pro Forma Results of Operations*

Selected unaudited pro forma combined results of operations for the three- and six-month periods ended June 30, 2003, assuming the TFC Merger occurred on January 1, 2003, are as follows:

	<b>Three Months Ended</b>		<b>Six Months Ended</b>
	<b>June 30,</b>		<b>June 30,</b>
	<b>2003</b>		<b>2003</b>
	<b>(In thousands)</b>		
Total revenue.....	\$ 26,340	\$	52,926
Net earnings.....	2,646	\$	9,349
Basic net earnings per share.....	0.13	\$	0.46
Diluted net earnings per share.....	0.12	\$	0.43

#### *Acquisition of Receivables and Other Assets from SeaWest Financial Corporation*

The Company acquired on April 2, 2004 automotive receivables and other assets (the "SeaWest Asset Acquisition") of SeaWest Financial Corporation ("SeaWest"). The aggregate purchase price was approximately \$63.2 million, which was funded with the proceeds of an acquisition financing facility and existing cash. The other assets included a \$2.8 million note to an affiliate of SeaWest and certain furniture and equipment. In addition, the Company has been appointed the successor servicer on three separate term securitization transactions originally sponsored by SeaWest (the "SeaWest Third Party Portfolio").

#### *Basis of Presentation*

The unaudited Condensed Consolidated Financial Statements of the Company have been prepared in conformity with accounting principles generally accepted in the United States of America, with the instructions to Form 10-Q and with Article 10 of Regulation S-X of the Securities and Exchange Commission, and include all adjustments that are, in the opinion of management, necessary for a fair



## CONSUMER PORTFOLIO SERVICES, INC.

### NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

presentation of the results for the interim periods presented. All such adjustments are, in the opinion of management, of a normal recurring nature. In addition, certain items in prior period financial statements have been reclassified for comparability to current period presentation. Results for the three- and six-month periods ended June 30, 2004 are not necessarily indicative of the operating results to be expected for the full year.

Certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed or omitted. These Condensed Consolidated Financial Statements should be read in conjunction with the Consolidated Financial Statements and Notes to Consolidated Financial Statements included in the Company's Annual Report on Form 10-K for the year ended December 31, 2003.

#### *Recent Developments*

In July 2003, the Company agreed with the other parties to its continuous or "warehouse" securitization facilities to amend the terms of such facilities. The effect of the amendments is to cause use of those facilities to be treated for financial accounting purposes as borrowings secured by pledged Contracts, rather than as sales of such Contracts.

In addition, the Company announced in August 2003 that it would structure its future term securitization transactions so that they would be treated for financial accounting purposes as borrowings secured by receivables, rather than as sales of receivables. The new structure for the warehouse facilities described in the preceding paragraph and the change in structure of the Company's term securitizations has affected and will affect the way in which the transactions are reported. The major effects are these: (i) the finance receivables are shown as assets of the Company on its balance sheet; (ii) the debt issued in the transactions is shown as indebtedness of the Company on its balance sheet; (iii) cash deposited to enhance the credit of the securitization transactions is shown as "restricted cash" on the Company's balance sheet; (iv) cash collected from borrowers and other sources related to the receivables prior to making the required payments under the Securitization Agreements is also shown as "Restricted cash" on the Company's balance sheet; (v) the servicing fee that the Company receives in connection with such receivables is recorded as a portion of the interest earned on such receivables in the Company's statements of operations; (vi) the Company has initially and periodically recorded as expense a provision for estimated credit losses on the receivables in the Company's statements of operations; and (vii) the portion of scheduled payments on the receivables representing interest is recorded as revenue as accrued in the Company's statements of operations.

These changes collectively represent a deferral of revenue and acceleration of expenses, and thus a more conservative approach to accounting for the Company's operations. The changes initially have resulted in the Company reporting lower earnings than it would have reported if it had continued structuring its securitizations to require recognition of gain on sale.

#### *Treatment of Securitizations*

Gain on sale may be recognized on the disposition of Contracts either outright or in securitization transactions. In those securitization transactions that were treated as sales for financial accounting purposes, the Company, or a wholly-owned, consolidated subsidiary of the Company, retained a residual interest in the Contracts that were sold to a wholly-owned, unconsolidated special purpose subsidiary. The Company's securitization transactions include "term" securitizations (the purchaser holds the Contracts for substantially their entire term) and "continuous" or "warehouse" securitizations (which finance the acquisition of the Contracts for future sale into term securitizations).

As of June 30, 2004 and December 31, 2003, the line item "Residual interest in securitizations" on the Company's Condensed Consolidated Balance Sheet represents the residual interests in certain term securitizations but no residual interest in warehouse securitizations, because the Company's warehouse securitizations were restructured in July 2003 as secured financings. Subsequent term securitizations of

## CONSUMER PORTFOLIO SERVICES, INC.

### NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

receivables purchased under the CPS programs in September 2003, December 2003 and May 2004 were also structured as secured financings. In addition, in June 2004, an affiliate of the Company completed a term securitization of Contracts purchased in the SeaWest Asset Acquisition and under TFC's programs, which was structured as a secured financing. The warehouse securitizations are accordingly reflected in the line items "Finance receivables" and "Warehouse lines of credit" on the Company's Condensed Consolidated Balance Sheet, and the term securitizations are reflected in the line items "Finance receivables" and "Securitization trust debt." The "Residual interest in securitizations" represents the discounted sum of expected future releases from securitization trusts. Accordingly, the valuation of the residual is heavily dependent on estimates of future performance.

The Company's securitization structure is generally as follows:

The Company sells Contracts it acquires to a wholly-owned Special Purpose Subsidiary ("SPS"), which has been established for the limited purpose of buying and reselling the Company's Contracts. The SPS then transfers the same Contracts to another entity, typically a statutory trust ("Trust"). The Trust issues interest-bearing asset backed securities (the "Notes"), generally in a principal amount equal to the aggregate principal balance of the Contracts. The Company typically sells these Contracts to the Trust at face value and without recourse, except that representations and warranties similar to those provided by the Dealer to the Company are provided by the Company to the Trust. One or more investors purchase the Notes issued by the Trust; the proceeds from the sale of the Notes are then used to purchase the Contracts from the Company. The Company may retain or sell subordinated Notes issued by the Trust. The Company purchases a financial guaranty insurance policy, guaranteeing timely payment of principal and interest on the senior Notes, from an insurance company (a "Note Insurer"). In addition, the Company provides "Credit Enhancement" for the benefit of the Note Insurer and the investors in the form of an initial cash deposit to a bank account (a "Spread Account") held by the Trust, in the form of overcollateralization of the Notes, where the principal balance of the Notes issued is less than the principal balance of the Contracts; in the form of subordinated Notes; or some combination of such Credit Enhancements. The agreements governing the securitization transactions (collectively referred to as the "Securitization Agreements") require that the initial level of Credit Enhancement be supplemented by a portion of collections from the Contracts until the level of Credit Enhancement reaches specified levels, and then maintained at those levels. The specified levels are generally computed as a percentage of the remaining unpaid principal amount under the related Contracts. The specified levels at which the Credit Enhancements are to be maintained will vary depending on the performance of the portfolios of Contracts held by the Trusts and on other conditions, and may also be varied by agreement among the Company, the SPS, the Note Insurers and the trustee. Such levels have increased and decreased from time to time based on performance of the portfolios, and have also varied by Securitization Agreement. The Securitization Agreements generally grant the Company the option to repurchase the sold Contracts from the Trust when the aggregate outstanding balance has amortized to a specified percentage of the initial aggregate balance.

The prior securitizations that were treated as sales for financial accounting purposes differ from secured financings in that the Trust to which the SPS sold the Contracts in those prior securitizations met the definition of a qualified special purpose entity under Statement of Financial Accounting Standards No. 140 ("SFAS 140"). As a result, assets and liabilities of the Trust in those prior securitizations are not consolidated into the Company's Condensed Consolidated Balance Sheet.

The Company's warehouse securitization structures are similar to the above, except that (i) the SPS that purchases the Contracts pledges the Contracts to secure promissory notes that it issues, (ii) the promissory notes are in an aggregate principal amount of not more than 73.0% to 73.5% of the aggregate principal balance of the Contracts (that is, at least 26.5% overcollateralization), and (iii) no increase in the required amount of Credit Enhancement is contemplated unless certain portfolio performance tests are breached. During the quarter ended September 30, 2003, the warehouse securitizations related to the CPS programs were amended to provide for the transactions to be reflected as secured financings for financial accounting purposes. The Contracts held by the warehouse SPS and the promissory notes that it issues are

## CONSUMER PORTFOLIO SERVICES, INC.

### NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

therefore included in the Company's Condensed Consolidated Financial Statements as of June 30, 2004 and December 31, 2003 as assets and liabilities, respectively.

Upon each sale of Contracts in a securitization structured as a secured financing, whether a term securitization or a continuous securitization, the Company retains on its Condensed Consolidated Balance Sheet the Contracts securitized as assets and records the Notes issued in the transaction as indebtedness of the Company.

Under the prior securitizations structured as sales for financial accounting purposes, the Company removed from its Condensed Consolidated Balance Sheet the Contracts sold and added to its Condensed Consolidated Balance Sheet (i) the cash received and (ii) the estimated fair value of the ownership interest that the Company retains in Contracts sold in the securitization. That retained or residual interest (the "Residual") consists of (a) the cash held in the Spread Account, if any, (b) overcollateralization, if any, (c) subordinated Notes retained, if any, and (d) receivables from Trust, which include the net interest receivables ("NIRs"). NIRs represent the estimated discounted cash flows to be received from the Trust in the future, net of principal and interest payable with respect to the Notes, and certain expenses. The excess of the cash received and the assets retained by the Company over the carrying value of the Contracts sold, less transaction costs, equals the net gain on sale of Contracts recorded by the Company. Until the maturity of these transactions, the Company's Condensed Consolidated Balance Sheet will reflect securitization transactions structured both as sales and as secured financings.

With respect to the prior securitizations structured as sales for financial accounting purposes, the Company allocated its basis in the Contracts between the Notes sold and the Residuals retained based on the relative fair values of those portions on the date of the sale. The Company recognized gains or losses attributable to the change in the fair value of the Residuals, which are recorded at estimated fair value. The Company is not aware of an active market for the purchase or sale of interests such as the Residuals; accordingly, the Company determines the estimated fair value of the Residuals by discounting the amount and timing of anticipated cash flows that it estimates will be released to the Company in the future (the cash out method), using a discount rate that the Company believes is appropriate for the risks involved. The anticipated cash flows include collections from both current and charged off receivables. The Company has used an effective pre-tax discount rate of approximately 14% per annum except for certain collections from charged off receivables related to the Company's securitizations in 2001 and later for which the Company has used a discount rate of approximately 25%.

The Company receives periodic base servicing fees for the servicing and collection of the Contracts. In addition, the Company is entitled to the cash flows from the Residuals that represent collections on the Contracts in excess of the amounts required to pay principal and interest on the Notes, the base servicing fees, and certain other fees (such as trustee and custodial fees). Required principal payments are generally defined as the payments sufficient to keep the principal balance of the Notes equal to the aggregate principal balance of the related Contracts (excluding those Contracts that have been charged off), or a pre-determined percentage of such balance. Where that percentage is less than 100%, the related Securitization Agreements require accelerated payment of principal until the principal balance of the Notes is reduced to the specified percentage. Such accelerated principal payment is said to create overcollateralization of the Notes.

