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**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549**

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**FORM 10-K**

ANNUAL REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

**For the fiscal year ended December 31, 2003**

TRANSITION REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

Commission file number: 1-14116

**CONSUMER PORTFOLIO SERVICES, INC.**

(Exact name of registrant as specified in its charter)

**California**  
(State or other jurisdiction of  
incorporation or organization)

**33-0459135**  
(I.R.S. Employer  
Identification No.)

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

**92618**  
(Zip Code)

**Registrant's telephone number, including area code: (949) 753-6800**

**Securities registered pursuant to section 12(b) of the Act:**

Title of each class:	Name of each exchange on which registered:
10.50% Participating Equity Notes due 2004	New York Stock Exchange
Rising Interest Subordinated Redeemable Securities due 2006	New York Stock Exchange

**Securities registered pursuant to section 12(g) of the Act:**

Common Stock, No Par Value

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Exchange Act during the past 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 if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

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

The aggregate market value of common equity held by non-affiliates of the registrant as of the last business day of the registrant's most recently completed second fiscal quarter (June 30, 2003) was \$38,463,000, based upon the \$2.74 per share closing price of the Common Stock on that date, as reported by the Nasdaq Stock Market. The number of shares of the registrant's Common Stock outstanding on March 16, 2004, was 20,705,324.

DOCUMENTS INCORPORATED BY REFERENCE

The registrant's proxy statement for its 2004 annual meeting of shareholders is incorporated by reference into Part III of this report.

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*This annual report of Consumer Portfolio Services, Inc. consists of Items 1 through 9 of our report on Form 10-K as filed with the Securities and Exchange Commission.*

# PART I

## Item 1. Business

### 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. From inception through December 31, 2003, the Company has purchased approximately \$4.9 billion of Contracts from Dealers. In addition, the Company obtained a total of approximately \$530 million of Contracts in its 2002 and 2003 acquisitions, described below. As of December 31, 2003, the Company had a total managed portfolio, net of unearned interest on pre-computed Contracts, of approximately \$741.1 million, including the remaining outstanding balance of Contracts acquired in the two acquisitions.

### Acquisitions

In March 2002, the Company acquired MFN Financial Corporation and its subsidiaries in a merger (the “MFN Merger”). In May 2003, the Company acquired TFC Enterprises, Inc. and its subsidiaries in a second merger (the “TFC Merger”). MFN Financial Corporation and its subsidiaries (“MFN”) and TFC Enterprises, Inc. and its subsidiaries (“TFC”) were engaged in businesses similar to that of the Company; buying Contracts from Dealers, repackaging those Contracts in securitization transactions, and servicing those Contracts. The Company acquired approximately \$380 million of Contracts in the MFN Merger, and approximately \$150 million in the TFC Merger. MFN ceased acquiring Contracts in March 2002; TFC continues to acquire Contracts under its “TFC Programs,” on terms and conditions similar to those it used prior to the TFC Merger. Contracts purchased by TFC after the TFC Merger accounted for less than 10% of the total purchases during the year.

### Securitizations

#### 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 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 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 and other expenses. That residual interest appears on the Company's Consolidated Balance Sheet as "Residual interest in securitizations," and its value is dependent on estimates of the future performance of the sold Contracts.

### **Change in Policy**

During August 2003 the Company announced that it would structure its future securitization transactions to be reflected as secured financings for financial accounting purposes. The first two term securitizations so structured occurred in September and December 2003. 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 TFC Merger the Company acquired finance receivables that had been previously securitized in term securitization transactions that were reflected as secured financings. As of December 31, 2003, the Company's Consolidated Balance Sheet included net finance receivables of approximately \$119.6 million and securitization trust debt of \$95.9 million related to finance receivables acquired in the two mergers, out of totals of net finance receivables of approximately \$266.2 million and securitization trust debt of approximately \$245.1 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 December 31, 2003 was approximately \$741.1 million. See "— Securitization of Contracts," "— The Servicing Agreements," "—Management's Discussion and Analysis of Financial Condition and Results of Operations," and "—Liquidity and Capital Resources."

### **The Market We Serve**

The Company's automobile financing programs are designed to serve customers who generally would not qualify for automobile financing from traditional sources, such as commercial banks, credit unions and the captive finance companies affiliated with major automobile manufacturers. Such customers generally have limited credit histories, low incomes or past credit problems, and are therefore often unable to obtain credit from traditional sources of automobile financing. (The terms "prime" and "sub-prime" reflect the Company's categorization of customers and bear no relationship to the prime rate of interest or persons who are able to borrow at that rate.) Because the Company serves customers who are unable to meet the credit standards imposed by most traditional automobile financing sources, the Company generally receives interest at rates higher than those charged by traditional automobile financing sources. The Company also sustains a higher level of credit losses than traditional automobile financing sources since the Company provides financing in a relatively high risk market.

## Marketing

The Company directs its marketing efforts to Dealers, rather than to consumers. As of December 31, 2003, the Company was a party to its standard form dealer agreements (“Dealer Agreements”) with over 3,000 Dealers. Approximately 95% of these Dealers are franchised new car dealers that sell both new and used cars and the remainders are independent used car dealers. For the year ended December 31, 2003, approximately 85% of the Contracts purchased by CPS (under the “CPS programs”) consisted of financing for used cars and the remaining 15% for new cars, as compared to 88% used and 12% new in the year ended December 31, 2002.

The Company establishes relationships with Dealers through Company representatives who contact a prospective Dealer to explain the Company's Contract purchase programs, and who thereafter provide Dealer training and support services. As of December 31, 2003, the Company had 42 representatives. The representatives are contractually obligated to represent the Company's financing program exclusively. The Company's representatives present the Dealer with a marketing package, which includes the Company's promotional material containing the terms offered by the Company for the purchase of Contracts, a copy of the Company's standard-form Dealer Agreement, examples of monthly reports, and required documentation relating to Contracts. Marketing representatives have no authority relating to the decision to purchase Contracts from Dealers.

Most of the Dealers under contract with CPS regularly submit Contracts to the Company for purchase, although they are under no obligation to submit any Contracts to the Company, nor is the Company obligated to purchase any Contracts. During the year ended December 31, 2003, no Dealer accounted for more than 1% of the total number of Contracts purchased by the Company under the CPS programs. The following table sets forth the geographical sources of the Contracts purchased by the Company under the CPS programs (based on the addresses of the customers as stated on the Company's records) during the years ended December 31, 2003 and 2002. Contracts purchased by MFN are not included in the table as MFN Contract purchases were terminated shortly after the MFN Merger. Contracts purchased by TFC after the TFC Merger are not included because such purchases accounted for less than 10% of the total purchases during the year. All Contracts are acquired from Dealers located within the United States.

	<b>Contracts Purchased During the Year Ended (1)</b>			
	<b>December 31, 2003</b>		<b>December 31, 2002</b>	
	<b>Number</b>	<b>Percent (2)</b>	<b>Number</b>	<b>Percent (2)</b>
Texas .....	2,333	9.8%	3,313	10.3%
Louisiana .....	1,637	6.8	1,680	5.2
Pennsylvania.....	1,567	6.6	1,539	4.8
Illinois.....	1,466	6.1	2,274	7.1
California.....	1,461	6.1	2,111	6.5
Ohio .....	1,398	5.8	1,733	5.4
Florida .....	1,343	5.6	1,453	4.5
North Carolina.....	1,281	5.4	1,979	6.1
Michigan.....	1,258	5.3	1,776	5.5
Maryland .....	1,070	4.5	945	2.9
Georgia .....	1,046	4.4	1,831	5.7
Kentucky .....	948	4.0	1,449	4.5
New York .....	932	3.9	1,215	3.8
Alabama.....	814	3.4	1,288	4.0
Other States .....	5,346	22.4	7,669	23.7
Total.....	<u>23,900</u>	<u>100.0%</u>	<u>32,255</u>	<u>100.0%</u>

(1) Excludes purchases under the TFC programs.

(2) Amounts may not total 100% due to rounding.

## **Origination of Contracts**

### **Dealer Origination**

When a retail automobile buyer elects to obtain financing from a Dealer, the Dealer takes a credit application to submit to its financing sources. Typically, a Dealer will submit the buyer's application to more than one financing source for review. The Company believes the Dealer's decision to finance the automobile purchase with the Company, rather than other financing sources, is based primarily on the monthly payment that will be offered to the automobile buyer, the purchase price offered for the Contract, the timeliness, consistency and predictability of response, the cash resources of the financing source, and any conditions to purchase.

Upon receipt of information from a Dealer, the Company's administrative personnel order a credit report to document the buyer's credit history. If, upon review by a Company credit analyst, it is determined that the Contract meets the Company's underwriting criteria, or would meet such criteria with modification, the Company requests and reviews further information and supporting documentation and, ultimately, decides whether to purchase the Contract. When presented with an application, the Company attempts to notify the Dealer within two hours as to whether it would purchase the related Contract. The Company's TFC subsidiaries seek to finance only vehicle purchases by members of The United States armed forces. The Contract purchase decision process for the TFC programs does not make use of credit reports, but relies on verification of military status.

The actual agreement for purchase of the vehicle ("Contract") is prepared by the Dealer. The Dealer also arranges for recording the Company's lien on the vehicle. After the appropriate documents are signed by the Dealer and the customer, the Dealer sells the Contract to the Company. During 2001 and the first quarter of 2002 the Company immediately sold most of the Contracts that it purchased, and held the remainder for its own account. See "—Flow Purchase Program."

The Company purchases Contracts under the CPS programs from Dealers at a price generally equal to the total amount financed under the Contracts, adjusted for an acquisition fee, which varies based on the perceived credit risk and, in some cases, the interest rate on the Contract. For the years ended December 31, 2003, 2002 and 2001, the average acquisition fee charged per Contract purchased under the CPS programs was \$372, \$313 and \$355, respectively, or 2.7%, 2.2% and 2.4%, respectively, of the amount financed. The Company also purchases certain Contracts under the CPS programs for a premium over the amount financed. The Company is willing to pay a premium when it estimates the credit risk to be low, compared to that of other Contracts that it purchases. During 2003, 2002 and 2001, respectively, the Company purchased 6,618, 9,971 and 9,962 of these Contracts, representing approximately 27.7%, 30.9% and 21.7% of all Contracts purchased under the CPS programs. The average premium paid to Dealers on these Contracts was \$447, \$435 and \$172, respectively.

The Company attempts to control misrepresentation regarding the customer's credit worthiness by carefully screening the Contracts it purchases, by establishing and maintaining professional business relationships with Dealers, and by including certain representations and warranties by the Dealer in the Dealer Agreement. Pursuant to the Dealer Agreement, the Company may require the Dealer to repurchase any Contract in the event that the Dealer breaches its representations or warranties. There can be no assurance, however, that any Dealer will have the willingness or the financial resources to satisfy its repurchase obligations to the Company.