If the amount of cash required for payment of fees, interest and principal exceeds the amount collected during the collection period, the shortfall is withdrawn from the Spread Account, if any. If the cash collected during the period exceeds the amount necessary for the above allocations, and there is no shortfall in the related Spread Account, the excess is released to the Company, or in certain cases is transferred to other Spread Accounts that may be below their required levels. If the Spread Account balance is not at the required credit enhancement level, then the excess cash collected is retained in the Spread Account until the specified level is achieved. Although Spread Account balances are held by the Trusts on behalf of the Company's SPS as the owner of the Residuals (in the case of securitization

## CONSUMER PORTFOLIO SERVICES, INC.

### NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

transactions structured as sales for financial accounting purposes) or the Trusts (in the case of securitization transactions structured as secured financings for financial accounting purposes), the cash in the Spread Accounts is restricted from use by the Company. Cash held in the various Spread Accounts is invested in high quality, liquid investment securities, as specified in the Securitization Agreements. The interest rate payable on the Contracts is significantly greater than the interest rate on the Notes. As a result, the Residuals described above are a significant asset of the Company. In determining the value of the Residuals, the Company must estimate the future rates of prepayments, delinquencies, defaults, default loss severity, and recovery rates, as all of these factors affect the amount and timing of the estimated cash flows. The Company estimates prepayments by evaluating historical prepayment performance of comparable Contracts. As of June 30, 2004, the Company has used prepayment estimates of approximately 18.9% to 23.5% cumulatively over the lives of the related Contracts. The Company estimates defaults and default loss severity using available historical loss data for comparable Contracts and the specific characteristics of the Contracts purchased by the Company. The Company estimates recovery rates of previously charged off receivables using available historical recovery data and projected future recovery levels. In valuing the Residuals as of June 30, 2004, the Company estimates that charge-offs as a percentage of the original principal balance will approximate 15.6% to 23.5% cumulatively over the lives of the related Contracts, with recovery rates approximating 2.5% to 5.4% of the original principal balance.

Following a securitization that is structured as a sale for financial accounting purposes, interest income is generally recognized on the balance of the Residuals at the same rate as used for calculating the present value of the NIRs, which is equal to 14% per annum. In addition, the Company will recognize additional revenue from the Residuals if the actual performance of the Contracts is better than the original estimate. If the actual performance of the Contracts were worse than the original estimate, then an impairment loss would be required to reduce the carrying value of the Residuals. In a securitization structured as a secured financing for financial accounting purposes, interest income is recognized when accrued under the terms of the related Contracts and, therefore, presents less potential for fluctuations in performance when compared to the approach used in a transaction structured as a sale for financial accounting purposes.

In all the Company's term securitizations, whether treated as secured financings or as sales, the Company has transferred the receivables (through a subsidiary) to the securitization Trust. The difference between the two structures is that in securitizations that are treated as secured financings the Company reports the assets and liabilities of the securitization Trust on its Consolidated Balance Sheet. Under both structures the Noteholders and the related securitization Trusts have no recourse to the Company for failure of the Contract obligors to make payments on a timely basis. The Company's Residuals, however, are subordinate to the Notes until the Noteholders are fully paid, and the Company is therefore at risk to that extent.

#### *Other Income*

Other income consists primarily of recoveries on certain previously charged off Contracts and state sales tax refunds.

#### *Stock Based Compensation*

As permitted by Statement of Financial Accounting Standards No. 123, "Accounting for Stock-Based Compensation" ("SFAS No. 123"), the Company accounts for stock-based employee compensation plans in accordance with Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees" and related interpretations, whereby stock options are recorded at intrinsic value equal to the excess of the share price over the exercise price at the measurement date. The Company provides the pro forma net income (loss), pro forma earnings (loss) per share, and stock based compensation plan disclosure requirements as set forth in SFAS No. 123. The Company accounts for re-priced options as variable awards.

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Compensation cost has been recognized for certain stock options in the Consolidated Financial Statements in accordance with APB Opinion No. 25. Had the Company determined compensation cost based on the fair value at the grant date for its stock options under Statement of Financial Accounting Standards No. 123 (“SFAS 123”), “Accounting for Stock Based Compensation,” the Company’s net income (loss) and earnings (loss) per share would have been reduced to the pro forma amounts indicated below.

	Three Months Ended		Six Months Ended	
	June 30,		June 30,	
	2004	2003	2004	2003
	(In thousands, except per share data)			
Net income (loss), as reported.....	\$ (174)	\$ 2,642	\$ (1,581)	\$ 8,920
Stock-based employee compensation expense, fair value method, net of tax.....	(209)	(162)	(396)	(425)
Previously recorded stock-based employee compensation expense, intrinsic value method, net of tax.....	85	340	86	259
Pro forma net income (loss).....	<u>\$ (298)</u>	<u>\$ 2,820</u>	<u>\$ (1,891)</u>	<u>\$ 8,754</u>
Net income (loss) per share.....				
Basic, as reported.....	\$ (0.01)	\$ 0.13	\$ (0.08)	\$ 0.44
Diluted, as reported (1).....	\$ (0.01)	\$ 0.12	\$ (0.08)	\$ 0.41
Pro forma Basic.....	\$ (0.01)	\$ 0.14	\$ (0.09)	\$ 0.43
Pro forma Diluted (1).....	\$ (0.01)	\$ 0.13	\$ (0.09)	\$ 0.41

(1) The assumed conversion of certain subordinated debt during the three- and six-month periods ended June 30, 2003, resulted in an increase to income for purposes of the diluted earnings per share calculation of \$18,000 and \$268,000, respectively.

Pro forma net income (loss) and income (loss) per share reflect only options granted in the years ended December 31, 1996 to June 30, 2004. Therefore, the full effect of calculating compensation cost for stock options under SFAS No. 123 is not reflected in the pro forma amounts presented above, as compensation expense for options granted prior to 1996 is not considered.

*Purchases of Company Stock*

During the six-month periods ended June 30, 2004 and 2003, the Company purchased 6,738 and 519,926 shares, respectively, of its common stock at an average price of \$3.75 and \$2.15, respectively.

*New Accounting Pronouncements*

In December 2003, the FASB issued FASB Interpretation No. 46 (revised December 2003, FIN 46R), *Consolidation of Variable Interest Entities*, which addresses how a business enterprise should evaluate whether it has a controlling financial interest in an entity through means other than voting rights and accordingly should consolidate the entity. FIN 46R replaces FASB Interpretation No. 46, *Consolidation of Variable Interest Entities*, which was issued in January 2003. The Company will be required to apply FIN 46R to variable interests in Variable Interest Entities (“VIEs”) created after December 31, 2003. For variable interests in VIEs created before January 1, 2004, the Interpretation will be applied beginning on January 1, 2005. For any VIEs that must be consolidated under FIN 46R that were created before January 1, 2004, the assets, liabilities and noncontrolling interests of the VIE initially would be measured at their carrying amounts with any difference between the net amount added to the balance sheet and any previously recognized interest being recognized as the cumulative effect of an accounting change. If determining the carrying amounts is not practicable, fair value at the date FIN 46R first applies may be used. Certain of the Company’s subsidiaries are qualifying special purpose entities formed in connection with off-balance sheet securitizations and are not subject to the requirements of FIN 46R. The Company’s subsidiaries that are considered VIEs subject to the requirements of FIN 46R consist of Trusts related to

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the Company's on-balance sheet securitizations, which are currently consolidated and in the Company's consolidated financial statements. The adoption of FIN 46R did not have a material effect on the Company.

**(2) Finance Receivables**

The following table presents the components of Finance Receivables, net of unearned interest:

	<b>June 30, 2004</b>	<b>December 31, 2003</b>
	<b>(In thousands)</b>	
Finance Receivables		
Automobile		
Simple Interest.....	\$ 375,104	\$ 178,679
Pre-compute or "Rule of 78's", net of unearned interest.....	110,845	133,339
Finance Receivables, net of unearned interest.....	485,949	312,018
Less: Unearned acquisition fees and discounts.....	(25,944)	(9,940)
Finance Receivables.....	<u>\$ 460,005</u>	<u>\$ 302,078</u>

The following table presents the contractual maturities of Finance Receivables, net of unearned income as of June 30, 2004:

	<b>Amount</b>	<b>%</b>
	<b>(Dollars in thousands)</b>	
Due in 2004.....	\$ 6,238	1.29%
Due in 2005.....	27,435	5.65%
Due in 2006.....	45,602	9.38%
Due in 2007.....	60,204	12.39%
Due in 2008.....	142,405	29.30%
Due thereafter.....	204,065	41.99%
Total.....	<u>\$ 485,949</u>	<u>100.00%</u>

The following table presents a summary of the activity for the allowance for credit losses for the six-month periods ended June 30, 2004 and 2003:

	<b>June 30, 2004</b>	<b>June 30, 2003</b>
	<b>(In thousands)</b>	
Balance at beginning of period.....	\$ 35,889	\$ 25,828
Addition to allowance for credit losses from acquisitions.....	-	24,271
Provision for credit losses.....	13,050	526
Net charge offs.....	(10,208)	(10,283)
Balance at end of period.....	<u>\$ 38,731</u>	<u>\$ 40,342</u>

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**(3) Residual Interest in Securitizations**

The following table presents the components of the residual interest in securitizations:

	<b>June 30, 2004</b>	<b>December 31, 2003</b>
(In thousands)		
Cash, commercial paper, United States government securities and other qualifying investments (Spread Accounts).....	\$ 29,363	\$ 35,693
Receivables from Trusts (NIRs).....	20,097	20,959
Overcollateralization.....	27,540	38,548
Investment in subordinated certificates.....	4,304	16,502
Residual interest in securitizations.....	\$ 81,304	\$ 111,702

The following table presents estimated remaining undiscounted credit losses included in the estimated fair value of the residual interest in securitizations as a percentage of the Company's servicing portfolio subject to recourse provisions:

	<b>June 30, 2004</b>	<b>December 31, 2003</b>
(Dollars in thousands)		
Undiscounted estimated credit losses.....	\$ 29,428	\$ 47,935
Managed portfolio held by non-consolidated subsidiary.....	322,953	425,534
Undiscounted estimated credit losses as percentage of managed portfolio held by non-consolidated subsidiary.....	9.1%	11.3%

**(4) Residual Interest Financing**

On March 16, 2004, a special-purpose subsidiary of CPS issued \$44 million of asset-backed 10% notes. The notes, issued by CPS Auto Receivables Trust 2004-R, are rated BBB by Standard & Poor's and have a final maturity date of October 16, 2009. The notes are secured by the Company's retained interest in four securitizations sponsored by CPS, two securitizations sponsored by MFN, and two securitization transactions sponsored by TFC. The notes are non-recourse obligations of the Company and will be repaid solely from the cash distributions on the retained interests securing the notes.

**(5) Securitization Trust Debt**

The Company's MFN and TFC subsidiaries have completed a number of securitization transactions that are treated as secured borrowings for financial accounting purposes, rather than as sales. CPS completed two such term securitization transactions in 2003 and one in the six months ended June 30, 2004. In addition, a subsidiary created as part of the SeaWest Asset Acquisition, Pacific Coast Receivables Corp., completed a similarly structured transaction in June 2004. The debt issued in these transactions is shown on the Company's consolidated balance sheet as "Securitization Trust Debt," and the components of such debt are summarized in the following table:

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Series	Issue Date	Initial Principal	Outstanding Principal at June 30, 2004	Outstanding Principal at December 31, 2003	Weighted Average Coupon as of June 30, 2004
(Dollars in thousands)					
PCR2004-1	June 24, 2004	\$ 76,257	\$ 76,257	\$ N/A	3.07%
CPS2004-A	May 5, 2004	76,347	73,001	N/A	3.16%
CPS2003-D	December 16, 2003	71,250	63,907	71,250	2.88%
CPS2003-C	September 30, 2003	83,125	66,828	77,928	2.76%
TFC2003-1	May 20, 2003	52,365	26,127	37,114	2.69%
TFC2002-2	October 9, 2002	62,589	15,550	25,436	2.95%
TFC2002-1	March 19, 2002	64,552	6,009	12,403	4.23%
MFN2001-A	June 28, 2001	301,000	9,379	20,987	5.07%
		\$ 787,485	\$ 337,058	\$ 245,118	

All of the securitization trust debt was sold in private placement transactions to qualified institutional buyers. The debt was issued through wholly-owned, bankruptcy remote, subsidiaries of CPS, TFC or MFN, and is secured by the assets of such subsidiaries, but not by other assets of the Company.

The terms of the various Securitization Agreements related to the issuance of the securitization trust debt require that certain delinquency and credit loss criteria be met with respect to the collateral pool, and require that the Company maintain a minimum net worth and meet other financial tests. As of June 30, 2004, the Company was not in default of any provisions of the agreements as amended. The Company is responsible for the administration and collection of the Contracts. The Securitization Agreements also require certain funds be held in restricted cash accounts to provide additional collateral for the borrowings or to be applied to make payments on the securitization trust debt. As of June 30, 2004, restricted cash under the various agreements totaled approximately \$61.3 million. Interest expense on the securitization trust debt is composed of the stated rate of interest plus amortization of additional costs of borrowing. Additional costs of borrowing include facility fees, insurance and deferred financing costs. Deferred financing costs related to the securitization trust debt are amortized in proportion to the principal distributed to the noteholders. Accordingly, the effective cost of borrowing of the securitization trust debt is greater than the stated rate of interest.

The wholly-owned bankruptcy remote subsidiaries of CPS, MFN and TFC were formed to facilitate the above asset-backed financing transactions. Similar bankruptcy remote subsidiaries issue the debt outstanding under the Company's warehouse lines of credit. "Bankruptcy remote" refers to a legal structure in which it is expected that the applicable entity would not be included in any bankruptcy filing by its parent or affiliates. All of the assets of these subsidiaries have been pledged as collateral for the related debt. All such transactions, treated as secured financings for accounting and tax purposes, are treated as sales for all other purposes, including legal and bankruptcy purposes. None of the assets of these subsidiaries are available to pay other creditors of the Company or its affiliates.

**(6) Senior Secured Debt**

On February 3, 2003, the Company borrowed \$25 million from Levine Leichtman Capital Partners II, L.P. ("LLCP"), net of fees and expenses of \$1.05 million. The indebtedness, represented by the "Term D Note," was originally due in April 2003, with Company options to extend the maturity to May 2003 and January 2004, upon payment of successive extension fees of \$125,000. The Company paid the fees to extend the maturity to January 2004.

The Company had previously borrowed other amounts from LLCP in the form of the "Term B Note" and the "Term C Note." The Company repaid in full the Term C Note on January 29, 2004 and repaid \$10.0 million of the Term D Note on January 15, 2004. In addition, on January 29, 2004 the maturities of the



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### NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Term B Note and the Term D Note were extended to December 15, 2005 and the interest rates applicable to both notes were decreased to 11.75% per annum. The Company paid LLCP fees equal to \$921,000 for these amendments, which will be amortized over the remaining life of the notes. As of June 30, 2004, the outstanding principal balances of the Term B Note and the Term D Note were \$19.8 million and \$15.0 million, respectively.

On May 28, 2004 and June 25, 2004, the Company borrowed \$15 million and \$10 million, respectively, from LLCP. The indebtedness, represented by the "Term E Note," and the "Term F Note," respectively bears interest at 11.75% per annum. Both the Term E Note and the Term F Note have maturities two years from their respective funding dates. As of June 30, 2004, the outstanding principal balances of the Term E Note and the Term F Note were \$15.0 million and \$10.0 million, respectively.

The Senior Secured Debt is secured by all of the assets of the Company.

#### (7) Net Gain on Sale of Contracts

The following table presents components of net gain on sale of Contracts:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2004	2003	2004	2003
	(In thousands)			
Gain recognized on sale.....	\$ -	\$ 3,375	\$ -	\$ 6,676
Deferred acquisition fees and discounts.....	-	2,299	-	4,590
Expenses related to sales.....	-	(1,105)	-	(2,076)
Provision for credit losses.....	-	(460)	-	(526)
Net gain on sale of Contracts.....	<u>\$ -</u>	<u>\$ 4,109</u>	<u>\$ -</u>	<u>\$ 8,664</u>

No gain on sale was recorded in the three-month and six-month periods ended June 30, 2004, due to the July 2003 decision to structure future securitizations as secured financings, rather than as sales.

#### (8) Interest Income

The following table presents the components of interest income:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2004	2003	2004	2003
	(In thousands)			
Interest on finance receivables.....	23,511	6,658	40,710	12,110
Residual interest income, net.....	1,890	4,647	4,634	8,388
Other interest income.....	321	137	801	272
Net interest income.....	<u>25,722</u>	<u>11,442</u>	<u>46,145</u>	<u>20,770</u>

#### (9) Earnings (Loss) Per Share

Diluted earnings (loss) per share for the three-month and six-month periods ended June 30, 2004 and 2003 were calculated using the weighted average number of shares outstanding for the related period. The

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**NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

following table reconciles the number of shares used in the computations of basic and diluted earnings (loss) per share for the three-month and six-month periods ended June 30, 2004 and 2003:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2004	2003	2004	2003
	<i>(In thousands)</i>			
Weighted average number of common shares outstanding during the period used to compute basic earnings (loss) per share.....	21,016	20,209	20,827	20,239
Incremental common shares attributable to exercise of outstanding options and warrants.....	-	1,022	-	842
Incremental common shares attributable to convertible debt.....	-	334	-	1,079
Weighted average number of common shares used to compute diluted earnings per share.....	21,016	21,565	20,827	22,160

The assumed conversion of certain subordinated debt during the three-month and six-month periods ended June 30, 2003, resulted in an increase to income for purposes of the diluted earnings per share calculation of \$18,000 and \$268,000, respectively, representing interest attributable to convertible debt that would not have been incurred if the convertible debt had been converted. Diluted net earnings for purposes of the diluted earnings per share calculation totaled \$2.8 million for the three months ended June 30, 2003 and \$9.2 million for the six months ended June 30, 2003.

If the anti-dilutive effects of common stock equivalents were not considered, additional shares included in the diluted earnings (loss) per share calculation for the three-month and six-month periods ended June 30, 2004 would have included an additional 973,000 and 780,000 shares, respectively, attributable to the conversion of certain subordinated debt and 1.8 million shares attributable to the exercise of outstanding options and warrants. No such anti-dilution existed for the three-month and six-month periods ended June 30, 2003.

**(10) Income Taxes**

As of December 31, 2003, the Company had a net deferred tax asset of \$411,000, which included a valuation allowance of \$37.4 million against certain deferred tax assets of \$44.6 million. Tax liabilities, net, at June 30, 2004 were \$3.1 million. The Company increased its valuation allowance by the income tax benefit for the period to result in no net income tax provision for the three- and six-month periods ended June 30, 2004. The tax benefit for the six months ended June 30, 2003 is primarily the result of the resolution of certain Internal Revenue Service examinations of previously filed MFN tax returns, resulting in a tax benefit of \$4.9 million, and other state tax matters. The Company has evaluated its deferred tax assets and believes that it is more likely than not that certain deferred tax assets will not be realized due to limitations imposed by the Internal Revenue Code and expected future taxable income.

**(11) Liquidity**

The Company's business requires substantial cash to support its purchases of Contracts and other operating activities. The Company's primary sources of cash have been cash flows from operating activities, including proceeds from sales of Contracts, amounts borrowed under various revolving credit facilities (also sometimes known as warehouse credit facilities), servicing fees on portfolios of Contracts previously sold in securitization transactions or serviced for third parties, customer payments of principal

## CONSUMER PORTFOLIO SERVICES, INC.

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and interest on finance receivables, and releases of cash from securitized pools of Contracts in which the Company has retained a residual ownership interest and from the Spread Accounts associated with such pools. The Company's primary uses of cash have been the purchases of Contracts, repayment of amounts borrowed under lines of credit and otherwise, operating expenses such as employee, interest, occupancy expenses and other general and administrative expenses, the establishment of Spread Accounts and initial over collateralization, if any, and the increase of Credit Enhancement to required levels in securitization transactions, and income taxes. There can be no assurance that internally generated cash will be sufficient to meet the Company's cash demands. The sufficiency of internally generated cash will depend on the performance of securitized pools (which determines the level of releases from those pools and their related Spread Accounts), the rate of expansion or contraction in the Company's managed portfolio, and the terms upon which the Company is able to acquire, sell, and borrow against Contracts.

Contracts are purchased from Dealers for a cash price generally approximating their principal amount, and generate cash flow over a period of years. As a result, the Company has been dependent on warehouse credit facilities to purchase Contracts, and on the availability of cash from outside sources in order to finance its continuing operations, as well as to fund the portion of Contract purchase prices not financed under warehouse credit facilities. As of June 30, 2004, the Company had \$225 million in warehouse credit capacity, in the form of a \$125 million facility and a \$100 million facility. Both warehouse facilities provide funding for Contracts purchased under the CPS Programs. A third facility in the amount of \$75 million, which the Company utilized to fund Contracts under the CPS Programs, expired on February 21, 2004. A fourth facility in the amount of \$25 million, which the Company utilized to fund Contracts under the TFC Programs, expired on June 24, 2004.

The Company's primary means of ensuring that its cash demands do not exceed its cash resources is to match its levels of Contract purchases to its availability of cash. The Company's ability to adjust the quantity of Contracts that it purchases and securitizes will be subject to general competitive conditions and the continued availability of warehouse credit facilities. There can be no assurance that the desired level of Contract acquisition can be maintained or increased. Obtaining releases of cash from the Trusts and their related Spread Accounts is dependent on collections from the related Trusts generating sufficient cash to maintain the Spread Accounts in excess of their respective requisite levels. There can be no assurance that collections from the related Trusts will continue to generate sufficient cash.

Certain of the Company's securitization transactions and the warehouse credit facilities contain various covenants requiring certain minimum financial ratios and results. As a result of amendments to the related Securitization Agreements executed during the first six months of 2004, the Company was in compliance with all of these covenants as of June 30, 2004.

#### **(12) Legal Proceedings**

The information provided under the caption "Legal Proceedings" in the Company's Annual Report of Form 10-K for the year ended December 31, 2003 is incorporated herein by reference. In addition, the reader should be aware of the following:

On June 2, 2004, Delmar Coleman filed a lawsuit in the circuit court of Tuscaloosa, Alabama, making allegations similar to those that were asserted in the *Lang* case, and seeking damages in an unspecified amount, on behalf of a purported nationwide class. The *Lang* case has been tentatively settled, as disclosed in the Annual Report, and related to alleged defects in the notices given with respect to repossessed vehicles. CPS believes that it has one or more defenses to each of the claims made in this lawsuit, and intends to defend the matter vigorously.

On June 15, 2004, Keywana Booker filed a lawsuit in the federal district court of Atlanta, Georgia, alleging violations of the Fair Debt Collection Practices Act, and seeking damages in an unspecified

**CONSUMER PORTFOLIO SERVICES, INC.**

**NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

amount on behalf of a purported class of Georgia residents. CPS believes that it has one or more defenses to each of the claims made in this lawsuit, and intends to defend the matter vigorously.

The Company is routinely involved in various legal proceedings resulting from its consumer finance activities and practices, both continuing and discontinued. The Company believes that there are substantive legal defenses to such claims, and intends to defend them vigorously. There can be no assurance, however, as to the outcome.

## **ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

### **General**

Consumer Portfolio Services, Inc. ("CPS," and together with its subsidiaries, the "Company") is a consumer finance company specializing in purchasing, selling and servicing retail automobile installment purchase contracts ("Contracts") originated by licensed motor vehicle dealers ("Dealers") in the sale of new and used automobiles, light trucks and passenger vans. Through its purchases, the Company provides indirect financing to Dealer customers with limited credit histories, low incomes or past credit problems ("Sub-Prime Customers"). The Company serves as an alternative source of financing for Dealers, allowing sales to customers who otherwise might not be able to obtain financing. The Company does not lend money directly to consumers. Rather, it purchases installment Contracts from Dealers.

CPS was incorporated and began its operations in 1991. In March 2002, CPS acquired by merger (the "MFN Merger") MFN Financial Corp. and its subsidiaries. In May 2003, CPS acquired by merger (the "TFC Merger") TFC Enterprises Inc. and its subsidiaries. Both MFN Financial Corp and TFC Enterprises Inc., through their respective subsidiaries, were engaged in businesses substantially similar to that of CPS, and in each merger CPS acquired a portfolio of receivables that had been held by the acquired company. Each merger was accounted for as a purchase. The indirect financing programs of subsidiaries of TFC Enterprises, Inc. were directed principally to members of the United States armed forces. The Company has continued to offer such financing programs (the "TFC Programs") subsequent to the TFC merger, in addition to its other financing programs (the "CPS Programs").

On April 2, 2004, the Company purchased a portfolio of Contracts and certain other assets (the "SeaWest Asset Acquisition") from SeaWest Financial Corporation ("SeaWest"). In addition, the Company was named the successor servicer for three term securitization transactions originally sponsored by SeaWest (the "SeaWest Third Party Portfolio"). The Company does not intend to offer financing programs similar to those previously offered by SeaWest.

### **Securitization**

#### *Generally*

Throughout the periods for which information is presented in this report, the Company has purchased Contracts with the intention of repackaging them in securitizations. All such securitizations have involved identification of specific Contracts, sale of those Contracts (and associated rights) to a special purpose subsidiary of the Company, and issuance of asset-backed securities to fund the transactions. Depending on the structure of the securitization, the transaction may be properly accounted for as a sale of the Contracts, or as a secured financing.