### **Objective Contract Purchase Criteria**

To be eligible for purchase by the Company, a Contract must have been originated by a Dealer that has entered into a Dealer Agreement to sell Contracts to the Company. The Contracts must be secured by a first priority lien on a new or used automobile, light truck or passenger van and must meet the Company's underwriting criteria. In addition, each Contract requires the customer to maintain physical damage insurance covering the financed vehicle and naming the Company as a loss payee. The Company or any purchaser of the Contract from the Company may, nonetheless, suffer a loss upon theft or physical damage of any financed vehicle if the

customer fails to maintain insurance as required by the Contract and is unable to pay for repairs to or replacement of the vehicle or is otherwise unable to fulfill his or her obligations under the Contract.

The Company believes that its objective underwriting criteria enable it to evaluate effectively the creditworthiness of Sub-Prime Customers and the adequacy of the financed vehicle as security for a Contract. These criteria include standards for price, term, amount of down payment, installment payment and interest rate; mileage, age and type of vehicle; principal amount of the Contract in relation to the value of the vehicle; customer income level, employment and residence stability, credit history and debt service ability; and other factors. Specifically, the Company's guidelines for the CPS programs limit the maximum principal amount of a purchased Contract to 115% of wholesale book value in the case of used vehicles or to 115% of the manufacturer's invoice in the case of new vehicles, plus, in each case, sales tax, licensing and, when the customer purchases such additional items, a service contract or a credit life or disability policy. The Company does not finance vehicles that are more than seven model years old or have in excess of 85,000 miles. Under most CPS programs, the maximum term of a purchased Contract is 72 months; a shorter maximum term may be applied based on the mileage of the vehicle, and Contracts with the maximum term of 72 months may be purchased if the customer is among the more creditworthy of CPS's obligors and the vehicle is not more than two model years old and has less than 30,000 miles. Contract purchase criteria are subject to change from time to time as circumstances may warrant. Upon receiving this information with the customer's application, the Company's underwriters verify the customer's employment, residency, insurance and credit information provided by the customer by contacting various parties noted on the customer's application, credit information bureaus and other sources. In addition, prior to purchasing a Contract under the CPS programs, CPS contacts each customer by telephone to confirm that the Customer understands and agrees to the terms of the related Contract.

*Credit Scoring.* Under the CPS programs, the Company uses a proprietary scoring model to assign to each Contract a "credit score" at the time the application is received from the Dealer and the customer's credit information is retrieved from the credit reporting agencies. The credit score is based on a variety of parameters, such as the customer's employment and residence stability, the amount of the down payment, and the age and mileage of the vehicle. The Company has developed the credit score as a means of improving its allocation of credit evaluation resources, and managing the risk inherent in the sub-prime market.

*Characteristics of Contracts.* All of the Contracts purchased by the Company are fully amortizing and provide for level payments over the term of the Contract. The average original principal amount financed under Contracts purchased, under the CPS programs, and in the year ended December 31, 2003, was approximately \$13,738, with an average original term of approximately 60.2 months and an average down payment amount of 13.5%. Based on information contained in customer applications, for this 12-month period, the retail purchase price of the related automobiles averaged \$14,104 (which excludes tax, license fees, and any additional costs such as a maintenance contract), the average age of the vehicle at the time the Contract was purchased was three years, and CPS customers averaged approximately 38 years of age, with approximately \$37,440 in average annual household income and an average of 5.3 years' history with his or her current employer.

All Contracts may be prepaid at any time without penalty. In the event a customer elects to prepay a Contract in full, the payoff amount is calculated by deducting the unearned interest from the Contract balance, in the case of a pre-computed Contract, or by adding accrued interest to the Contract balance, in the case of a simple interest Contract.

Each Contract purchased by the Company prohibits the sale or transfer of the financed vehicle without the Company's consent and allows for the acceleration of the maturity of a Contract upon a sale or transfer without such consent. The Company generally does not consent to a sale or transfer of a financed vehicle unless the related Contract is prepaid in full.

*Dealer Compliance.* The Dealer Agreement and related assignment contain representations and warranties by the Dealer that an application for state registration of each financed vehicle, naming the Company as secured

party with respect to the vehicle, was effected at the time of sale of the related Contract to the Company, and that all necessary steps have been taken to obtain a perfected first priority security interest in each financed vehicle in favor of the Company under the laws of the state in which the financed vehicle is registered. If a Dealer or the Company, because of clerical error or otherwise, has failed to take such action in a timely manner, or to maintain such interest with respect to a financed vehicle, neither the Company nor any purchaser of the related Contract from the Company would have a perfected security interest in the financed vehicle and its security interest may be subordinate to the interest of, among others, subsequent purchasers of the financed vehicle, holders of perfected security interests and a trustee in bankruptcy of the customer. The security interest of the Company or the purchaser of a Contract may also be subordinate to the interests of third parties if the interest is not perfected due to administrative error by state recording officials. Moreover, fraud or forgery could render a Contract unenforceable. In such events, the Company could suffer a loss with respect to the related Contract. In the event the Company suffers such a loss, it will generally have recourse against the Dealer from which it purchased the Contract. This recourse will be unsecured, and there can be no assurance that any particular Dealer will satisfy any such repurchase obligations to the Company.

### **Servicing of Contracts**

*General.* The Company's servicing activities consist of mailing monthly billing statements; collecting, accounting for and posting of all payments received; responding to customer inquiries; taking all necessary action to maintain the security interest granted in the financed vehicle or other collateral; investigating delinquencies; communicating with the customer to obtain timely payments; repossessing and liquidating the collateral when necessary; and generally monitoring each Contract and the related collateral.

*Collection Procedures.* The Company believes that its ability to monitor performance and collect payments owed from Sub-Prime Customers is primarily a function of its collection approach and support systems. The Company believes that if payment problems are identified early and the Company's collection staff works closely with customers to address these problems, it is possible to correct many of them before they deteriorate further. To this end, the Company utilizes pro-active collection procedures, which include making early and frequent contact with delinquent customers; educating customers as to the importance of maintaining good credit; and employing a consultative and customer service approach to assist the customer in meeting his or her obligations, which includes attempting to identify the underlying causes of delinquency and cure them whenever possible. In support of its collection activities, the Company maintains a computerized collection system specifically designed to service automobile installment sale contracts with Sub-Prime Customers and similar consumer obligations.

With the aid of its high-penetration automatic dialer, as well as manual efforts made by collection staff, the Company typically attempts to make telephonic contact with delinquent customers on the sixth day after their monthly payment due date. Using coded instructions from a collection supervisor, the automatic dialer will attempt to contact customers based on their physical location, state of delinquency, size of balance or other parameters. If the automatic dialer obtains a "no-answer" or a busy signal, it records the attempt on the customer's record and moves on to the next call. If a live voice answers the automatic dialer's call, the call is transferred to a waiting collector as the customer's pertinent information is simultaneously displayed on the collector's workstation. The collector then inquires of the customer the reason for the delinquency and when the Company can expect to receive the payment. The collector will attempt to get the customer to make a promise for the delinquent payment for a time generally not to exceed one week from the date of the call. If the customer makes such a promise, the account is routed to a promise queue and is not contacted until the outcome of the promise is known. If the payment is made by the promise date and the account is no longer delinquent, the account is routed out of the collection system. If the payment is not made, or if the payment is made, but the account remains delinquent, the account is returned to the queue for subsequent contacts.

If a customer fails to make or keep promises for payments, or if the customer is uncooperative or attempts to evade contact or hide the vehicle, a supervisor will review the collection activity relating to the account to determine if repossession of the vehicle is warranted. Generally, such a decision will occur between the 45th

and 90th day past the customer's payment due date, but could occur sooner or later, depending on the specific circumstances.

If the Company elects to repossess the vehicle, it assigns the task to an independent local repossession service. Such services are licensed and/or bonded as required by law. When the vehicle is recovered, the reposessor delivers it to a wholesale auto auction, where it is kept until sold. The Uniform Commercial Code ("UCC") and other state laws regulate repossession sales by requiring that the secured party provide the customer with reasonable notice of the date, time and place of any public sale of the collateral, the date after which any private sale of the collateral may be held and of the customer's right to redeem the financed vehicle prior to any such sale and by providing that any such sale be conducted in a commercially reasonable manner. Financed vehicles that have been repossessed are generally resold by the Company through unaffiliated automobile auctions, which are attended principally by car dealers. Net liquidation proceeds are applied to the customer's outstanding obligation under the Contract. Such proceeds usually are insufficient to pay the customer's obligation in full, resulting in a deficiency.

Under the UCC and other laws applicable in most states, a creditor is entitled to obtain a judgment against a customer for such a deficiency. However, some states impose prohibitions or limitations on deficiency judgments. When obtained, deficiency judgments are entered against defaulting individuals who may have little capital or income. Therefore, in many cases, it may not be useful to seek a deficiency judgment against a customer or, if one is obtained, it may be settled at a significant discount.

### Credit Experience

The Company's financial results are dependent on the performance of the Contracts in which it retains an ownership interest. The tables below document the delinquency, repossession and net credit loss experience of all Contracts that the Company was servicing as of the respective dates shown. Credit experience for CPS, MFN (since the date of the MFN Merger) and TFC (since the date of the TFC Merger) is shown on both a combined and individual basis in the tables below.

#### Delinquency Experience (1) CPS, MFN and TFC Combined

	December 31, 2003		December 31, 2002		December 31, 2001	
	Number of Contracts	Amount	Number of Contracts	Amount	Number of Contracts	Amount
Gross servicing portfolio (1) .....	84,860	\$ 773,220	86,940	\$ 616,519	44,080	\$ 288,756
Period of delinquency (2)						
31-60 days .....	2,506	17,982	3,658	18,388	2,149	12,409
61-90 days .....	1,340	8,942	1,541	6,595	721	4,018
91+ days .....	1,522	9,452	825	3,422	552	3,488
Total delinquencies (2) .....	5,368	36,376	6,024	28,405	3,422	19,915
Amount in repossession (3) .....	1,242	11,751	1,402	10,835	787	5,757
Total delinquencies and amount in repossession (2) .....	6,610	\$ 48,127	7,426	\$ 39,240	4,209	\$ 25,672
Delinquencies as a percentage of gross servicing portfolio .....	6.3%	4.7%	6.9%	4.6%	7.8%	6.9%
Total delinquencies and amount in repossession as a percentage of gross servicing portfolio .....	7.8%	6.2%	8.5%	6.4%	9.6%	8.9%