When structured to be treated as a secured financing, the subsidiary is consolidated with the Company. Accordingly, the sold Contracts and the related securitization trust debt appear as assets and liabilities, respectively, of the Company on its Condensed Consolidated Balance Sheet. The Company then recognizes interest and fee income on the receivables and interest expense on the securities issued in the securitization, and records as expense a provision for probable credit losses on the receivables.

When structured to be treated as a sale, the subsidiary is not consolidated with the Company. Accordingly, the securitization removes the sold Contracts from the Company's Condensed Consolidated Balance Sheet, the asset-backed securities (debt of the non-consolidated subsidiary) do not appear as debt of the Company, and the Company shows as an asset a retained residual interest in the sold Contracts. The residual interest represents the discounted value of what the Company expects will be the excess of future collections on the Contracts over principal and interest due on the asset-backed securities. That residual

interest appears on the Company's balance sheet as "Residual interest in securitizations," and the determination of its value is dependent on estimates of the future performance of the sold Contracts.

#### *Change in Policy*

In August 2003, the Company announced that it would structure its future securitization transactions to be reflected as secured financings for financial accounting purposes. Its first three term securitizations of finance receivables originated under the CPS Programs so structured occurred in September 2003, December 2003 and May 2004. The Company had structured all of its prior term securitization transactions related to the CPS Programs to be reflected as sales for financial accounting purposes. In the MFN Merger and in the TFC Merger the Company acquired finance receivables that had been previously securitized in term securitization transactions that were reflected as secured financings. In addition, the Company acquired finance receivables as part of the SeaWest Asset Acquisition that were subsequently securitized, together with receivables purchased under the TFC Programs, in a term securitization transaction in June 2004 that is reflected as a secured financing. As of June 30, 2004, the Company's Condensed Consolidated Balance Sheet included net finance receivables of approximately \$131.5 million and securitization trust debt of \$103.1 million related to finance receivables acquired in the two mergers and the SeaWest Asset Acquisition, out of totals of net finance receivables of approximately \$421.3 million and securitization trust debt of approximately \$337.1 million.

#### *Credit Risk Retained*

Whether a securitization is treated as a secured financing or as a sale for financial accounting purposes, the related special purpose subsidiary may be unable to release excess cash to the Company if the credit performance of the securitized Contracts falls short of pre-determined standards. Such releases represent a material portion of the cash that the Company uses to fund its operations. An unexpected deterioration in the performance of securitized Contracts could therefore have a material adverse effect on both the Company's liquidity and its results of operations, regardless of whether such Contracts are treated as having been sold or as having been financed. For estimation of the magnitude of such risk, it may be appropriate to look to the size of the Company's "managed portfolio," which represents both financed and sold Contracts as to which such credit risk is retained. The Company's managed portfolio as of June 30, 2004 was approximately \$900.3 million (this amount includes \$85.3 million related to the SeaWest Third Party Portfolio on which the Company earns only servicing fees and has no credit risk).

## **Results of Operations**

#### *Acquisition*

The Company's Condensed Consolidated Balance Sheet and Condensed Consolidated Statements of Operations as of and for the three and six months ended June 30, 2004 and 2003, include the results of operations of TFC Enterprises, Inc. for the period subsequent to May 20, 2003, which is the date on which the Company acquired that corporation and its subsidiaries in the TFC Merger. See Note 1 of Notes to Condensed Consolidated Financial Statements, Acquisition of TFC Enterprises, Inc.

#### *Effects of Change in Securitization Structure*

The Company's decision to structure future securitization transactions as borrowings secured by receivables for financial accounting purposes, rather than as sales of receivables, has affected and will affect the way in which the transactions are reported. The major effects are these: (i) the finance receivables are shown as assets of the Company on its balance sheet; (ii) the debt issued in the transactions is shown as indebtedness of the Company; (iii) cash deposited to enhance the credit of the securitization transactions ("Spread Accounts") is shown as "Restricted cash" on the Company's balance sheet; (iv) cash collected from borrowers and other sources related to the receivables prior to making the required payments under the Securitization Agreements is also shown as "Restricted cash" on the

Company's balance sheet; (v) the servicing fee that the Company receives in connection with such receivables is recorded as a portion of the interest earned on such receivables in the Company's statements of operations, (vi) the Company has initially and periodically recorded as expense a provision for estimated credit losses on the receivables in the Company's statements of operations; and (vii) the portion of scheduled payments on the receivables representing interest is recorded as revenue as accrued in the Company's statements of operations.

These changes collectively represent a deferral of revenue and acceleration of expenses, and thus a more conservative approach to accounting for the Company's operations. The changes initially have resulted in the Company's reporting lower earnings than it would have reported if it had continued structuring its securitizations to require recognition of gain on sale. Accordingly, reported net earnings may continue to be negative through 2004. Management expects that for the next six to 12 months, growth in the Company's portfolio of receivables in excess of current expectations would further delay achievement of positive net earnings. The Company's cash availability and cash requirements have been unaffected by the change in structure.

The Company's first three term securitizations of Contracts originated under the CPS Programs structured as secured financings closed in September 2003, December 2003 and May 2004. In March 2004, the Company completed a securitization of its retained interest in eight securitization transactions previously sponsored by the Company and its affiliates, which was also structured as a secured financing. In addition, in June 2004, the Company completed a term securitization of Contracts purchased in the SeaWest Asset Acquisition and under the TFC Programs, which was structured as a secured financing. The Company's MFN and TFC subsidiaries completed term securitizations structured as secured financings prior to their becoming subsidiaries of the Company. The structures of the Company's two warehouse securitization transactions that related to the CPS Programs were amended in July 2003 to be treated as secured financings for financial accounting purposes. The Company's third warehouse securitization credit facility available to the Company at the time, which related to the TFC Programs, was structured as a secured financing for financial accounting purposes since the date of the TFC Merger. Such third warehouse facility expired on June 24, 2004.

*The three-month period ended June 30, 2004 compared to the three-month period ended June 30, 2003*

*Revenues.* During the three months ended June 30, 2004, revenues were \$32.7 million, an increase of \$8.3 million, or 34.3%, from the prior year period revenue amount of \$24.3 million. The primary reason for the increase in revenues is an increase in interest income. Interest income for the three-month period ended June 30, 2004 increased \$14.3 million, or 124.8%, to \$25.7 million in 2004 from \$11.4 million for the same period in 2003. The primary reasons for the increase in interest income are the change in securitization structure implemented during the third quarter of 2003 as described above and the interest income earned on the portfolios of Contracts acquired in the TFC Merger and the SeaWest Asset Acquisition. This increase was partially offset by the decline in the balance of the portfolio of Contracts acquired in the MFN Merger and a decrease in residual interest income.

The increase in interest income is offset in part by the elimination of net gain on sale of Contracts revenue and a decrease in servicing fees. As a result of the change in securitization structure, zero net gain on sale of Contracts was recorded in the current period, compared to \$4.1 million in the year earlier period. Net gain on sale of Contracts is not expected to be a significant component of the Company's revenues in future periods.

Servicing fees of \$3.5 million in the three months ended June 30, 2004 decreased \$1.0 million, or 21.4%, from \$4.5 million in the same period a year earlier. The decrease in servicing fees is the result of the change in securitization structure and the consequent decline in the Company's managed portfolio held by non-consolidated subsidiaries. The decrease was partially offset by the servicing fees earned on the SeaWest Third Party Portfolio. The Contracts in the Company's managed portfolio held by non-consolidated subsidiaries were securitized in structures treated as sales for financial accounting purposes

and, therefore, do not appear on the Company's Condensed Consolidated Balance Sheet. As a result of the decision to structure future securitizations as secured financings, the Company's managed portfolio held by non-consolidated subsidiaries will decline in future periods, and servicing fee revenue is anticipated to continue to decline proportionately. As of June 30, 2004 and 2003, the Company's managed portfolio owned by consolidated vs. non-consolidated subsidiaries was as follows:

	June 30, 2004		June 30, 2003	
	Amount	%	Amount	%
Total Managed Portfolio	(Dollars in millions)			
Owned by Consolidated Subsidiaries.....	\$ 492.0	54.6%	\$ 243.2	32.3%
Owned by Non-Consolidated Subsidiaries.....	323.0	35.9%	510.8	67.7%
SeaWest Third Party Portfolio.....	85.3	9.5%	-	0.0%
Total.....	\$ 900.3	100.0%	\$ 754.0	100.0%

At June 30, 2004, the Company was generating income and fees on a managed portfolio with an outstanding principal balance approximating \$900.3 million (this amount includes \$85.3 million related to the SeaWest Third Party Portfolio on which the Company earns only servicing fees), compared to a managed portfolio with an outstanding principal balance approximating \$754.0 million as of June 30, 2003. As the portfolio of Contracts acquired in the MFN Merger and the TFC Merger decreases, the portfolio of Contracts originated under the CPS Programs continues to expand. At June 30, 2004 and 2003, the managed portfolio composition was as follows:

Originating Entity	June 30, 2004		June 30, 2003	
	Amount	%	Amount	%
	(Dollars in millions)			
CPS.....	\$ 614.8	68.3%	\$ 482.9	64.0%
TFC.....	101.1	11.2%	146.3	19.4%
MFN.....	38.7	4.3%	124.8	16.6%
SeaWest.....	60.4	6.7%	-	-
SeaWest Third Party Portfolio.....	85.3	9.5%	-	-
Total.....	\$ 900.3	100.0%	\$ 754.0	100.0%

Other income decreased \$0.9 million, or 20.2%, to \$3.5 million during the quarter ended June 30, 2004 from \$4.3 million during the same 2003 period. The period over period decrease resulted primarily from decreased recoveries on previously charged off MFN Contracts. Such recoveries were \$2.0 million for the three months ended June 30, 2004, compared to \$3.1 million for the same period in 2003.

*Expenses.* The Company's operating expenses consist primarily of personnel costs and other operating expenses, which are incurred as applications and Contracts are received, processed and serviced. Factors that affect margins and net earnings include changes in the automobile and automobile finance market environments and macroeconomic factors such as interest rates and the unemployment level.

Personnel costs include base salaries, commissions and bonuses paid to employees, and certain expenses related to the accounting treatment of outstanding warrants and stock options, and are one of the Company's most significant operating expenses. These costs (other than those relating to stock options) generally fluctuate with the level of applications and Contracts processed and serviced.

Other operating expenses include interest expense, provision for credit losses, facilities expenses, telephone and other communication services, credit services, computer services (including personnel costs associated with information technology support), professional services, marketing and advertising expenses, and depreciation and amortization.



Total operating expenses were \$32.9 million for the second quarter of 2004, compared to \$21.2 million for the second quarter of 2003. The increase is primarily due to the \$6.3 million expense recorded as provision for credit losses during the 2004 period. Increased general and administrative expenses and increased interest expense also contributed.

Personnel costs increased to \$9.8 million during the three months ended June 30, 2004, representing 29.8% of total operating expenses, from \$9.4 million for the comparable 2003 period, or 44.5% of total operating expenses. The increase is primarily the result of staff additions related to the TFC Merger in May 2003 and the SeaWest Asset Acquisition in April 2004. This increase was partially offset by staff reductions since the MFN Merger in 2002 related to the integration and consolidation of certain service and administrative activities and the decline in the balance of the portfolio of Contracts acquired in the MFN Merger. The decrease as a percentage of total operating expenses reflects the higher operating expenses incurred in the current period, primarily a result of the provision for credit loss.

General and administrative expenses increased to \$6.5 million, or 19.7% of total operating expenses, in the second quarter of 2004, as compared to \$4.0 million, or 19.1% of total operating expenses, in the second quarter of 2003. The increase is due primarily to increased legal expenses and incremental corporate expenses associated with the TFC Merger, which closed in May 2003.

Interest expense for the three-month period ended June 30, 2004, increased \$2.4 million, or 47.5%, to \$7.5 million, compared to \$5.1 million in the comparable period in 2003. The increase is primarily the result of changes in the amount and composition of securitization trust debt carried on the Company's Condensed Consolidated Balance Sheet, such debt increased as a result of the SeaWest Asset Acquisition and the change in securitization structure implemented beginning in July 2003, partially offset by the decrease in the balance of the securitization trust debt acquired in the MFN Merger. As the Company continues to structure future securitization transactions as secured financings, securitization trust debt and the related interest expense are expected to increase.

The Company increased its valuation allowance by the income tax benefit for the period to result in no net income tax provision for the three-month period ended June 30, 2004. An income tax expense of \$0.5 million recorded during the 2003 period.

*The six-month period ended June 30, 2004 compared to the six-month period ended June 30, 2003*

*Revenues.* During the six months ended June 30, 2004, revenues were \$60.2 million, an increase of \$12.9 million, or 27.4%, from the prior year period revenue amount of \$47.3 million. The primary reason for the increase in revenues is an increase in interest income. Interest income for the six-month period ended June 30, 2004 increased \$25.4 million, or 122.2%, to \$46.1 million in 2004 from \$20.8 million in 2003. The primary reasons for the increase in interest income are the change in securitization structure implemented during the third quarter of 2003 as described above and the interest income earned on the portfolios of Contracts acquired in the TFC Merger and the SeaWest Asset Acquisition. This increase was partially offset by the decline in the balance of the portfolio of Contracts acquired in the MFN Merger and a decrease in residual interest income.

The increase in interest income is offset in part by the elimination of net gain on sale of Contracts revenue and a decrease in servicing fees. As a result of the change in securitization structure, zero net gain on sale of Contracts was recorded in the current period, compared to \$8.7 million in the year earlier period. The 2003 gain on sale of Contracts amount is net of a negative fair value adjustment of \$1.8 million related to the Company's analysis and estimate of the expected ultimate performance of the Company's previously securitized pools that are held by non-consolidated subsidiaries.

Servicing fees of \$6.8 million in the six months ended June 30, 2004 decreased \$2.2 million, or 24.6%, from \$9.1 million in the same period a year earlier. The decrease in servicing fees is the result of the change in securitization structure and the consequent decline in the Company's managed portfolio held by

non-consolidated subsidiaries. The decrease was partially offset by the servicing fees earned on the SeaWest Third Party Portfolio.

Other income decreased \$1.5 million, or 17.5%, to \$7.2 million during the six months ended June 30, 2004 from \$8.8 million during the 2003 period. The period over period decrease resulted primarily from decreased recoveries on previously charged off MFN Contracts. Such recoveries were \$4.6 million for the six months ended June 30, 2004, compared to \$6.8 million for the same period in 2003.

*Expenses.* The Company's operating expenses consist primarily of personnel costs and other operating expenses, which are incurred as applications and Contracts are received, processed and serviced. Factors that affect margins and net earnings include changes in the automobile and automobile finance market environments and macroeconomic factors such as interest rates and the unemployment level.

Personnel costs include base salaries, commissions and bonuses paid to employees, and certain expenses related to the accounting treatment of outstanding warrants and stock options, and are one of the Company's most significant operating expenses. These costs (other than those relating to stock options) generally fluctuate with the level of applications and Contracts processed and serviced.

Other operating expenses include interest expense, provision for credit losses, facilities expenses, telephone and other communication services, credit services, computer services (including personnel costs associated with information technology support), professional services, marketing and advertising expenses, and depreciation and amortization.

Total operating expenses were \$61.8 million for the second quarter of 2004, compared to \$40.8 million for the second quarter of 2003. The increase is primarily due to the \$13.1 million expense recorded as provision for credit loss during the 2004 period. Increased general and administrative expenses and increased interest expense also contributed.

Personnel costs increased to \$19.4 million during the six months ended June 30, 2004, representing 31.5% of total operating expenses, from \$17.9 million for the comparable 2003 period, or 42.8% of total operating expenses. The increase is primarily the result of staff additions related to the TFC Merger in May 2003 and the SeaWest Asset Acquisition in April 2004. This increase was partially offset by staff reductions since the MFN Merger in 2002 related to the integration and consolidation of certain service and administrative activities and the decline in the balance of the portfolio of Contracts acquired in the MFN Merger. The decrease as a percentage of total operating expenses reflects the higher operating expenses, primarily a result of the provision for credit loss.

General and administrative expenses increased to \$10.4 million, or 16.9% of total operating expenses, in the second quarter of 2004, as compared to \$8.1 million, or 19.3% of total operating expenses, in the second quarter of 2003. The increase is due primarily to increased legal expenses and incremental corporate expenses associated with the TFC Merger, which closed in May 2003. The decrease as a percentage of total operating expenses reflects the higher operating expenses primarily a result of the provision for credit loss.

Interest expense for the six-month period ended June 30, 2004, increased \$2.8 million, or 26.3%, to \$13.4 million, compared to \$10.6 million in the comparable period in 2003. The increase is primarily the result of changes in the amount and composition of securitization trust debt carried on the Company's Condensed Consolidated Balance Sheet, such debt increased as a result of the SeaWest Asset Acquisition and the change in securitization structure implemented beginning in July 2003, partially offset by the decrease in the balance of the securitization trust debt acquired in the MFN Merger.

The Company increased its valuation allowance by the income tax benefit for the period to result in no net income tax provision for the six-month period ended June 30, 2004. In the 2003 period, an income tax benefit of \$3.4 million was recorded. The income tax benefit in the prior period was primarily the result of the resolution of certain IRS examinations of tax returns filed by MFN prior to the MFN Merger. The resulting tax benefit of \$4.9 million was offset in part by an income tax provision of \$1.5 million.

## **Liquidity and Capital Resources**

The Company's business requires substantial cash to support its purchases of Contracts and other operating activities. The Company's primary sources of cash have been cash flows from operating activities, including proceeds from sales of Contracts, amounts borrowed under various revolving credit facilities (also sometimes known as warehouse credit facilities), servicing fees on portfolios of Contracts previously sold in securitization transactions or serviced for third parties, customer payments of principal and interest on finance receivables, and releases of cash from securitized pools of Contracts in which the Company has retained a residual ownership interest and from the Spread Accounts associated with such pools. The Company's primary uses of cash have been the purchases of Contracts, repayment of amounts borrowed under lines of credit and otherwise, operating expenses such as employee, interest, occupancy expenses and other general and administrative expenses, the establishment of Spread Accounts and initial overcollateralization, if any, and the increase of Credit Enhancement to required levels in securitization transactions, and income taxes. There can be no assurance that internally generated cash will be sufficient to meet the Company's cash demands. The sufficiency of internally generated cash will depend on the performance of securitized pools (which determines the level of releases from those pools and their related Spread Accounts), the rate of expansion or contraction in the Company's managed portfolio, and the terms upon which the Company is able to acquire, sell, and borrow against Contracts.

Net cash provided by operating activities for the six-month periods ended June 30, 2004 and 2003 was \$33.5 million and \$46.9 million, respectively. Cash from operating activities is generally provided by the net releases from the Company's securitization Trusts.

Net cash used in investing activities for the six-month periods ended June 30, 2004 and 2003 was \$168.9 million and \$10.2 million, respectively. Cash used in investing activities has generally related to purchases of Contracts, the cost of acquiring TFC and the purchase of furniture and equipment.

Net cash provided by financing activities for the six months ended June 30, 2004, was \$117.5 million compared with net cash used in financing activities of \$36.0 million for the six months ended June 30, 2003. Cash used or provided by financing activities is primarily attributable to the repayment or issuance of debt.

The primary reason for the significant increase in cash used in investing activities and cash provided by financing activities period over period is the change in the securitization structure implemented in the third quarter of 2003.

Contracts are purchased from Dealers for a cash price generally approximating their principal amount, and generate cash flow over a period of years. As a result, the Company has been dependent on warehouse credit facilities to purchase Contracts, and on the availability of cash from outside sources in order to finance its continuing operations, as well as to fund the portion of Contract purchase prices not financed under warehouse credit facilities. As of June 30, 2004 the Company had \$225 million in warehouse credit capacity, in the form of a \$125 million facility and a \$100 million facility. Both warehouse facilities provide funding for Contracts purchased under the CPS Programs. A third facility in the amount of \$75 million, which the Company utilized to fund Contracts under the CPS Programs, expired on February 21, 2004. A fourth facility in the amount of \$25 million, which the Company utilized to fund Contracts under the TFC Programs, expired on June 24, 2004.

The \$125 million warehouse facility is structured to allow the Company to fund a portion of the purchase price of Contracts by drawing against a floating rate variable funding note issued by CPS Warehouse Trust. This facility was established on March 7, 2002, in the maximum amount of \$100 million. Such maximum amount was increased to \$125 million in November 2002. Approximately 73% of the principal balance of Contracts may be advanced to the Company under this facility, subject to collateral tests and certain other conditions and covenants. Notes under this facility bear interest at a rate of one-month commercial paper plus 1.18% per annum. This facility was renewed in April 2004 and expires on April 3, 2005.

The \$100 million warehouse facility is similarly structured to allow CPS to fund a portion of the purchase price of Contracts by drawing against a floating rate variable funding note issued by Page Funding LLC. Approximately 73.5% of the principal balance of Contracts may be advanced to the Company under this facility, subject to collateral tests and certain other conditions and covenants. Notes under this facility accrue interest at a rate of one-month LIBOR plus 1.50% per annum. This facility was entered into on June 30, 2004 and expires on June 30, 2007. The lender has annual termination options.

The \$75 million warehouse facility was similarly structured to allow CPS to fund a portion of the purchase price of Contracts by drawing against a floating rate variable funding note issued by CPS Funding LLC. Approximately 72.5% of the principal balance of Contracts could be advanced to the Company under this facility, subject to collateral tests and certain other conditions and covenants. Notes under this facility accrued interest at a rate of one-month LIBOR plus 0.75% per annum. This facility expired on February 21, 2004.

The \$25 million warehouse facility was similarly structured to allow TFC to fund a portion of the purchase price of Contracts by drawing against a floating rate variable funding note issued by TFC Warehouse I LLC. Approximately 71% of the principal balance of Contracts could be advanced to TFC under this facility, subject to collateral tests and certain other conditions and covenants. Notes under this facility accrued interest at a rate of one-month LIBOR plus 1.75% per annum. This facility was entered into as part of the TFC Merger on May 20, 2003 and expired on June 24, 2004. The Company is currently in discussions with several parties regarding a replacement facility.

These facilities are independent of each other. With the two currently existing facilities, two different financial institutions purchase the notes issued by these facilities, and two different insurers insure the notes (each a "Note Insurer"). The Note Insurer on the \$125 million facility is the controlling party whereas the lender on the \$100 million facility is the controlling party. Up through June 30, 2003, sales of Contracts to the special purpose subsidiaries ("SPS") related to two of the three then existing facilities had been treated as sales for financial accounting purposes. The Company, therefore, removed these securitized Contracts and related debt from its Condensed Consolidated Balance Sheet and recognized a gain on sale in the Company's Condensed Consolidated Statement of Operations related to Contracts financed through this facility. Indebtedness related to Contracts funded by the third facility existing as of June 30, 2003, however, was on the Company's Condensed Consolidated Balance Sheet and no gain on sale has ever been recognized in the Company's Condensed Consolidated Statement of Operations. During July 2003, each of the first two facilities was amended, with the effect that subsequent use of such facilities is treated for financial accounting purposes as a borrowing secured by such receivables, rather than as a sale of receivables. The effects of that amendment are similar to those discussed above with respect to the change in securitization structure. Both existing facilities as of June 30, 2004 are treated for financial accounting purposes as secured financings.

For the portfolio owned by non-consolidated subsidiaries, cash used to increase Credit Enhancement amounts to required levels for the six-month periods ended June 30, 2004 and 2003 was \$1.3 million and \$1.3 million, respectively. Cash released from Trusts and their related Spread Accounts to the Company for the six-month periods ended June 30, 2004 and 2003, was \$12.1 million and \$13.9 million, respectively. Changes in the amount of Credit Enhancement required for term securitization transactions and releases from Trusts and their related Spread Accounts are affected by the relative size, seasoning and

performance of the various pools of Contracts securitized that make up the Company's managed portfolio to which the respective Spread Accounts are related. The Company did not make any initial deposits to Spread Accounts or fund initial over-collateralization related to term securitization transactions owned by non-consolidated subsidiaries during the six-months ended June 30, 2004 compared to \$17.3 million during the six-months ended June 30, 2003.