**CPS**

	<u>December 31, 2003</u>		<u>December 31, 2002</u>		<u>December 31, 2001</u>	
	<u>Number of Contracts</u>	<u>Amount</u>	<u>Number of Contracts</u>	<u>Amount</u>	<u>Number of Contracts</u>	<u>Amount</u>
Gross servicing portfolio (1) .....	47,615	\$543,776	43,244	\$394,845	44,080	\$ 288,756
Period of delinquency (2)						
31-60 days .....	1,175	11,766	1,734	10,738	2,149	12,409
61-90 days .....	657	5,719	643	3,619	721	4,018
91+ days .....	<u>393</u>	<u>3,105</u>	<u>282</u>	<u>1,508</u>	<u>552</u>	<u>3,488</u>
Total delinquencies (2) .....	2,225	20,590	2,659	15,865	3,422	19,915
Amount in repossession (3) .....	<u>725</u>	<u>8,434</u>	<u>654</u>	<u>6,305</u>	<u>787</u>	<u>5,757</u>
Total delinquencies and amount in repossession (2) .....	<u>2,950</u>	<u>\$ 29,024</u>	<u>3,313</u>	<u>\$ 22,170</u>	<u>4,209</u>	<u>\$ 25,672</u>
Delinquencies as a percentage of gross servicing portfolio .....	4.7%	3.8%	6.2%	4.0%	7.8%	6.9%
Total delinquencies and amount in repossession as a percentage of gross servicing portfolio .....	6.2%	5.3%	7.7%	5.6%	9.6%	8.9%

**MFN**

	<u>December 31, 2003</u>		<u>December 31, 2002</u>	
	<u>Number of Contracts</u>	<u>Amount</u>	<u>Number of Contracts</u>	<u>Amount</u>
Gross servicing portfolio (1) .....	20,282	\$77,717	43,696	\$ 221,674
Period of delinquency (2)				
31-60 days .....	769	2,128	1,924	7,650
61-90 days .....	327	843	898	2,976
91+ days .....	<u>227</u>	<u>532</u>	<u>543</u>	<u>1,914</u>
Total delinquencies (2) .....	1,323	3,503	3,365	12,540
Amount in repossession (3) .....	<u>369</u>	<u>1,899</u>	<u>748</u>	<u>4,530</u>
Total delinquencies and amount in repossession (2) .....	<u>1,692</u>	<u>\$ 5,402</u>	<u>4,113</u>	<u>\$ 17,070</u>
Delinquencies as a percentage of gross servicing portfolio .....	6.5%	4.5%	7.7%	5.7%
Total delinquencies and amount in repossession as a percentage of gross servicing portfolio .....	8.3%	7.0%	9.4%	7.7%

**TFC**

	<u>December 31, 2002</u>	
	<u>Number of</u>	
	<u>Contracts</u>	<u>Amount</u>
	<u>(Dollars in thousands)</u>	
Gross servicing portfolio (1)....	16,963	\$ 151,727
Period of delinquency (2)		
31-60 days.....	562	4,088
61-90 days.....	356	2,380
91+ days.....	<u>902</u>	<u>5,815</u>
Total delinquencies (2) .....	1,820	12,283
Amount in repossession (3) .....	<u>148</u>	<u>1,418</u>
Total delinquencies and amount in repossession (2)...	<u>1,968</u>	<u>\$ 13,701</u>
Delinquencies as a percentage of gross servicing portfolio ..	10.7%	8.1%
Total delinquencies and amount in repossession as a percentage of gross servicing portfolio .....	11.6%	9.0%

(1) All amounts and percentages are based on the amount remaining to be repaid on each Contract, including, for pre-computed Contracts, any unearned interest. The information in the table represents the gross principal amount of all Contracts purchased by the Company on an other than flow basis, including Contracts subsequently sold by the Company in securitization transactions that it continues to service.

(2) The Company considers a Contract delinquent when an obligor fails to make at least 90% of a contractually due payment by the following due date, which date may have been extended within limits specified in the Servicing Agreements. The period of delinquency is based on the number of days payments are contractually past due. Contracts less than 31 days delinquent are not included.

(3) Amount in repossession represents financed vehicles that have been repossessed but not yet liquidated.

**Net Charge-Off Experience (1)**

**CPS, MFN and TFC Combined**

	<u>Year Ended December 31,</u>		
	<u>2003</u>	<u>2002</u>	<u>2001</u>
	<u>(Dollars in thousands)</u>		
Average servicing portfolio outstanding .....	\$ 674,523	\$ 524,286	\$ 341,498
Net charge-offs as a percentage of average servicing portfolio (2) (3).....	6.8%	8.6%	6.2%

**CPS**

	<u>Year Ended December 31,</u>		
	<u>2003</u>	<u>2002</u>	<u>2001</u>
	<u>(Dollars in thousands)</u>		
Average servicing portfolio outstanding .....	\$ 483,647	\$ 291,863	\$ 341,498
Net charge-offs as a percentage of average servicing portfolio (2).....	4.7%	5.0%	6.2%

## MFN

	<u>Year Ended</u> <u>December 31, 2003</u> <u>(Dollars in thousands)</u>	<u>Year Ended</u> <u>December 31, 2002</u> <u>(Dollars in thousands)</u>
Average servicing portfolio outstanding .....	\$ 123,140	\$ 278,908
Net charge-offs as a percentage of average servicing portfolio (2).....	12.6%	11.0%

## TFC

	<u>Year Ended</u> <u>December 31, 2003</u> <u>(Dollars in thousands)</u>
Average servicing portfolio outstanding .....	\$ 133,428
Net charge-offs as a percentage of average servicing portfolio (2) (4).....	11.3%

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(1) All amounts and percentages are based on the principal amount scheduled to be paid on each Contract, net of unearned income on pre-computed Contracts. The information in the table represents all Contracts serviced by the Company.

(2) Net charge-offs include the remaining principal balance, after the application of the net proceeds from the liquidation of the vehicle (excluding accrued and unpaid interest).

(3) The fluctuation in net charge-offs as a percentage of the average servicing portfolio between 2002 and 2001 is primarily due to the addition of MFN Contracts, which are anticipated to charge off at rates greater than CPS Contracts.

(4) TFC Contracts are expected to charge off at rates greater than CPS. To partially compensate for this higher risk, TFC Contracts are purchased with a higher acquisition fee than CPS Contracts.

### Flow Purchase Program

From May 1999 through the second quarter of 2002, the Company purchased Contracts primarily for immediate and outright resale to non-affiliated third parties. The Company sold such Contracts for a mark-up above what the Company paid the Dealer. In such sales, the Company made certain representations and warranties to the purchasers, normal in the industry, which related primarily to the legality of the sale of the underlying motor vehicle and to the validity of the security interest that conveyed to the purchaser. These representations and warranties were generally similar to the representations and warranties given by the originating Dealer to the Company. In the event of a breach of such representations or warranties, the Company might incur liabilities in favor of the purchaser(s) of the Contracts and there can be no assurance that the Company would be able to recover, in turn, against the originating Dealer(s).

One of the two flow purchasers ceased to purchase Contracts in December 2001, and the other ceased to purchase in May 2002. The flow purchase program accordingly ended at that time.

### Securitization of Contracts

The Company purchases Contracts for resale in or to be financed through securitization transactions. See "Management's Discussion and Analysis of Financial Condition and Results of Operations — Liquidity and Capital Resources" and Note 1 of Notes to Consolidated Financial Statements. During 2003, the Company funded such purchases primarily with proceeds from three short-term revolving warehouse lines of credit. These warehouse lines of credit included a \$125 million floating rate variable funding note facility, a \$75 million floating rate variable funding note facility and a \$25 million floating rate variable funding note facility. The first two warehouse facilities provided funding for Contracts purchased under CPS' programs while the third facility provided funding for Contracts purchased under TFC's programs. On February 21, 2004, the \$75 million facility expired and, as a result, the Company's current warehouse credit capacity is \$150 million. These facilities are independent of each other. Two different institutions purchased the notes issued by these

facilities and three different insurers insured the notes. Approximately 71.6% to 73.0% of the principal balance of Contracts may be advanced to the Company under these facilities, subject to collateral tests and certain other conditions and covenants. Long-term funding for the purchase of Contracts is achieved by the Company through term securitization transactions, in which the liabilities (the asset-backed securities) are repaid as the underlying Contracts amortize. Proceeds from term securitization transactions are used primarily to repay the warehouse facilities. The Company completed four term securitization transactions in 2003 and three term securitization transactions in 2002.

In a securitization, the Company is required to make certain representations and warranties, which are generally similar to the representations and warranties made by Dealers in connection with the Company's purchase of the Contracts. If the Company breaches any of its representations or warranties to a purchaser of the Contracts, the Company will be obligated to repurchase the Contract from such purchaser at a price equal to the principal balance plus accrued and unpaid interest. The Company may then be entitled under the terms of its Dealer Agreement to require the selling Dealer to repurchase the Contract at a price equal to the Company's purchase price, less any principal payments made by the customer. Subject to any recourse against Dealers, the Company will bear the risk of loss on repossession and resale of vehicles under Contracts repurchased by it.

Upon the sale or financing of a portfolio of Contracts in a securitization transaction, generally utilizing a trust that is specifically created for such purpose ("Trust"), the Company retains the obligation to service the Contracts, and receives a monthly fee for doing so. Among other services performed, the Company mails to obligors monthly billing statements directing them to mail payments on the Contracts to a lockbox account. The Company engages an independent lockbox processing agent to retrieve and process payments received in the lockbox account. This results in a daily deposit to the Trust's bank account of the entire amount of each day's lockbox receipts and the simultaneous electronic data transfer to the Company of customer payment data records. Pursuant to the Servicing Agreements, as defined below, the Company is required to deliver monthly reports to the Trust reflecting all transaction activity with respect to the Contracts. The reports contain, among other information, a reconciliation of the change in the aggregate principal balance of the Contracts in the portfolio to the amounts deposited into the Trust's bank account as reflected in the daily reports of the lockbox processing agent.

In its securitization transactions, the Company generally warrants that, to the best of the Company's knowledge, no such liens or claims are pending or threatened with respect to a financed vehicle, that may be or become prior to or equal with the lien of the related Contracts. In the event that any of the Company's representations or warranties proves to be incorrect, the Trust would be entitled to require the Company to repurchase the Contract relating to such financed vehicle.

### **The Servicing Agreements**

The Company currently services all Contracts that it owns, as well as those Contracts included in portfolios that it has sold to securitization Trusts. The Company does not service Contracts that were sold in its flow purchase program. Pursuant to the Company's usual form of servicing agreement (the Company's servicing agreements with purchasers of portfolios of Contracts are collectively referred to as the "Servicing Agreements"), CPS is obligated to service all Contracts sold to the Trusts in accordance with the Company's standard procedures. The Servicing Agreements generally provide that the Company will bear all costs and expenses incurred in connection with the management, administration and collection of the Contracts serviced.

The Company is entitled under most of the Servicing Agreements to receive a base monthly servicing fee between 2.5% and 5.0% per annum computed as a percentage of the declining outstanding principal balance of the non-defaulted Contracts in the pool. Each month, after payment of the Company's base monthly servicing fee and certain other fees, the Trust receives the paid principal reduction of the Contracts in its pool and interest thereon at the fixed rate that was agreed when the Contracts were sold to the Trust. If, in any month, collections on the Contracts are insufficient to pay such amounts and any principal reduction due to charge-

offs, the shortfall is satisfied from the Spread Account established in connection with the sale of the pool. The “Spread Account” is an account established at the time the Company sells a pool of Contracts, to provide security to the Note Insurers, as defined below. If collections on the Contracts exceed such amounts, the excess is utilized, first, to build up or replenish the Spread Account or other credit enhancement to the extent required, next, in certain cases to cover deficiencies in Spread Accounts for other pools, and the balance, if any, constitutes excess cash flows, which are distributed to the Company.