The acquisition of Contracts for subsequent sale in securitization transactions, and the need to fund Spread Accounts and initial over collateralization, if any, and increase Credit Enhancement levels when those transactions take place, results in a continuing need for capital. The amount of capital required is most heavily dependent on the rate of the Company's Contract purchases, the advance rate on the warehouse facilities, the required level of initial Credit Enhancement in securitizations, and the extent to which the previously established Trusts and their related Spread Accounts either release cash to the Company or capture cash from collections on securitized Contracts. The Company is limited in its ability to purchase Contracts by its available cash and the capacity of its warehouse facilities. As of June 30, 2004, the Company had cash on hand of \$15.3 million and available Contract purchase commitments from its warehouse credit facilities of \$167.9 million. The Company's plans to manage its need for liquidity include the completion of additional term securitizations that would provide additional credit availability from the warehouse credit facilities, and matching its levels of Contract purchases to its availability of cash. There can be no assurance that the Company will be able to complete term securitizations on favorable economic terms or that the Company will be able to complete term securitizations at all. If the Company is unable to complete such securitizations, interest income and other portfolio related income would decrease.

The Company's primary means of ensuring that its cash demands do not exceed its cash resources is to match its levels of Contract purchases to its availability of cash. The Company's ability to adjust the quantity of Contracts that it purchases and securitizes will be subject to general competitive conditions and the continued availability of warehouse credit facilities. There can be no assurance that the desired level of Contract acquisition can be maintained or increased. Obtaining releases of cash from the Trusts and their related Spread Accounts is dependent on collections from the related Trusts generating sufficient cash to maintain the Spread Accounts in excess of their respective requisite levels. There can be no assurance that collections from the related Trusts will continue to generate sufficient cash.

Certain of the Company's securitization transactions and the warehouse credit facilities contain various covenants requiring certain minimum financial ratios and results. As a result of amendments to the related Securitization Agreements executed during the first six months of 2004, the Company was in compliance with all of these covenants as of June 30, 2004.

The Securitization Agreements of the Company's term securitization transactions and one of the warehouse credit facilities are terminable by the Note Insurers in the event of certain defaults by the Company and under certain other circumstances. Similar termination rights are held by the lender in the other warehouse credit facility. Were a Note Insurer (or the lender in such warehouse facility) in the future to exercise its option to terminate the Securitization Agreements, such a termination would have a material adverse effect on the Company's liquidity and results of operations. The Company continues to receive Servicer extensions on a monthly and/or quarterly basis, pursuant to the Securitization Agreements.

## **Critical Accounting Policies**

### *(a) Allowance for Finance Credit Losses*

In order to estimate an appropriate allowance for losses incurred on finance receivables held on the Company's Condensed Consolidated Balance Sheet, the Company uses a loss allowance methodology commonly referred to as "static pooling," which stratifies its finance receivable portfolio into separately

identified pools. Using analytical and formula-driven techniques, the Company estimates an allowance for finance credit losses, which management believes is adequate for known and inherent losses in its portfolio of finance receivable Contract. Provision for losses is charged to the Company's Consolidated Statement of Operations. Net losses incurred on finance receivables are charged to the allowance. Management evaluates the adequacy of the allowance by examining current delinquencies, the characteristics of the portfolio and the value of the underlying collateral. As conditions change, the Company's level of provisioning and/or allowance may change as well.

*(b) Treatment of Securitizations*

Gain on sale may be recognized on the disposition of Contracts either outright or in securitization transactions. In those securitization transactions that were treated as sales for financial accounting purposes, the Company, or a wholly-owned, consolidated subsidiary of the Company, retains a residual interest in the Contracts that were sold to a wholly-owned, unconsolidated special purpose subsidiary. The Company's securitization transactions include "term" securitizations (the purchaser holds the Contracts for substantially their entire term) and "continuous" or "warehouse" securitizations (which finance the acquisition of the Contracts for future sale into term securitizations).

As of June 30, 2004 and December 31, 2003 the line item "Residual interest in securitizations" on the Company's Consolidated Balance Sheet represents the residual interests in certain term securitizations but no residual interest in warehouse securitizations, because the Company's warehouse securitizations were restructured in July 2003 as secured financings. Subsequent term securitizations of receivables purchased were also structured as secured financings. The warehouse securitizations are accordingly reflected in the line items "Finance receivables" and "Warehouse lines of credit" on the Company's Consolidated Balance Sheet, and the term securitizations are reflected in the line items "Finance receivables" and "Securitization trust debt." The "Residual interest in securitizations" represents the discounted sum of expected future releases from securitization trusts. Accordingly, the valuation of the residual is heavily dependent on estimates of future performance.

The Company's securitization structure is generally as follows:

The Company sells Contracts it acquires to a wholly-owned Special Purpose Subsidiary ("SPS"), which has been established for the limited purpose of buying and reselling the Company's Contracts. The SPS then transfers the same Contracts to another entity, typically a statutory trust ("Trust"). The Trust issues interest-bearing asset backed securities (the "Notes"), generally in a principal amount equal to the aggregate principal balance of the Contracts. The Company typically sells these Contracts to the Trust at face value and without recourse, except that representations and warranties similar to those provided by the Dealer to the Company are provided by the Company to the Trust. One or more investors purchase the Notes issued by the Trust; the proceeds from the sale of the Notes are then used to purchase the Contracts from the Company. The Company may retain or sell subordinated Notes issued by the Trust. The Company purchases a financial guaranty insurance policy, guaranteeing timely payment of principal and interest on the senior Notes, from a Note Insurer. In addition, the Company provides "Credit Enhancement" for the benefit of the Note Insurer and the investors in the form of an initial cash deposit to a bank account (a "Spread Account") held by the Trust, in the form of overcollateralization of the Notes, where the principal balance of the Notes issued is less than the principal balance of the Contracts, in the form of subordinated Notes, or some combination of such Credit Enhancements. The agreements governing the securitization transactions (collectively referred to as the "Securitization Agreements") require that the initial level of Credit Enhancement be supplemented by a portion of collections from the Contracts until the level of Credit Enhancement reaches specified levels, and then maintained at those levels. The specified levels are generally computed as a percentage of the principal amount remaining unpaid under the related Contracts. The specified levels at which the Credit Enhancements are to be maintained will vary depending on the performance of the portfolios of Contracts held by the Trusts and on other conditions, and may also be varied by agreement among the Company, the SPS, the Note Insurers and the trustee. Such levels have increased and decreased from time to time based on

performance of the portfolios, and have also varied by Securitization Agreement. The Securitization Agreements generally grant the Company the option to repurchase the sold Contracts from the Trust when the aggregate outstanding balance has amortized to a specified percentage of the initial aggregate balance.

The prior securitizations that were treated as sales for financial accounting purposes differ from secured financings in that the Trust to which the SPS sold the Contracts met the definition of a qualified special purpose entity under Statement of Financial Accounting Standards No. 140 (“SFAS 140”). As a result, assets and liabilities of the Trust are not consolidated into the Company’s Condensed Consolidated Balance Sheet.

The Company’s warehouse securitization structures are similar to the above, except that (i) the SPS that purchases the Contracts pledges the Contracts to secure promissory notes which it issues, (ii) the promissory notes are in an aggregate principal amount of not more than 73.0% to 73.5% of the aggregate principal balance of the Contracts (that is, at least 26.5% overcollateralization), and (iii) no increase in the required amount of Credit Enhancement is contemplated unless certain portfolio performance tests are breached. During the quarter ended September 30, 2003 the warehouse securitizations related to the CPS Programs were amended to provide for the transactions to be reflected as secured financings for financial accounting purposes. The Contracts held by the warehouse SPS and the promissory notes that it issues are therefore included in the Company’s Condensed Consolidated Financial Statements as of June 30, 2004 and December 31, 2003 as assets and liabilities, respectively.

Upon each sale of Contracts in a securitization structured as a secured financing, whether a term securitization or a warehouse securitization, the Company retains on its Condensed Consolidated Balance Sheet the Contracts securitized as assets and records the Notes issued in the transaction as indebtedness of the Company.

Under the prior securitizations structured as sales for financial accounting purposes, the Company removed from its Condensed Consolidated Balance Sheet the Contracts sold and added to its Condensed Consolidated Balance Sheet (i) the cash received, if any, and (ii) the estimated fair value of the ownership interest that the Company retains in Contracts sold in the securitization. That retained or residual interest (the “Residual”) consists of (a) the cash held in the Spread Account, if any, (b) overcollateralization, if any, (c) subordinated Notes retained, if any, and (d) receivables from Trust, which include the net interest receivables (“NIRs”). NIRs represent the estimated discounted cash flows to be received from the Trust in the future, net of principal and interest payable with respect to the Notes, and certain expenses. The excess of the cash received and the assets retained by the Company over the carrying value of the Contracts sold, less transaction costs, equals the net gain on sale of Contracts recorded by the Company. Until the maturity of these transactions, the Company’s Condensed Consolidated Balance Sheet will reflect securitization transactions structured both as sales and as secured financings.

With respect to the prior securitizations structured as sales for financial accounting purposes, the Company allocates its basis in the Contracts between the Notes sold and the Residuals retained based on the relative fair values of those portions on the date of the sale. The Company recognized gains or losses attributable to the change in the fair value of the Residuals, which are recorded at estimated fair value. The Company is not aware of an active market for the purchase or sale of interests such as the Residuals; accordingly, the Company determines the estimated fair value of the Residuals by discounting the amount and timing of anticipated cash flows that it estimates will be released to the Company in the future (the cash out method), using a discount rate that the Company believes is appropriate for the risks involved. The anticipated cash flows include collections from both current and charged off receivables. The Company has used an effective pre-tax discount rate of approximately 14% per annum except for certain collections from charged off receivables related to the Company’s securitizations in 2001 and later where the Company has used a discount rate of approximately 25%.

The Company receives periodic base servicing fees for the servicing and collection of the Contracts. In addition, the Company is entitled to the cash flows from the Trusts that represent collections on the

Contracts in excess of the amounts required to pay principal and interest on the Notes, the base servicing fees, and certain other fees (such as trustee and custodial fees). Required principal payments are generally defined as the payments sufficient to keep the principal balance of the Notes equal to the aggregate principal balance of the related Contracts (excluding those Contracts that have been charged off), or a predetermined percentage of such balance. Where that percentage is less than 100%, the related Securitization Agreements require accelerated payment of principal until the principal balance of the Notes is reduced to the specified percentage. Such accelerated principal payment is said to create overcollateralization of the Notes.

If the amount of cash required for payment of fees, interest and principal exceeds the amount collected during the collection period, the shortfall is withdrawn from the Spread Account, if any. If the cash collected during the period exceeds the amount necessary for the above allocations, and there is no shortfall in the related Spread Account or other form of Credit Enhancement, the excess is released to the Company, or in certain cases is transferred to other Spread Accounts that may be below their required levels. If the total Credit Enhancement amount is not at the required level, then the excess cash collected is retained in the Trust until the specified level is achieved. Although Spread Account balances are held by the Trusts on behalf of the Company's SPS as the owner of the Residuals (in the case of securitization transactions structured as sales for financial accounting purposes) or the Trusts (in the case of securitization transactions structured as secured financings for financial accounting purposes), the cash in the Spread Accounts is restricted from use by the Company. Cash held in the various Spread Accounts is invested in high quality, liquid investment securities, as specified in the Securitization Agreements. The interest rate payable on the Contracts is significantly greater than the interest rate on the Notes. As a result, the Residuals described above are a significant asset of the Company. In determining the value of the Residuals, the Company must estimate the future rates of prepayments, delinquencies, defaults and default loss severity, and recovery rates, as all of these factors affect the amount and timing of the estimated cash flows. The Company estimates prepayments by evaluating historical prepayment performance of comparable Contracts. As of June 30, 2004, the Company has used prepayment estimates of approximately 18.9% to 23.5% cumulatively over the lives of the related Contracts. The Company estimates defaults and default loss severity using available historical loss data for comparable Contracts and the specific characteristics of the Contracts purchased by the Company. The Company estimates recovery rates of previously charged off receivables using available historical recovery data and projected future recovery levels. In valuing the Residuals, the Company estimates that charge-offs as a percentage of the original principal balance will approximate 15.6% to 23.5% cumulatively over the lives of the related Contracts, with recovery rates approximating 2.5% to 5.4% of the original principal balance.

Following a securitization that is structured as a sale for financial accounting purposes, interest income is generally recognized on the balance of the Residuals at the same rate as used for calculating the present value of the NIRs, which is equal to 14% per annum. In addition, the Company will recognize additional revenue from the Residuals if the actual performance of the Contracts is better than the original estimate. If the actual performance of the Contracts were worse than the original estimate, then a downward adjustment to the carrying value of the Residuals and a related expense would be required. In a securitization structured as a secured financing for financial accounting purposes, interest income is recognized when accrued under the terms of the related Contracts and, therefore, presents less potential for fluctuations in performance when compared to the approach used in a transaction structured as a sale for financial accounting purposes.