Pursuant to the Servicing Agreements, the Company is generally required to charge off the balance of any Contract by the earlier of the end of the month in which the Contract becomes five scheduled installments past due or, in the case of repossessions, the month that the proceeds from the liquidation of the financed vehicle are received by the Company or if the vehicle has been in repossession inventory for more than 90 days. In the case of a repossession, the amount of the charge-off is the difference between the outstanding principal balance of the defaulted Contract and the net repossession sale proceeds. In the event collections on the Contracts are not sufficient to pay to the holders (“Investors”) of interests in the Trust the entire principal balance of Contracts charged off during the month, the trustee draws on the related Spread Account to pay the Investors. The amount drawn would then have to be restored to the Spread Account from future collections on the Contracts remaining in the pool before the Company would again be entitled to receive excess cash. In addition, the Company would not be entitled to receive any further monthly servicing fees with respect to the defaulted Contracts. Subject to any recourse against the Company in the event of a breach of the Company’s representations and warranties with respect to any Contracts and after any recourse to any insurer guarantees backing the Notes, as defined below, the Investors bear the risk of all charge-offs on the Contracts in excess of the Spread Account. The Investors’ rights with respect to distributions from the Trusts are senior to the Company’s rights. Accordingly, variation in performance of pools of Contracts affects the Company’s ultimate realization of value derived from such Contracts.

The Servicing Agreements are terminable by the insurers of certain of the Trust’s obligations (“Note Insurers”) in the event of certain defaults by the Company and under certain other circumstances. Were a Note Insurer in the future to exercise its option to terminate the Servicing 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 Servicing Agreements.

## **Competition**

The automobile financing business is highly competitive. The Company competes with a number of national, regional and local finance companies with operations similar to those of the Company. 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, Ford Motor Credit Corporation, Chrysler Finance Corporation and Nissan Motors Acceptance 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 in relation to the availability and cost of capital to 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 that 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’ purchase of automobiles from manufacturers, which is not offered by the Company.

The Company believes that the principal competitive factors affecting a Dealer’s decision to offer Contracts for sale to a particular financing source are the purchase price offered for the Contracts, the reasonableness of the financing source’s underwriting guidelines and documentation requests, the predictability and timeliness of purchases and the financial stability of the funding source. The Company believes that it can obtain from

Dealers sufficient Contracts for purchase at attractive prices by consistently applying reasonable underwriting criteria and making timely purchases of qualifying Contracts.

### **Government Regulation**

Several federal and state consumer protection laws, including the federal Truth-In-Lending Act, the federal Equal Credit Opportunity Act, the federal Fair Debt Collection Practices Act and the Federal Trade Commission Act, regulate the extension of credit in consumer credit transactions. These laws mandate certain disclosures with respect to finance charges on Contracts and impose certain other restrictions on Dealers. In many states, a license is required to engage in the business of purchasing Contracts from Dealers. In addition, laws in a number of states impose limitations on the amount of finance charges that may be charged by Dealers on credit sales. The so-called Lemon Laws enacted by various states provide certain rights to purchasers with respect to motor vehicles that fail to satisfy express warranties. The application of Lemon Laws or violation of such other federal and state laws may give rise to a claim or defense of a customer against a Dealer and its assignees, including the Company and purchasers of Contracts from the Company. The Dealer Agreement contains representations by the Dealer that, as of the date of assignment of Contracts, no such claims or defenses have been asserted or threatened with respect to the Contracts and that all requirements of such federal and state laws have been complied with in all material respects. Although a Dealer would be obligated to repurchase Contracts that involve a breach of such warranty, there can be no assurance that the Dealer will have the financial resources to satisfy its repurchase obligations to the Company. Certain of these laws also regulate the Company's servicing activities, including its methods of collection.

Although the Company believes that it is currently in material compliance with applicable statutes and regulations, there can be no assurance that the Company will be able to maintain such compliance. The past or future failure to comply with such statutes and regulations could have a material adverse effect upon the Company. Furthermore, the adoption of additional statutes and regulations, changes in the interpretation and enforcement of current statutes and regulations or the expansion of the Company's business into jurisdictions that have adopted more stringent regulatory requirements than those in which the Company currently conducts business could have a material adverse effect upon the Company. In addition, due to 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 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. A significant judgment against the Company or within the industry in connection with any such litigation could have a material adverse effect on the Company's financial condition, results of operations or liquidity. See "Legal Proceedings."

### **Employees**

As of December 31, 2003, the Company had 681 full-time and 11 part-time employees, of whom 7 are senior management personnel, 404 are collections personnel, 108 are Contract origination personnel, 56 are marketing personnel (42 of whom are marketing representatives), 72 are operations and systems personnel, and 34 are administrative personnel. The Company believes that its relations with its employees are good. The Company is not a party to any collective bargaining agreement.

### **ITEM 2. PROPERTY**

The Company's headquarters are located in Irvine, California, where it leases approximately 115,000 square feet of general office space from an unaffiliated lessor. The annual base rent is approximately \$1.9 million through October 2003, and increases to \$2.1 million for the following five years. In addition to base rent, the Company pays the property taxes, maintenance and other expenses of the premises.

In March 1997, the Company established a branch collection facility in Chesapeake, Virginia. The Company leases approximately 28,000 square feet of general office space in Chesapeake, Virginia, at a base rent that is currently \$454,525 per year, increasing to \$501,545 over a 10-year term.

The remaining four regional servicing centers occupy a total of approximately 49,000 square feet of leased space in Orlando, Florida; Atlanta, Georgia; Hinsdale, Illinois and Cleveland, Ohio. The termination dates of such leases range from 2007 to 2008.

See Notes 2 and 14 of Notes to Consolidated Financial Statements.

### **ITEM 3. LEGAL PROCEEDINGS**

*Stanwich Litigation.* CPS is currently a defendant in a class action (the “Stanwich Case”) pending in the California Superior Court, Los Angeles County. The plaintiffs in that case are persons entitled to receive regular payments (the “Settlement Payments”) under out-of-court settlements reached with third party defendants. Stanwich Financial Services Corp. (“Stanwich”), an affiliate of the former Chairman of the Board of Directors of CPS, is the entity that is obligated to pay the Settlement Payments. Stanwich has defaulted on its payment obligations to the plaintiffs and in June 2001 filed for reorganization under the Bankruptcy Code, in the federal Bankruptcy Court of Connecticut. CPS is also a defendant in certain cross-claims brought by other defendants in the case, which assert claims of equitable and/or contractual indemnity against CPS.

In November 2001, one of the defendants in the Stanwich Case, Jonathan Pardee, asserted claims for indemnity against CPS in a separate action, which is now pending in federal district court in Rhode Island. CPS has filed counterclaims in the Rhode Island federal court against Mr. Pardee. CPS is defending this matter and pursuing its counterclaims vigorously.

In February 2002, CPS entered into a term sheet with Stanwich, the plaintiffs in the Stanwich Case and others, which provides for CPS’s release upon its repayment of the amounts concededly owed to Stanwich, all of which amounts have been recorded in CPS’s financial statements as indebtedness.

The California court in December 2003 preliminarily approved a settlement of the Stanwich Case. That settlement will result in CPS being released from all claims pending in the California court, other than an alleged contractual indemnity in favor of one of the financial institution co-defendants. As to that institution, CPS has an agreement in principle to settle its cross-claim. The court-approved settlement requires of CPS only that it repay the amounts it concededly owes to Stanwich, all of which amounts have been recorded in CPS’s financial statements as indebtedness.

The reader should consider that any adverse judgment against CPS in the Stanwich Case (or the related case in Rhode Island) for indemnification, in an amount materially in excess of any liability already recorded in respect thereof, could have a material adverse effect.

*Other Litigation.* On November 15, 2000, Denise and Gary Lang filed a lawsuit against CPS in South Carolina Common Pleas Court, Beaufort County, alleging that they, and a purported nationwide class, were harmed by an alleged failure to refer, in the notice given after repossession of their vehicle, to the right to purchase the vehicle by tender of the full amount owed under the retail installment contract. They sought damages in an unspecified amount. CPS filed a counterclaim to recover any delinquent amounts owed by the members of the putative class in the event that the class were to be certified. In February 2004, CPS reached an agreement to settle that case on a class basis for payment of attorneys’ fees and other immaterial consideration.

On September 26, 2001, Maggie Chandler, Bobbie Mike and Mary Ann Benford each commenced a lawsuit against subsidiaries of MFN (now subsidiaries of CPS) in three different state courts in Mississippi. A similar case was filed in December 2002 in a fourth Mississippi court. Plaintiffs in all four cases alleged deceptive practices related to various loans and the related purchase and sale of insurance, and sought unspecified

damages. In September 2003, the defendant subsidiaries reached an agreement in principle to settle all such cases, and any similar cases that might be brought by other clients of the same plaintiff law firms.

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

Not applicable.

#### **ITEM 4A. EXECUTIVE OFFICERS OF THE REGISTRANT**

Information regarding the Company's executive officers follows:

**Charles E. Bradley, Jr.**, 44, has been the President and a director of the Company since its formation in March 1991. In January 1992, Mr. Bradley was appointed Chief Executive Officer of the Company. From March 1991 until December 1995 he served as Vice President and a director of CPS Holdings, Inc. From April 1989 to November 1990, he served as Chief Operating Officer of Barnard and Company, a private investment firm. From September 1987 to March 1989, Mr. Bradley, Jr. was an associate of The Harding Group, a private investment banking firm.

**William L. Brummund, Jr.**, 51, has been Senior Vice President – Operations since March 1991. From 1986 to March 1991, Mr. Brummund was Vice President and Systems Administrator for Far Western Bank, Tustin, California.

**Nicholas P. Brockman**, 59, has been Senior Vice President – Collections since January 1996. He was Senior Vice President of Contract Originations from April 1991 to January 1996. From 1986 to March 1991, Mr. Brockman served as a Vice President and Branch Manager of Far Western Bank.

**Mark A. Creatura**, 44, has been Senior Vice President – General Counsel since October 1996. From October 1993 through October 1996, he was Vice President and General Counsel at Urethane Technologies, Inc., a polyurethane chemicals formulator. Mr. Creatura was previously engaged in the private practice of law with the Los Angeles law firm of Troy & Gould Professional Corporation, from October 1985 through October 1993.

**Curtis K. Powell**, 47, has been Senior Vice President – Contract Origination since June 2001. Previously, he was the Company's Senior Vice President – Marketing, from April 1995. He joined the Company in January 1993 as an independent marketing representative until being appointed Regional Vice President of Marketing for Southern California in November 1994. From June 1985 through January 1993, Mr. Powell was in the retail automobile sales and leasing business.

**Robert E. Riedl**, 40, has been Senior Vice President – Chief Financial Officer since August 2003. Mr. Riedl joined the Company as Senior Vice President – Risk Management in January 2003. Mr. Riedl was a Principal at Northwest Capital Appreciation ("NCA"), a middle market private equity firm, from 2000 to 2002. For a year prior to joining Northwest Capital, Mr. Riedl served as Senior Vice President for one of NCA's portfolio companies, SLP Capital. Mr. Riedl was an investment banker for ContiFinancial Services Corporation from 1995 until joining SLP Capital in 1999.

**Christopher Terry**, 36, has been Senior Vice President – Asset Recovery since January 2003. He joined the Company in January 1995 as a loan officer, held a series of successively more responsible positions, and was promoted to Vice President - Asset Recovery in June 1999. Mr. Terry was previously a branch manager with Norwest Financial from 1990.

## PART II

### ITEM 5. MARKET FOR COMMON EQUITY AND RELATED STOCKHOLDER MATTERS

The Company's Common Stock is traded on the Nasdaq National Market System, under the symbol "CPSS." The following table sets forth the high and low sales prices reported by Nasdaq for the Common Stock for the periods shown.

	<u>High</u>	<u>Low</u>
January 1 - March 31, 2002.....	2.000	1.110
April 1 - June 30, 2002.....	3.250	1.750
July 1 - September 30, 2002.....	2.650	1.410
October 1 - December 31, 2002.....	2.290	1.550
January 1 - March 31, 2003.....	2.200	1.500
April 1 - June 30, 2003.....	3.455	1.630
July 1 - September 30, 2003.....	3.700	2.480
October 1 - December 31, 2003.....	4.180	2.750

As of March 15, 2004, there were 88 holders of record of the Company's Common Stock. To date, the Company has not declared or paid any dividends on its Common Stock. The payment of future dividends, if any, on the Company's Common Stock is within the discretion of the Board of Directors and will depend upon the Company's income, its capital requirements and financial condition, and other relevant factors. The instruments governing the Company's outstanding debt place certain restrictions on the payment of dividends. The Company does not intend to declare any dividends on its Common Stock in the foreseeable future, but instead intends to retain any cash flow for use in the Company's operations.

The table below presents information regarding outstanding options to purchase the Company's Common Stock.

Plan category	Number of securities to be issued upon exercise of outstanding options, warrants and rights	Weighted-average exercise price of outstanding options, warrants and rights	Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column (a))
		<b>December 31, 2003</b>	
	(a)	(b)	(c)
Equity compensation plans approved by security holders	3,872,269	\$1.96	146,631
Equity compensation plans not approved by security holders	None	N/A	N/A
Total	3,872,269	\$1.96	146,631

## ITEM 6. SELECTED FINANCIAL DATA

	Year Ended December 31,				
	2003	2002	2001	2000 (1)	1999 (1)
	(In thousands, except per share data)				
<b>Statement of Operations Data:</b>					
Gain (loss) on sale of Contracts, net (2).....	\$ 6,369	\$ 16,444	\$ 32,765	\$ 16,234	\$ (14,844)
Interest income.....	58,164	48,644	17,205	3,480	3,032
Servicing fees.....	17,058	14,621	10,666	15,848	27,761
Total revenue.....	100,934	93,314	62,576	35,951	14,805
Operating expenses.....	103,973	93,252	62,256	68,354	86,968
Income (loss) before extraordinary item (3).....	395	2,996	320	(22,147)	(44,532)
Extraordinary item (4).....	—	17,412	—	—	—
Net income (loss).....	395	20,408	320	(22,147)	(44,532)
Basic income (loss) per share before ex. item.....	0.02	0.15	0.02	(1.10)	(2.38)
Diluted income (loss) per share before ex. item.....	0.02	0.14	0.02	(1.10)	(2.38)
Basic income (loss) per share, ex. item.....	—	0.87	—	—	—
Diluted income (loss) per share, ex. item.....	—	0.83	—	—	—
Basic income (loss) per share.....	0.02	1.03	0.02	(1.10)	(2.38)
Diluted income (loss) per share.....	0.02	0.97	0.02	(1.10)	(2.38)

	December 31,				
	2003	2002	2001	2000	1999
	(In thousands)				
<b>Balance Sheet Data:</b>					
Cash and restricted cash.....	\$ 100,486	\$ 51,859	\$ 13,924	\$ 24,315	\$ 3,324
Finance receivables, net.....	266,189	84,592	—	18,830	2,421
Residual interest in securitizations.....	111,702	127,170	106,103	99,199	172,530
Total assets.....	492,470	285,448	151,204	175,694	220,314
Term debt.....	384,622	175,942	82,555	102,614	119,173
Total liabilities.....	410,310	202,874	89,518	113,572	135,877
Total shareholders' equity.....	82,160	82,574	61,686	62,122	84,437

(1) Beginning with the year ended December 31, 1999 and through December 31, 2000, the Company did not sell any Contracts in securitization transactions.

(2) The decrease in 2003 is primarily the result of the change in securitization structure implemented in the third quarter of 2003.

(3) Results for 2003 and 2002, include a tax benefit of \$3.4 million and \$2.9 million, respectively.

(4) On March 8, 2002, CPS acquired 100% of MFN Financial Corporation and subsidiaries, resulting in the recognition of \$17.4 million of negative goodwill as an extraordinary gain, which is reflected in the Company's 2002 Consolidated Statement of Operations.

## **ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

The following analysis of the financial condition of the Company should be read in conjunction with "Selected Financial Data" and the Company's Consolidated Financial Statements and the Notes thereto and the other financial data included elsewhere in this report. The Company's Consolidated Balance Sheet and Consolidated Statement of Operations as of and for the year ended December 31, 2003 include the results of operations of TFC Enterprises, Inc. for the period subsequent to May 20, 2003, the TFC Merger date, through December 31, 2003. The Company's Consolidated Balance Sheet and Consolidated Statement of Operations as of and for the year ended December 31, 2002 include the results of operations of MFN Financial Corporation for the period subsequent to March 8, 2002, the MFN Merger date, through December 31, 2002. See Note 2 of Notes to Consolidated Financial Statements.

### **Overview**

Consumer Portfolio Services, Inc. and its subsidiaries (collectively, the "Company") specialize in purchasing, selling and servicing retail automobile installment sale contracts ("Contracts") originated by automobile dealers ("Dealers") located throughout the United States. Through its purchase of Contracts, the Company provides indirect financing to Dealer customers with limited credit histories, low incomes or past credit problems, who generally would not be expected to qualify for financing provided by banks or by automobile manufacturers' captive finance companies.

On March 8, 2002, the Company acquired MFN Financial Corporation and its subsidiaries in a merger (the "MFN Merger"). On May 20, 2003, the Company acquired TFC Enterprises, Inc. and its subsidiaries in a second merger (the "TFC Merger"). Each merger was accounted for as a purchase. MFN Financial Corporation and its subsidiaries ("MFN") and TFC Enterprises, Inc. and its subsidiaries ("TFC") were engaged in businesses similar to that of the Company: buying Contracts from Dealers, repackaging those Contracts in securitization transactions, and servicing those Contracts. MFN ceased acquiring Contracts in May 2002; TFC continues to acquire Contracts under its "TFC Programs," which provide financing for vehicle purchases exclusively by members of The United States armed forces.

The Company historically has generated revenue primarily from the gains recognized on the sale or securitization of Contracts, servicing fees earned on Contracts sold, interest earned on Residuals, as defined below, and interest on finance receivables. During the years ended December 31, 2002 and 2001, the Company sold some Contracts on a servicing released basis, as part of a program (the "flow purchase program") in which the Company sold Contracts to unaffiliated third parties immediately after purchasing such Contracts from Dealers. The flow purchase program ended in May 2002. During the years ended December 31, 2002 and 2001, the Company's gain on sale of Contracts included, \$5.7 million and \$16.6 million, respectively, representing mark-up on Contracts sold in the flow purchase program.

### **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 properly be 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 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 and other expenses.

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 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 Consolidated Balance Sheet as "Residual interest in securitizations," and its value is dependent on estimates of the future performance of the sold Contracts.

### **Change in Policy**

During August 2003 the Company announced that it would structure its future securitization transactions to be reflected as secured financings for financial accounting purposes. The first two term securitizations so structured occurred in September and December 2003. The Company had structured all of its prior term securitization transactions to be treated 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. As of December 31, 2003, the Company's Consolidated Balance Sheet included net finance receivables of approximately \$119.6 million and securitization trust debt of \$95.9 million related to finance receivables acquired in the two mergers, out of totals of net finance receivables of approximately \$266.2 million and securitization trust debt of approximately \$245.1 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 December 31, 2003 was approximately \$741.1 million.

### **Critical Accounting Policies**

The Company believes that its accounting policies related to (a) Allowance for Finance Credit Losses, (b) Residual Interest in Securitizations and Gain on Sale of Contracts and (c) Income Taxes could be considered critical. Such policies are described below.

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

In order to estimate an appropriate allowance for losses to be incurred on finance receivables, 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 Contracts. Provision for loss 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 December 31, 2002 the line item "Residual interest in securitizations" on the Company's Consolidated Balance Sheet includes residual interests in both term and warehouse securitizations. As of 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 in September 2003 and December 2003 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 key economic assumptions used in measuring all residual interests in securitizations as of December 31, 2003 and 2002 are included in the table below. The pre-tax discount rate remained constant at 14%.

	<u>2003</u>	<u>2002</u>
Prepayment speed (Cumulative).....	18.1% - 22.1%	19.8% - 22.9%
Credit losses (Cumulative) .....	11.8% - 18.0%	10.0% - 15.4%

Key economic assumptions and the sensitivity of the current fair value of residual cash flows to immediate 10% and 20% adverse changes in those assumptions are as follows:

	<u>December 31, 2003</u>
	<u>(Dollars in thousands)</u>
Carrying amount/fair value of residual interest in securitizations.....	\$ 111,702
Weighted average life in years.....	3.74
Prepayment Speed Assumption (Cumulative).....	18.1% - 22.1%
Estimated fair value assuming 10% adverse change.....	\$ 110,938
Estimated fair value assuming 20% adverse change.....	110,916
Expected Credit Losses (Cumulative).....	11.8% - 18.0%
Estimated fair value assuming 10% adverse change.....	\$ 100,907
Estimated fair value assuming 20% adverse change.....	90,312
Residual Cash Flows Pre-tax Discount Rate (Annual) .....	14.0%
Estimated fair value assuming 10% adverse change .....	\$ 109,594
Estimated fair value assuming 20% adverse change.....	107,477

These sensitivities are hypothetical and should be used with caution. As the figures indicate, changes in fair value based on 10% and 20% percent variation in assumptions generally cannot be extrapolated because the

relationship of the change in assumption to the change in fair value may not be linear. Also, in this table, the effect of a variation in a particular assumption on the fair value of the retained interest is calculated without changing any other assumption; in reality, changes in one factor may result in changes in another (for example, increases in market rates may result in lower prepayments and increased credit losses), which could magnify or counteract the sensitivities.