In all the Company's term securitizations, whether treated as secured financings or as sales, the Company has sold the receivables (through a subsidiary) to the securitization Trust. The difference between the two structures is that in securitizations that are treated as secured financings the Company reports the assets and liabilities of the securitization Trust on its Consolidated Balance Sheet. Under both structures the Noteholders and the related securitization Trusts have no recourse to the Company for failure of the Contract obligors to make payments on a timely basis. The Company's Residuals, however, are



subordinate to the Notes until the Noteholders are fully paid, and the Company is therefore at risk to that extent.

*(c) Income taxes*

The Company and its subsidiaries file consolidated federal income and combined state franchise tax returns. The Company utilizes the asset and liability method of accounting for income taxes, under which deferred income taxes are recognized for the future tax consequences attributable to the differences between the financial statement values of existing assets and liabilities and their respective tax bases. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred taxes of a change in tax rates is recognized in income in the period that includes the enactment date. The Company has estimated a valuation allowance against that portion of the deferred tax asset whose utilization in future periods is not more than likely.

In determining the possible realization of deferred tax assets, future taxable income from the following sources are considered: (a) the reversal of taxable temporary differences; (b) future operations exclusive of reversing temporary differences; and (c) tax planning strategies that, if necessary, would be implemented to accelerate taxable income into periods in which net operating losses might otherwise expire.

### **Forward Looking Statements**

This report on Form 10-Q includes certain “forward-looking statements,” including, without limitation, the statements or implications to the effect that prepayments as a percentage of original balances will approximate 18.9% to 23.5% cumulatively over the lives of the related Contracts, that charge-offs as a percentage of original balances will approximate 15.6% to 23.5% cumulatively over the lives of the related Contracts, with recovery rates approximating 2.5% to 5.4% of original principal balances. Other forward-looking statements may be identified by the use of words such as “anticipates,” “expects,” “plans,” “estimates,” or words of like meaning. As to the specifically identified forward-looking statements, factors that could affect charge-offs and recovery rates include changes in the general economic climate, which could affect the willingness or ability of obligors to pay pursuant to the terms of Contracts, changes in laws respecting consumer finance, which could affect the ability of the Company to enforce rights under Contracts, and changes in the market for used vehicles, which could affect the levels of recoveries upon sale of repossessed vehicles. Factors that could affect the Company’s revenues in the current year include the levels of cash releases from existing pools of Contracts, which would affect the Company’s ability to purchase Contracts, the terms on which the Company is able to finance such purchases, the willingness of Dealers to sell Contracts to the Company on the terms that it offers, and the terms on which the Company is able to complete term securitizations once Contracts are acquired. Factors that could affect the Company’s expenses in the current year include competitive conditions in the market for qualified personnel, and interest rates (which affect the rates that the Company pays on Notes issued in its securitizations). The statements concerning the Company structuring future securitization transactions as secured financings and the effects of such structures on financial items and on the Company’s future profitability also are forward-looking statements. Any change to the structure of the Company’s securitization transaction could cause such forward-looking statements not to be accurate. Both the amount of the effect of the change in structure on the Company’s profitability and the duration of the period in which the Company’s profitability would be affected by the change in securitization structure are estimates. The accuracy of such estimates will be affected by the rate at which the Company purchases and sells Contracts, any changes in that rate, the credit performance of such Contracts, the financial terms of future securitizations, any changes in such terms over time, and other factors that generally affect the Company’s profitability.

Additional risk factors, any of which could have a material effect on the Company's performance, are set forth below:

*Dependence on Warehouse Financing.* The Company's primary source of day-to-day liquidity is continuous securitization of Contracts, under which it sells or pledges Contracts, as often as once a week, to either of two special-purpose affiliated entities. Such transactions function as a "warehouse" in which Contracts are held. The Company expects to continue to effect similar transactions (or to obtain replacement or additional financing) as current arrangements expire or become fully utilized; however, there can be no assurance that such financing will be obtainable on favorable terms. To the extent that the Company is unable to maintain its existing structure or is unable to arrange new warehouse facilities, the Company may have to curtail Contract purchasing activities, which could have a material adverse effect on the Company's financial condition, results of operations and liquidity.

*Dependence on Securitization Program.* The Company is dependent upon its ability to continue to finance pools of Contracts in term securitizations in order to generate cash proceeds for new purchases. Adverse changes in the market for securitized Contract pools, or a substantial lengthening of the warehousing period, would burden the Company's financing capabilities, could require the Company to curtail its purchase of Contracts, and could have a material adverse effect on the Company. In addition, as a means of reducing the percentage of cash collateral that the Company would otherwise be required to deposit and maintain in Spread Accounts, all of the Company's securitizations since June 1994 have utilized credit enhancement in the form of financial guaranty insurance policies issued by monoline financial guaranty insurers. The Company believes that financial guaranty insurance policies reduce the costs of securitizations relative to alternative forms of credit enhancements available to the Company. No insurer is required to insure Company-sponsored securitizations and there can be no assurance that any will continue to do so. Similarly, there can be no assurance that any securitization transaction will be available on terms acceptable to the Company, or at all. The timing of any securitization transaction is affected by a number of factors beyond the Company's control, any of which could cause substantial delays, including, without limitation, market conditions and the approval by all parties of the terms of the securitization.

*Risk of General Economic Downturn.* The Company's business is directly related to sales of new and used automobiles, which are affected by employment rates, prevailing interest rates and other domestic economic conditions. Delinquencies, repossessions and losses generally increase during economic slowdowns or recessions. Because of the Company's focus on Sub-Prime Customers, the actual rates of delinquencies, repossessions and losses on such Contracts could be higher under adverse economic conditions than those experienced in the automobile finance industry in general. Any sustained period of economic slowdown or recession could adversely affect the Company's ability to sell or securitize pools of Contracts. The timing of any economic changes is uncertain, and sluggish sales of automobiles and weakness in the economy could have an adverse effect on the Company's business and that of the Dealers from which it purchases Contracts.

*Dependence on Performance of Securitized Contracts.* Under the financial structures the Company has used to date in its term securitizations, certain excess cash flows generated by the Contracts sold in the term securitizations are used to increase overcollateralization or are retained in a Spread Account within the securitization trusts to provide liquidity and credit enhancement. While the specific terms and mechanics of each Spread Account vary among transactions, the Company's Securitization Agreements generally provide that the Company will receive excess cash flows only if the amount of Credit Enhancement has reached specified levels and/or the delinquency or losses related to the Contracts in the pool are below certain predetermined levels. In the event delinquencies and losses on the Contracts exceed such levels, the terms of the securitization: (i) may require increased Credit Enhancement to be accumulated for the particular pool; (ii) may restrict the distribution to the Company of excess cash flows associated with other pools; or (iii) in certain circumstances, may permit the insurers to require the transfer of servicing on some or all of the

Contracts to another servicer. Any of these conditions could materially adversely affect the Company's liquidity, financial condition and operations.

*Creditworthiness of Consumers.* The Company specializes in the purchase, sale and servicing of Contracts to finance automobile purchases by Sub-Prime Customers, which entail a higher risk of non-performance, higher delinquencies and higher losses than Contracts with more creditworthy customers. While the Company believes that the underwriting criteria and collection methods it employs enable it to control the higher risks inherent in Contracts with Sub-Prime Customers, no assurance can be given that such criteria and methods will afford adequate protection against such risks. The Company has experienced fluctuations in the delinquency and charge-off performance of its Contracts. In the event that portfolios of Contracts sold and serviced by the Company experience greater defaults, higher delinquencies or higher net losses than anticipated, the Company's income could be negatively affected. A larger number of defaults than anticipated could also result in adverse changes in the structure of the Company's future securitization transactions, such as a requirement of increased cash collateral or other Credit Enhancement in such transactions.

*Probable Increase in Cost of Funds.* The Company's profitability is determined by, among other things, the difference between the rate of interest charged on the Contracts purchased by the Company and the rate of interest payable to purchasers of Notes issued in securitizations. The Contracts purchased by the Company generally bear finance charges close to or at the maximum permitted by applicable state law. The interest rates payable on such Notes are fixed, based on interest rates prevailing in the market at the time of sale. Consequently, increases in market interest rates tend to reduce the "spread" or margin between Contract finance charges and the interest rates required by investors and, thus, the potential operating profits to the Company from the purchase, securitization and servicing of Contracts. Operating profits expected to be earned by the Company on portfolios of Contracts previously securitized are insulated from the adverse effects of increasing interest rates because the interest rates on the related Notes were fixed at the time the Contracts were sold. With interest rates near historical lows as of the date of this report, it is reasonable to expect that interest rates will increase in the near to intermediate term. Any future increases in interest rates would likely increase the interest rates on Notes issued in future term securitizations and could have a material adverse effect on the Company's results of operations and liquidity.

*Prepayments and Credit Losses.* Gains from the sale of Contracts in the Company's past securitization transactions structured as sales for financial accounting purposes have constituted a significant portion of the revenue of the Company. A portion of the gains is based in part on management's estimates of future prepayments and credit losses and other considerations in light of then-current conditions. If actual prepayments with respect to Contracts occur more quickly than was projected at the time such Contracts were sold, as can occur when interest rates decline, or if credit losses are greater than projected at the time such Contracts were sold, a charge to income may be required and would be recorded in the period of adjustment. If actual prepayments occur more slowly or if net losses are lower than estimated with respect to Contracts sold, total revenue would exceed previously estimated amounts.

Provisions for credit losses are recorded in connection with the origination and throughout the life of Contracts that are held on the Company's Condensed Consolidated Balance Sheet. Such provisions are based on management's estimates of future credit losses in light of then-current conditions. If actual credit losses in a given period exceed the allowance for credit losses, a bad debt expense during the period would be required.

*Competition.* The automobile financing business is highly competitive. The Company competes with a number of national, local and regional finance companies. In addition, competitors or potential competitors include other types of financial services companies, such as commercial banks, savings and loan associations, leasing companies, credit unions providing retail loan financing and lease financing for new and used vehicles and captive finance companies affiliated with major automobile manufacturers such as General Motors Acceptance Corporation and Ford Motor Credit Corporation. Many of the Company's competitors and potential competitors possess substantially greater financial, marketing,

technical, personnel and other resources than the Company. Moreover, the Company's future profitability will be directly related to the availability and cost of its capital relative to that of its competitors. The Company's competitors and potential competitors include far larger, more established companies that have access to capital markets for unsecured commercial paper and investment grade rated debt instruments, and to other funding sources which may be unavailable to the Company. Many of these companies also have long-standing relationships with Dealers and may provide other financing to Dealers, including floor plan financing for the Dealers' purchases of automobiles from manufacturers, which is not offered by the Company. There can be no assurance that the Company will be able to continue to compete successfully.

*Litigation.* Because of the consumer-oriented nature of the industry in which the Company operates and the application of certain laws and regulations, industry participants are regularly named as defendants in class-action litigation involving alleged violations of federal and state laws and regulations and consumer law torts, including fraud. Many of these actions involve alleged violations of consumer protection laws. Although the Company is not involved in any such material consumer protection litigation, a significant judgment against the Company or within the industry in connection with any such litigation, or an adverse outcome in the litigation identified under the caption "Legal Proceedings" in this report and in the Company's most recently filed report on Form 10-K, could have a material adverse effect on the Company's financial condition, results of operations and liquidity.

*Dependence on Dealers.* The Company is dependent upon establishing and maintaining relationships with unaffiliated Dealers to supply it with Contracts. During the three- and six-month periods ended June 30, 2004, no Dealer accounted for more than 1.0% of the Contracts purchased by the Company. The Dealer Agreements do not require Dealers to submit a minimum number of Contracts for purchase by the Company. The failure of Dealers to submit Contracts that meet the Company's underwriting criteria would have a material adverse effect on the Company's financial condition, results of operations and liquidity.

*Government Regulations.* The Company's business is subject to numerous federal and state consumer protection laws and regulations, which, among other things: (i) require the Company to obtain and maintain certain licenses and qualifications; (ii) limit the interest rates, fees and other charges the Company is allowed to charge; (iii) limit or prescribe certain other terms of its Contracts; (iv) require the Company to provide specified disclosures; and (v) regulate certain servicing and collection practices and define its rights to repossess and sell collateral. An adverse change in existing laws or regulations, or in the interpretation thereof, the promulgation of any additional laws or regulations, or the failure to comply with such laws and regulations could have a material adverse effect on the Company's financial condition, results of operations and liquidity.