The Company's securitization structure has generally been 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 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 an account (“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 Enhancement is to be maintained will vary depending on the performance of the pools 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 various pools, 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 of the Contracts has amortized to a specified percentage of the initial aggregate balance.

The prior securitizations that are treated as sales for financial accounting purposes differ from secured financings in that the Trust to which the SPS sells the Contracts meets 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 Consolidated Balance Sheet.

The Company's warehouse securitization structures were 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 71% to 73% of the aggregate principal balance of the Contracts (that is, at least 27% 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 cause the transactions to be treated as secured financings for financial accounting purposes. The Contracts held by the warehouse SPSs and the promissory notes that they issue are therefore included in the Company's Consolidated Financial Statements as of 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 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 Consolidated Balance Sheet the Contracts sold and added to its 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 Consolidated Balance Sheet will reflect both securitization transactions structured as sales and others structured as secured financings.

With respect to 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 recognizes 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.

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 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 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. The Company has used prepayment estimates of approximately 18.1% to 22.1% 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 15.9% to 23.1% cumulatively over the lives of the related Contracts, with recovery rates approximating 2.2% to 5.3% of the original principal balance.

Following a securitization that is structured as a sale for financial accounting purposes, interest income is recognized on the balance of the Residuals at the same rate as used for calculating the present value of the NIRs, which is 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 that is 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 a 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 more likely than not.

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.

See "Liquidity and Capital Resources" and Note 1 of Notes to Consolidated Financial Statements.

## **Results of Operations**

### **Acquisitions**

The Company's Consolidated Balance Sheet and Consolidated Statement of Operations as of and for the years ended December 31, 2003 and 2002 include the results of operations of MFN Financial Corporation for the period subsequent to March 8, 2002, the date on which the Company acquired that corporation and its subsidiaries in the MFN Merger. See Note 2 of Notes to Consolidated Financial Statements, Acquisition of MFN Financial Corporation.

The Company's Consolidated Balance Sheet and Consolidated Statement of Operations as of and for the year ended December 31, 2003 include the results of operations of TFC Enterprises, Inc. for the period subsequent to May 20, 2003, the date on which the Company acquired that corporation and its subsidiaries in the TFC Merger. See Note 2 of Notes to Consolidated Financial Statements, Acquisition of TFC Enterprises, Inc.

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

The Company's July 2003 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 posted to enhance the credit of the securitization transactions ("Spread Accounts") is shown as "Restricted cash" on the Company's balance sheet; (iv) the servicing fee that the Company receives in connection with such receivables is recorded as a portion of the interest earned on such receivables; (v) the Company has initially and will periodically record as expense a provision for estimated credit losses on the receivables; and (vi) the portion of scheduled payments on the receivables representing interest is recorded as revenue as accrued.

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 to structure its securitizations to require recognition of gain on sale. As a result, reported earnings have been less than they would have been had the Company continued to structure its securitizations to record a gain on sale and, accordingly, reported net earnings may be negative or nominally positive for approximately the next year. 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 should be unaffected by the change in structure.

The Company's first two term securitizations structured as secured financings closed in September and December 2003. The Company's MFN and TFC subsidiaries completed term securitizations structured as secured financings prior to becoming subsidiaries of the Company. The structures of the Company's two warehouse securitization transactions that relate 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, which relates to the TFC programs, has been structured as a secured financing for financial accounting purposes since the date of the TFC Merger.

### **The Year Ended December 31, 2003 Compared to the Year Ended December 31, 2002**

*Revenues.* During the year ended December 31, 2003, revenues were \$100.9 million, an increase of \$7.6 million, or 8.2%, from the prior year revenue of \$93.3 million. With the change in securitization structure and consequent end to recording gain on sale revenue in the third quarter of 2003, net gain on sale of Contracts decreased \$10.1 million, or 61.3%, to \$6.4 million in 2003, compared to \$16.4 million in 2002. The 2003 gain on sale amount is net of a negative fair value adjustment of \$4.1 million related to the Company's analysis and estimate of the expected ultimate performance of the Company's previously securitized pools which are held by non-consolidated subsidiaries. The decrease in gain on sale from 2002 to 2003 was partially offset by a negative fair value adjustment of approximately \$2.5 million recorded during the first quarter of 2002 related to the Company's residual interest in securitizations. Also in the first quarter of 2002, the Company recognized a charge of approximately \$500,000 related to a loss realized upon the sale of a subordinated certificate ("B Piece") from the Company's 2002-A securitization.

Interest income for the year ended December 31, 2003 increased \$9.5 million, or 19.6%, to \$58.2 million in 2003 from \$48.6 million in 2002. The primary reasons for the increase in interest income are the change in securitization structure, the interest income earned on the portfolio of Contracts acquired in the TFC Merger

and an increase in residual interest income. This increase was partially offset by the decline in the balance of the portfolio of Contracts acquired in the MFN Merger.

Servicing fees totaling \$17.1 million in the year ended December 31, 2003 increased \$2.4 million, or 16.7%, from \$14.6 million in the same period a year earlier. The increase in servicing fees can be attributed to the growth of the Company's managed portfolio held by non-consolidated subsidiaries related to the CPS programs. For the year ended December 31, 2003, the Company's managed portfolio held by non-consolidated subsidiaries had an average outstanding principal balance approximating \$489.9 million, compared to \$347.3 million for the year ended December 31, 2002. At December 31, 2003, the Company's managed portfolio held by consolidated subsidiaries had an outstanding principal balance approximating \$315.6 million, compared to \$117.1 million as of December 31, 2002. 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 decline proportionately.

At December 31, 2003, the Company was generating income and fees on a managed portfolio with an outstanding principal balance approximating \$741.1 million, compared to a managed portfolio with an outstanding principal balance approximating \$595.2 million as of December 31, 2002. As the portfolio of Contracts acquired in the MFN Merger amortizes, the portfolio of Contracts originated under the CPS and TFC programs continues to expand. At December 31, 2003 and 2002, the managed portfolio composition was as follows:

	<u>December 31, 2003</u>		<u>December 31, 2002</u>	
	<u>Amount</u>	<u>%</u>	<u>Amount</u>	<u>%</u>
<b>Originating Entity</b>				
		<b>(\$ in millions)</b>		
CPS.....	\$ 543.8	73.4 %	\$ 394.3	66.2%
TFC.....	123.6	16.7	—	—
MFN.....	<u>73.7</u>	<u>9.9</u>	<u>200.9</u>	<u>33.8</u>
Total.....	<u>\$ 741.1</u>	<u>100.0 %</u>	<u>\$ 595.2</u>	<u>100.0%</u>

Other income increased 42% to \$19.3 million in 2003 from \$13.6 million in 2002. The period over period increase can be attributed in part to the receipt of state sales tax refunds of \$3.2 million during third quarter of 2003 and recoveries on previously charged off MFN Contracts totaling \$12.2 million for the year ended December 31, 2003, compared to \$10.5 million for the comparable period in 2002.

*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 income include changes in the automobile and automobile finance market environments, macroeconomic factors such as interest rates and the unemployment level, and mix of business between Contracts purchased on a flow basis and Contracts purchased on an other than flow basis. The Company ceased to purchase Contracts on a flow basis in May 2002.

Personnel costs include base salaries, commissions and bonuses paid to employees, and certain expenses related to the accounting treatment of outstanding 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 consist primarily of interest expense, provisions 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 \$104.0 million for the year ended December 31, 2003, compared to \$93.3 million for the same period in 2002. Total operating expenses for the year ended December 31, 2003 would

have been significantly lower except for the \$11.4 million provision for credit loss expense recorded during the third and fourth quarters of 2003. Such provision for credit loss is a result of the decision to structure securitizations as financings, rather than as sales. Provisions for credit loss expense should be anticipated to increase in future periods.

Personnel costs decreased to \$37.1 million during the year ended December 31, 2003, representing 35.7% of total operating expenses, compared to \$37.8 million for the 2002 period, or 40.5% of total operating expenses. The decrease is primarily the result of 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. This decrease was partially offset by staff additions related to the TFC Merger in May 2003.

In connection with the termination of MFN origination activities and the integration and consolidation of certain activities (see above) related to the MFN Merger and the TFC Merger, the Company has recognized certain liabilities related to the costs to exit these activities and terminate the affected employees of MFN and TFC. These activities include service departments such as accounting, finance, human resources, information technology, administration, payroll and executive management. Such exit and termination costs have been charged against these liabilities and are not reflected in the Company's Consolidated Statement of Operations.

General and administrative expenses increased to \$21.3 million, or 20.5% of total operating expenses, in the year ended December 31, 2003, from \$20.1 million, or 21.6% of total operating expenses, in the same period of 2002. The decrease as a percentage of total operating expenses is a result primarily of the change in securitization structure during the third quarter of 2003 which increased total expenses, and of continued general cost cutting during the period, offset in part by an increase in legal and other corporate expenses.

Interest expense for the year ended December 31, 2003, decreased \$64,000, or 0.3%, to \$23.9 million in 2003. The slight decrease is the result of changes in the amount and composition of securitization trust debt carried on the Company's Consolidated Balance Sheet: such debt related to the MFN Merger declined as it was paid down, partially offset by the addition of securitization trust debt associated with the TFC Merger and with the securitizations subsequent to the Company's change in securitization structure. As the Company continues to structure future securitization transactions as secured financings, the balances of securitization trust debt and the related interest expense are expected to increase.

Marketing expenses decreased by \$873,000, or 14.0%, and represented 5.2% of total operating expenses. The decrease is primarily due to the decrease in Contracts purchased by the Company during the year ended December 31, 2003.

Occupancy expenses decreased by \$97,000, or 2.4%, and represented 3.8% of total operating expenses. The decrease is primarily due to the closure during 2003 of certain facilities acquired in the MFN Merger. The decrease was partially offset by the addition of facilities acquired in the TFC Merger.

Depreciation and amortization expenses decreased by \$138,000, or 12.1%, to \$1.0 million from \$1.1 million.

Income tax benefit of \$3.4 million and \$2.9 million was recorded in the 2003 and 2002 periods, respectively. The 2003 benefit 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 which have been included in the current period tax provision. The 2002 benefit is due to tax legislation passed in early 2002, which enabled the Company to reverse a previously recorded valuation allowance of approximately \$3.2 million, as well as to record benefit during the same 2002 period. The Company does not expect any comparable income tax benefit in future periods.

*Extraordinary Item.* The year ended December 31, 2002 included \$17.4 million of unallocated negative goodwill, which represented the difference between the net assets acquired and the purchase price paid by the Company in connection with the MFN Merger.

### **The Year Ended December 31, 2002 Compared to the Year Ended December 31, 2001**

*Revenue.* During the year ended December 31, 2002, revenues increased \$30.7 million, or 49.1%, to \$93.3 million compared to \$62.6 million for the year ended December 31, 2001. Net gain on sale of Contracts decreased by \$16.3 million, from \$32.8 million for the year ended December 31, 2001, to \$16.4 million for the year ended December 31, 2002. The primary reason for the decrease in the gain on sale component of revenue is the decrease in Contract purchases to \$463.2 million in 2002 from \$672.3 million in 2001. This reduction was primarily a result of the termination of the flow purchase program in May 2002. The Company securitized \$281.2 million of Contracts during the year ended December 31, 2002, compared to \$141.7 million during the year ended December 31, 2001. During the year ended December 31, 2002, the Company sold \$181.1 million of Contracts on a flow basis compared to \$537.9 million of Contracts in the year ended December 31, 2001.