### **ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

#### *Interest Rate Risk*

The Company is subject to interest rate risk during the period between when Contracts are purchased from Dealers and when such Contracts become part of a term securitization. Specifically, the interest rates on the warehouse facilities are adjustable while the interest rates on the Contracts are fixed. Historically, the Company's term securitization facilities have had fixed rates of interest. To mitigate some of this risk, the Company has in the past, and intends to continue to, structure certain of its securitization transactions to include pre-funding structures, whereby the amount of Notes issued exceeds the amount of Contracts initially sold to the Trusts. In pre-funding, the proceeds from the pre-funded portion are held in an escrow account until the Company sells the additional Contracts to the Trust in amounts up to the balance of the pre-funded escrow account. In pre-funded securitizations, the Company locks in the borrowing costs with respect to the Contracts it subsequently delivers to the Trust. However, the Company incurs an expense in pre-funded securitizations equal to the difference between the money market yields earned on the

proceeds held in escrow prior to subsequent delivery of Contracts and the interest rate paid on the Notes outstanding, the amount as to which there can be no assurance.

The Company is subject to market risks due to fluctuations in interest rates primarily as a result of its commitments to enter into new Contracts. The table below outlines the carrying values and estimated fair values of financial instruments:

	June 30, 2004		December 31, 2003	
	Carrying Value	Fair Value	Carrying Value	Fair Value
<b>Financial Instrument</b>	<b>(In thousands)</b>			
Finance receivables, net.....	\$ 421,274	421,274	\$ 266,189	266,189
Residual interest in securitizations.....	81,304	81,304	111,702	111,702
Warehouse lines of credit.....	57,114	57,114	33,709	33,709
Notes payable.....	2,132	2,132	3,330	3,330
Residual interest financing.....	33,799	33,799	-	-
Securitization trust debt.....	337,058	337,058	245,118	245,118
Senior secured debt.....	59,829	59,829	49,965	49,965
Subordinated debt.....	15,000	15,150	35,000	35,506
Related party debt.....	-	-	17,500	17,763

Much of the information used to determine fair value is highly subjective. When applicable, readily available market information has been utilized. However, for a significant portion of the Company's financial instruments, active markets do not exist. Therefore, considerable judgments were required in estimating fair value for certain items. The subjective factors include, among other things, the estimated timing and amount of cash flows, risk characteristics, credit quality and interest rates, all of which are subject to change. Since the fair value is estimated as of the dates shown in the table, the amounts that will actually be realized or paid at settlement or maturity of the instruments could be significantly different.

#### **ITEM 4. CONTROLS AND PROCEDURES**

CPS maintains a system of internal controls and procedures designed to provide reasonable assurance as to the reliability of its published financial statements and other disclosures included in this report. As of the end of the period covered by this report, CPS evaluated the effectiveness of the design and operation of such disclosure controls and procedures. Based upon that evaluation, the principal executive officer (Charles E. Bradley, Jr.) and the principal financial officer (Robert E. Riedl) concluded that the disclosure controls and procedures are effective in recording, processing, summarizing and reporting, on a timely basis, material information relating to CPS that is required to be included in its reports filed under the Securities Exchange Act of 1934. There have been no significant changes in our internal controls over financial reporting during our most recently completed fiscal quarter that materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

## **PART II — OTHER INFORMATION**

#### **ITEM 1. LEGAL PROCEEDINGS**

The information provided under the caption "Legal Proceedings" in the Company's Annual Report on Form 10-K for the year ended December 31, 2003, is incorporated herein by reference. In addition, the reader should be aware of the following:

On June 2, 2004, Delmar Coleman filed a lawsuit in the circuit court of Tuscaloosa, Alabama, making allegations similar to those that were asserted in the *Lang* case, and seeking damages in an unspecified amount, on behalf of a purported nationwide class. The *Lang* case has been tentatively settled, as disclosed in the Annual Report, and related to alleged defects in the notices given with respect to repossessed vehicles. CPS believes that it has one or more defenses to each of the claims made in this lawsuit, and intends to defend the matter vigorously.

On June 15, 2004, Keywana Booker filed a lawsuit in the federal district court of Atlanta, Georgia, alleging violations of the Fair Debt Collection Practices Act, and seeking damages in an unspecified amount on behalf of a purported class of Georgia residents. CPS believes that it has one or more defenses to each of the claims made in this lawsuit, and intends to defend the matter vigorously.

The Company is routinely involved in various legal proceedings resulting from its consumer finance activities and practices, both continuing and discontinued. The Company believes that there are substantive legal defenses to such claims, and intends to defend them vigorously. There can be no assurance, however, as to the outcome.

## **ITEM 2. CHANGES IN SECURITIES, USE OF PROCEEDS AND ISSUER PURCHASES OF EQUITY SECURITIES**

The Company's 10.50% Participating Equity Notes due 2004 matured on April 15, 2004. On that date, the Company paid the aggregate outstanding principal balance of such notes, in the amount of \$15,000,000, and the accrued interest thereon.

During the three months ended June 30, 2004, the Company purchased a total of 6,738 shares of its common stock, as described in the following table:

### **ISSUER PURCHASES OF EQUITY SECURITIES**

<b>Period (1)</b>	<b>Total Number of Shares Purchased</b>	<b>Average Price Paid per Share</b>	<b>Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs(2)</b>	<b>Approximate Dollar Value of Shares that May Yet be Purchased Under the Plans or Programs</b>
April 2004	—	—	—	1,603,130
May 2004	6,738	\$3.75	6,738	1,577,863
June 2004	—	—	—	1,577,863
Total	6,738	\$3.75	6,738	

(1) Each monthly period is the calendar month.

(2) The Company announced in August 2000 its intention to purchase up to \$5 million of its outstanding securities, inclusive of annual \$1 million sinking fund redemptions on its Rising Interest Redeemable Subordinated Securities due 2006. In October 2002, the July 2000 program having been exhausted, the Company's board of directors authorized the purchase of up to an additional \$5 million of such securities, which program was first announced in the Company's annual report for the year 2002, filed on March 26, 2003. All purchases described in the table above were under the plan announced in March 2003, which has no fixed expiration date.

On June 30, 2004, the Company issued 333,333 shares of its common stock to John G. Poole, a director of the Company, upon conversion at maturity, and pursuant to its terms, of a \$1,000,000 note held by Mr. Poole since 1998. The issuance of shares was exempt from registration under the Securities Act of 1933 pursuant to Section 3(a)(9) thereof, as the shares were issued in exchange for the outstanding note, and no commission was paid for soliciting such exchange.

#### ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

The annual meeting of shareholders of the Company was held on April 26, 2004. At the meeting, each of the eight nominees to the Board of Directors was elected for a one-year term by the shareholders, with votes cast as follows:

<u>Nominee</u>	<u>Votes For</u>	<u>Votes Withheld</u>
Charles E. Bradley, Jr.	19,435,762	701,700
Thomas L. Chrystie	19,405,562	731,960
E. Bruce Fredrikson	19,405,562	731,960
John E. McConnaughey, Jr.	19,405,562	731,960
John G. Poole	19,405,562	731,960
William B. Roberts	19,435,762	701,700
John C. Warner	19,621,962	515,500
Daniel S. Wood	19,435,762	701,700

The shareholders also approved each other proposal placed before the annual meeting. Such proposals were (i) approval of an amendment to the Company's 1997 Long-Term Incentive Stock Plan, which increased the number of shares issuable from 4,900,000 to 6,900,000, and (ii) ratification of the appointment of KPMG LLP as independent auditors of the Company for the fiscal year ending December 31, 2004. Votes on such proposals were cast as follows:

	<b>Approval of Plan Amendment</b>	<b>Ratification of Selection of Independent Auditors</b>
For	5,906,270	14,353,475
Against	5,879,905	313,380
Abstain	14,540	4,591,400
Broker Non-votes	8,336,747	879,207

#### ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K

(a) The following exhibits are filed with this report:

- 10.33 Receivables Purchase Agreement relating to receivables purchased from SeaWest Receivables Corporation I (incorporated by reference to Exhibit 2.1 to the registrant's amended report on Form 8-K, as filed June 3, 2004).
- 10.34 Receivables Purchase Agreement relating to receivables purchased from SeaWest Funding Corporation (incorporated by reference to Exhibit 2.2 to the registrant's amended report on Form 8-K, as filed June 3, 2004).
- 10.35 Receivables Purchase Agreement relating to receivables purchased from

- SeaWest Financial Corporation (incorporated by reference to Exhibit 2.3 to the registrant's amended report on Form 8-K, as filed June 3, 2004).
- 10.36 General Assignment and Bill of Sale relating to certain tangible assets of SeaWest Financial Corporation (incorporated by reference to Exhibit 2.4 to the registrant's amended report on Form 8-K, as filed June 3, 2004).
- 31.1 Rule 13a-14(a) Certification of the Chief Executive Officer of the registrant.
- 31.2 Rule 13a-14(a) Certification of the Chief Financial Officer of the registrant.
- 32 Section 1350 Certifications.\*

\* These Certifications shall not be deemed "filed" for purposes of Section 18 of the Securities Exchange Act of 1934, as amended, or otherwise subject to the liability of that section. These Certifications shall not be deemed to be incorporated by reference into any filing under the Securities Act of 1933, as amended, or the Exchange Act, except to the extent that the registration statement specifically states that such Certifications are incorporated therein.

(b) The Company filed two reports on Form 8-K during the quarter for which this report is filed. The first such report was filed on April 19, 2004, and amended on June 3, 2004. It reported information under item 2 of Form 8-K, to the effect that the Company had acquired certain assets (predominantly automotive receivables) by purchase. The second such report was filed on May 10, 2004. It reported information under item 12 of Form 8-K, to the effect that the Company had issued a quarterly earnings release. Pursuant to Item 7, the text of such release was attached as an exhibit.

## SIGNATURES

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

CONSUMER PORTFOLIO SERVICES, INC.

(Registrant)

Date: August 16, 2004

/s/ CHARLES E. BRADLEY, JR.

Charles E. Bradley, Jr.

*President and Chief Executive Officer*

(Principal Executive Officer)

Date: August 16, 2004

/s/ ROBERT E. RIEDL

Robert E. Riedl

*Senior Vice President and Chief Financial Officer*

(Principal Financial Officer)



**CERTIFICATION**

I, Charles E. Bradley, Jr., certify that:

1. I have reviewed this quarterly report on Form 10-Q of Consumer Portfolio Services, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the registrant and have:
  - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - (b) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - (c) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
  - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: August 16, 2004

/s/ CHARLES E. BRADLEY, JR.

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Chief Executive Officer

**CERTIFICATION**

I, Robert E. Riedl, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Consumer Portfolio Services, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the registrant and have:
  - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - (b) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - (c) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
  - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: August 16, 2004

/s/ ROBERT E. RIEDL

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Chief Financial Officer

**Certification Pursuant To  
18 U.S.C. Section 1350,  
As Adopted Pursuant To  
Section 906 of The Sarbanes-Oxley Act Of 2002**

In connection with the Quarterly Report on Form 10-Q of Consumer Portfolio Services, Inc. (the "Company") for the quarterly period ended June 30, 2004, as filed with the Securities and Exchange Commission on the date hereof (the "Report"), Charles E. Bradley, Jr., as Chief Executive Officer of the Company, and Robert E. Riedl, as Chief Financial Officer of the Company, each hereby certifies, pursuant to 18 U.S.C. §1350, as adopted pursuant to §906 of the Sarbanes-Oxley Act of 2002, that:

(1) The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and

(2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

/s/ CHARLES E. BRADLEY, JR.

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Charles E. Bradley, Jr.  
Chief Executive Officer  
August 16, 2004

/s/ ROBERT E. RIEDL

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Robert E. Riedl  
Chief Financial Officer  
August 16, 2004

This certification accompanies each Report pursuant to § 906 of the Sarbanes-Oxley Act of 2002 and shall not, except to the extent required by the Sarbanes-Oxley Act of 2002, be deemed filed by the Company for purposes of §18 of the Securities Exchange Act of 1934, as amended.

A signed original of this written statement required by Section 906 has been provided to the Company and will be retained by the Company and furnished to the Securities and Exchange Commission or its staff upon request.