Gain on sale of Contracts also includes the effect of fluctuations in the Company's estimate of the required provision for losses on certain CPS Contracts and recovery of losses on such Contracts. During 2001, recoveries exceeded the provision for losses; in 2002 the provision for losses was greater than recoveries. During 2002, the amount of Contracts for which the Company recorded a provision for credit losses increased, requiring the Company to provide for losses on such Contracts in an amount exceeding related recoveries. For the year ended December 31, 2002 the Company recorded a \$2.6 million provision for credit losses, compared to a reduction of the provision for Contract losses of \$5.7 million for the year ended December 31, 2001. Also during 2002, as a result of revised Company estimates resulting from analyses of the current and historical performance of certain of the Company's securitized pools; the Company recorded a pre-tax charge to gain on sale of approximately \$2.5 million.

Interest income increased \$31.4 million to \$48.6 million in the year ended December 31, 2002, from \$17.2 million in the prior year. The increase in interest income is primarily due to the expansion of the Company's managed portfolio held by consolidated subsidiaries, primarily as a result of the MFN Merger, as well as the addition of Contracts to the CPS portfolio and the related increase in the Company's residual interest in securitizations as a result of the increased level of securitizations. As of December 31, 2002, the managed portfolio, net of unearned income on pre-computed Contracts, was \$595.2 million (\$200.9 million represented Contracts acquired in the MFN Merger), compared to \$285.5 million as of December 31, 2001.

Servicing fees increased by \$4.0 million, or 37.1%, to \$14.6 million for the year ended December 31, 2002, from \$10.7 million for the year ended December 31, 2001. Servicing fees consist of base fees, which are payable at the rate of 2.5% per annum on the principal balance of the outstanding CPS Contracts (5.0% on MFN Contracts) in the related Trusts, plus any other fees collected by the Company, such as late fees and returned check fees. The increase in servicing fees is primarily due to the increase in the Company's managed portfolio held by non-consolidated subsidiaries. At December 31, 2002, the Company's managed portfolio held by non-consolidated subsidiaries had an outstanding principal balance approximating \$478.1 million, compared to \$281.5 million as of December 31, 2001. At December 31, 2002, the Company's managed portfolio held by consolidated subsidiaries had an outstanding principal balance approximating \$117.1 million, compared to \$4.0 million as of December 31, 2001. Although the Company is paid a servicing fee on receivables held by consolidated subsidiaries, such servicing fee is not recorded separately as revenue, but is included in the interest accrued on such receivables.

Other income increased to \$13.6 million in 2002 from \$1.9 million in 2001. The period over period increase can be attributed primarily to the recoveries on previously charged off MFN Contracts totaling \$10.5 million for the year ended December 31, 2002.

*Expenses.* During the year ended December 31, 2002, operating expenses increased by \$31.0 million, or 49.8%, to \$93.3 million, compared to the year ended December 31, 2001 operating expenses of \$62.3 million. 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 income include changes in the automobile and automobile finance market environments, macroeconomic factors such as interest rates, and mix of business between Contracts purchased on a flow basis and Contracts purchased on an other than flow basis. The overall increase in expenses is primarily attributable to the MFN Merger. Personnel costs increased \$13.8 million, or 57.4%, to \$37.8 million in 2002 from \$24.0 million in 2001. 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 the Company's most significant operating expenses, representing approximately 40.5% of 2002 operating expenses. These costs generally fluctuate with the level of applications and Contracts processed and serviced, with the mix of revenue and with overall portfolio performance. Other material operating expenses include 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.

In connection with the termination of MFN origination activities and the integration and consolidation of certain activities related to the MFN Merger (see above), 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. Such exit and termination costs have been charged against these liabilities and are not reflected in the Company's Consolidated Statement of Operations.

General and administrative expenses increased by \$7.5 million, or 59.2%, and represented 21.6% of total operating expenses. The increase in general and administrative expenses is primarily due to the MFN Merger and an increase in costs associated with servicing the Company's expanded portfolio. Also included in 2002 general and administrative expenses is \$669,000 related to the write off a related party receivable from CARSUSA, Inc. See Note 13 of Notes to Consolidated Financial Statements.

Interest expense increased by \$9.6 million, or 66.9%, and represented 25.7% of total operating expenses. The increase is due to the interest expense resulting from the MFN acquisition, including interest expense related to acquisition debt and the interest expense related to its managed portfolio held by consolidated subsidiaries. See "Liquidity and Capital Resources."

Marketing expenses decreased by \$843,000, or 11.9%, and represented 6.7% of total operating expenses. The decrease is primarily due to the decrease in Contracts purchased during the year ended December 31, 2002.

Occupancy expenses increased by \$860,000, or 27.2%, and represented 4.3% of total operating expenses. The increase is primarily due to the addition of facilities acquired in the MFN Merger.

Depreciation and amortization expenses increased by \$119,000, or 11.7%, to \$1.1 million from \$1.0 million.

The results for the years ended December 31, 2002 and 2001, include net income of \$116,732 and \$161,710, respectively, from the Company's subsidiary CPS Leasing, Inc.

Income tax benefit of \$2.9 million, including the elimination of the valuation allowance of \$3.2 million, was recorded in the 2002 period pursuant to relevant tax statutes and regulations. The Company's provision for income taxes was zero for the year ended December 31, 2001.

## Liquidity and Capital Resources

### 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, customer payments of principal and interest on finance receivables, fees for origination of Contracts, 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 years ended December 31, 2003, 2002 and 2001 was \$99.8 million, \$146.9 million and \$5.7 million, respectively. Cash from operating activities is generally provided by the net releases from the Company's securitization Trusts and from the amortization and liquidation of Contracts offset by the purchase of finance receivables. The decrease in 2003 vs. 2002 is primarily a result of lower cash releases from the MFN Trusts as the principal balance of the Contracts in those two pools has decreased significantly year-over-year. The increase in net cash from operating activities in 2002 compared to 2001 is primarily a result of the decrease in purchases of contracts held for sale from \$672.3 million in 2001 to \$463.3 in 2002.

On May 20, 2003, the Company completed the TFC Merger (see Note 2 of Notes to Consolidated Financial Statements). The acquisition cost was approximately \$23.7 million, and was substantially funded by existing cash. Cash flows from the underlying purchased assets are expected to provide adequate liquidity to repay the assumed liabilities and generate positive cash flows from which to fund the Company's operating activities. On March 8, 2002, the Company completed the MFN Merger (see Note 2 of Notes to Consolidated Financial Statements). The acquisition cost was approximately \$123.2 million, and was substantially funded by existing cash and borrowings. Cash flows from the underlying purchased assets are expected to provide adequate liquidity to repay the acquisition borrowings, as well as generate positive cash flows from which to fund the Company's operating activities.

Net cash used in investing activities for the years ended December 31, 2003, 2002 and 2001, was \$179.8 million, \$29.8 million and \$536,000, respectively. With the change in the securitization structure implemented in the third quarter of 2003, \$175.3 million of Contracts were purchased for investment in 2003 as compared to none in 2002 and 2001. Cash used in the TFC Merger, net of the cash acquired in the transaction, totaled \$10.2 million for the year ended December 31, 2003. Cash used in the acquisition of MFN Financial Corporation, net of the cash acquired in the transaction, totaled \$29.5 million for the year ended December 31, 2002.

Net cash provided by financing activities for the year ended December 31, 2003, was \$80.3 million compared with net cash used in financing activities of \$86.8 million and \$21.7 million for the years ended December 31, 2002 and 2001, respectively. Cash used or provided by financing activities is primarily attributable to the repayment or issuance of debt. In connection with the TFC Merger the Company assumed securitization trust debt related to three securitization transactions held by consolidated subsidiaries (see Note 7 of Notes to

Consolidated Financial Statements) and assumed additional subordinated debt (see Note 8 of Notes to Consolidated Financial Statements). In connection with the MFN Merger the Company assumed securitization trust debt related to one securitization transaction held by a consolidated subsidiary and one securitization transaction held by a non-consolidated subsidiary (see Note 7 of Notes to Consolidated Financial Statements) and incurred additional senior secured debt (see Note 8 of Notes to Consolidated Financial Statements). Cash used in financing activities is primarily attributable to the repayment of outstanding debt. With the change in the securitization structure implemented in the third quarter of 2003, \$154.4 million of securitization trust debt was issued in 2003 as compared to none in 2002 and 2001. In connection with the MFN Merger the amount of outstanding debt, securitization trust debt and senior secured debt, and the required repayment thereof, increased compared to prior years.

The Company believes that cash flows generated as a result of the TFC Merger and the MFN Merger will be sufficient to meet the obligations assumed or incurred as a result of such mergers. There can be no assurance that internally generated cash will be sufficient to meet such cash demands. The sufficiency of internally generated cash will depend on the performance of the securitized pools. At the time of the TFC Merger, TFC had outstanding \$6.3 million in principal amount of subordinated debt, which the Company assumed as part of the TFC Merger. Such debt bears interest at the rate of 13.25% per annum payable monthly in arrears, requires monthly amortization and is due in June 2005. At the time of the MFN Merger, MFN had outstanding \$22.5 million in principal amount of senior subordinated debt, which was due and repaid in full on March 23, 2002. Such debt bore interest at the rate of 11.00% per annum, payable quarterly in arrears.

Contracts are purchased from Dealers for a cash price 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 revolving warehouse credit facilities. As of December 31, 2003, the Company had \$225 million in warehouse credit capacity, in the form of a \$125 million facility, a \$75 million facility and a \$25 million facility. The first two warehouse facilities provide funding for Contracts purchased under CPS' programs while the third facility provides funding for Contracts purchased under TFC's programs. On February 21, 2004, the \$75 million facility expired and, as a result, the Company's current warehouse credit capacity is \$150 million.

Through May 2002, the Company's Contract purchasing program consisted of both (i) flow purchases for immediate resale to non-affiliates and (ii) purchases for the Company's own account made on other than a flow basis, funded primarily by advances under a revolving warehouse credit facility. Flow purchases allowed the Company to purchase Contracts with minimal demands on liquidity. The Company's revenues from the resale of flow purchase Contracts, however, were materially less than those that may be received by holding Contracts to maturity or by selling Contracts in securitization transactions. During the year ended December 31, 2003 the Company purchased \$357.3 million of Contracts for its own account, compared to \$282.2 million for its own account and \$181.1 million of Contracts on a flow basis in 2002. For the year ended December 31, 2001, the Company purchased \$134.4 million of Contracts for its own account and \$537.9 million on a flow basis. The Company's flow purchase program ended in May 2002.

The \$125 million warehouse facility is 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 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 accrue interest at a rate of one-month commercial paper plus 1.18% per annum. This facility expires on April 4, 2004. The Company is currently in discussions with the related parties to renew such facility.

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 Company is currently in discussions with several parties regarding a replacement facility.

The \$25 million warehouse facility is 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 may be advanced to TFC 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 1.75% per annum. This facility was entered into as part of the TFC Merger on May 20, 2003 and has a 364-day term. The Company is currently in discussions with the related parties to renew such facility.

These facilities are independent of each other. Two different financial institutions purchase the notes issued by these facilities, and three different insurers insure the notes. Up through June 30, 2003, sales of Contracts to the special purpose subsidiaries (“SPS”) related to the first two facilities had been treated as sales for financial accounting purposes. The Company, therefore, removed these securitized Contracts and related debt from its Consolidated Balance Sheet and recognized a gain on sale in the Company’s Consolidated Statement of Operations. Indebtedness related to Contracts funded by the third facility, however, was retained on the Company’s Consolidated Balance Sheet and no gain on sale has ever been recognized in the Company’s 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 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.

The Company securitized \$416.9 million of Contracts in four private placement transactions during the year ended December 31, 2003. The first two such transactions were structured as sales for financial accounting purposes, resulting in a gain on sale of \$6.4 million (net of a negative fair value adjustment of \$4.1 million related to the performance of previously securitized pools). The final two transactions of 2003 were structured as secured financings and, therefore, resulted in no gain on sale. The Company securitized \$281.2 million of Contracts in three private placement transactions during the year ended December 31, 2002. All of these transactions were structured as sales for financial accounting purposes, resulting in a gain on sale of \$16.9 million (net of a pre-tax charge of \$2.5 million related to the performance of previously securitized pools). \$141.7 million of Contracts were securitized in one private placement transaction during the year ended December 31, 2001, resulting in a gain on sale of \$9.2 million. In March 2004 a wholly-owned bankruptcy remote consolidated subsidiary of the Company issued \$44 million of asset-backed notes secured by its retained interest in eight term securitization transactions. The notes, which have an interest rate of 10% per annum and a final maturity in October 2009, are required to be repaid from the distributions on the underlying retained interests. In connection with the issuance of the notes, the Company incurred and capitalized issuance costs of \$1.2 million.

Prior to June 2002, the Company also purchased Contracts on a flow basis, which, as compared with purchases of Contracts for the Company’s own account, involved a materially reduced demand on the Company’s cash. The Company’s plan for meeting its liquidity needs is to match its levels of Contract purchases to its availability of cash.

Cash used to increase Credit Enhancement amounts to required levels for the years ended December 31, 2003, 2002 and 2001 was \$20.9 million, \$24.2 million and \$24.6 million, respectively. Cash released from Trusts and their related Spread Accounts to the Company for the years ended December 31, 2003, 2002 and 2001, was \$25.9 million, \$60.4 million and \$43.7 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. During the year ended December 31, 2003 the Company made initial deposits to Spread Accounts and funded initial overcollateralization of \$18.7 million related to its term securitization transactions, compared to \$16.7 million in the 2002 period and \$2.5 million in the 2001 period. The acquisition of Contracts for subsequent sale in securitization transactions, and the need to fund Spread Accounts and initial overcollateralization, 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 (other than flow purchases), 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 currently limited in its ability to purchase Contracts due to certain liquidity constraints. As of December 31, 2003, the Company had cash on hand of \$33.2 million and available Contract purchase commitments from its warehouse credit facilities of \$200.7 million. The Company's plans to manage the 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 and other Credit Enhancement 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 financial covenants requiring certain minimum financial ratios and results. The Company was in violation of four of these covenants as of December 31, 2003, including maximum leverage, minimum equity, maximum financial loss and interest coverage. As of December 31, 2003, the Company had received a waiver of such non-compliance from the controlling party. In March 2004, each of these financial covenants was amended with the controlling party such that all breaches have been cured.

The Servicing Agreements of the Company's securitization transactions and warehouse credit facilities are terminable by the insurers of certain of the Trust's obligations ("Note Insurers") in the event of certain defaults by the Company and under certain other circumstances. Were a Note Insurer in the future to exercise its option to terminate the Servicing 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 Servicing Agreements.

#### Contractual Obligations

The following table summarizes the Company's material contractual obligations as of December 31, 2003 (dollars in thousands):

**Payment due by period**

	<u>Total</u>	<u>Less than 1 Year</u>	<u>1 to 3 Years</u>	<u>3 to 5 Years</u>	<u>More than 5 Years</u>
Long Term Debt.....	\$ 102,465	\$ 83,328	\$ 14,000	\$ 5,137	\$ —
Operating Leases.....	\$ 16,948	\$ 4,511	\$ 7,894	\$ 4,543	\$ —

Long term debt includes Senior secured, subordinated and related party debt.

**Credit Facilities**

The terms on which credit has been available to the Company for purchase of Contracts have varied over the three-year period ended December 31, 2003, as shown in the following recapitulation:

In November 2000, the Company (through its subsidiary CPS Funding LLC) entered into a floating rate variable note purchase facility under which up to \$75 million of notes may be outstanding at any time subject to collateral tests and other conditions. The Company uses funds derived from this facility to purchase Contracts under the CPS programs, which are pledged to secure the notes. The collateral tests and other conditions generally allow the Company to borrow up to approximately 72.5% of the price paid for such Contracts. Notes issued under this facility bear interest at one-month LIBOR plus 0.75% per annum. The balance of notes outstanding related to this facility at December 31, 2003 was zero. This facility expired on February 21, 2004. The Company is currently in discussions with several parties regarding a replacement facility.

Additionally, in March 2002, the Company (through its subsidiary CPS Warehouse Trust) entered into a second floating rate variable note purchase facility, under which up to \$125.0 million of notes may be outstanding at any time, subject to collateral tests and other conditions. The Company uses funds derived from this facility to purchase Contracts under the CPS programs, which are pledged to secure the notes. The collateral tests and other conditions generally allow the Company to borrow up to approximately 73% of the price paid for such Contracts. Notes issued under this facility bear interest at commercial paper plus 1.18% per annum. The balance of notes outstanding related to this facility at December 31, 2003 was \$13.2 million. This facility expires on April 4, 2004. The Company is currently in discussions with the related parties to renew such facility.

One of the covenants within this warehouse credit facility and four of the six term securitizations insured by this Note Insurer requires that the Company maintain additional warehouse facilities with minimum borrowing capacity of \$75.0 million. With the expiration of the CPS Funding LLC facility described above, the Company is in breach of such covenant. The Company has until June 20, 2004 to cure such breach prior to it becoming an event of default under this warehouse facility and four term securitizations. While the Company is currently in discussions with several parties about a replacement facility and believes that it will be successful in replacing the facility within the required time frame, there can be no assurances that it will do so. If the Company is unsuccessful in these efforts, the Note Insurer will have the right to declare an event of default. Remedies available to the Note Insurer in such event include, among other things, transferring the servicing rights to the portfolio that it insures to another servicer and trapping excess cash releases to the Company from its warehouse facility and four term securitizations that it insures. To the extent that the Note Insurer was to follow either of these remedies, it would have a material adverse effect on the liquidity and the operations of the Company.

In connection with the TFC Merger in May 2003, the Company (through its subsidiary TFC Warehouse I LLC) entered in to a third floating rate variable note purchase facility, under which up to \$25.0 million of notes may be outstanding at any time, subject to collateral tests and other conditions. The Company uses funds derived from this facility to purchase Contracts under the TFC programs, which are pledged to secure the notes. The collateral tests and other conditions generally allow the Company to borrow up to approximately 71% of the price paid for such Contracts. Notes issued under this facility bear interest at LIBOR plus 1.75%

per annum. The balance of notes outstanding related to this facility at December 31, 2002 was \$20.5 million. This facility expires on May 19, 2004. The Company is currently in discussions with the related parties to renew such facility.

## Capital Resources

Prior to 1999, and again in 2001, 2002 and 2003, the Company has funded increases in its managed portfolio through securitization transactions, as discussed above, and funded its other capital needs with cash from operations and with the proceeds from the issuance of long-term debt and/or equity.

The acquisition of Contracts for subsequent sale in securitization transactions, and the need to fund Spread Accounts and initial overcollateralization, if any, 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 (other than purchases made on a flow basis), the required level of initial credit enhancement in securitizations, and the extent to which the Trusts and related Spread Accounts either release cash to the Company or capture cash from collections on securitized Contracts. The Company plans to adjust its levels of Contract purchases so as to match anticipated releases of cash from the Trusts and related Spread Accounts with its capital requirements.

## Capitalization

Over the three-year period ended December 31, 2003, the Company has managed its capitalization by issuing and restructuring debt and issuing/purchasing common stock and equivalents, as summarized in the following table:

	<b>Years Ended December 31,</b>		
	<b>2003</b>	<b>2002</b>	<b>2001</b>
	<b>(In thousands)</b>		
<b>Securitization trust debt:</b>			
Beginning balance .....	\$ 71,630	\$ —	\$ —
Assumption in connection with MFN & TFC Merger.....	115,597	156,923	—
Issuances .....	154,375	—	—
Payments .....	<u>(96,484)</u>	<u>(85,293)</u>	<u>—</u>
Ending balance .....	<u>\$ 245,118</u>	<u>\$ 71,630</u>	<u>\$ —</u>
<b>Senior secured debt:</b>			
Beginning balance .....	\$ 50,072	\$ 26,000	\$ 38,000
Issuances .....	25,000	46,242	—
Payments .....	<u>(25,107)</u>	<u>(22,170)</u>	<u>(12,000)</u>
Ending balance .....	<u>\$ 49,965</u>	<u>\$ 50,072</u>	<u>\$ 26,000</u>
<b>Subordinated debt:</b>			
Beginning balance .....	\$ 36,000	\$ 36,989	\$ 37,699
Assumption in connection with MFN & TFC Merger .....	—	22,500	—
Payments .....	<u>(1,000)</u>	<u>(23,489)</u>	<u>(710)</u>
Ending balance .....	<u>\$ 35,000</u>	<u>\$ 36,000</u>	<u>\$ 36,989</u>
<b>Related party debt:</b>			
Beginning balance .....	\$ 17,500	\$ 17,500	\$ 21,500
Issuances .....	—	—	—
Payments .....	<u>—</u>	<u>—</u>	<u>(4,000)</u>
Ending balance .....	<u>\$ 17,500</u>	<u>\$ 17,500</u>	<u>\$ 17,500</u>
Increase (decrease) of Common Stock and equivalents.....	<u>\$ 23</u>	<u>\$ 2,074</u>	<u>\$ (757)</u>

The assumption of debt related to the TFC Merger is included in the 2003 activity in the table above. The assumption of debt related to the MFN Merger is included in the 2002 activity in the table above.

During the first quarter of 2001, the Company purchased a total of \$8,000,000 of outstanding indebtedness held by Levine Leichtman Capital Partners II, L.P. (“LLCP”) and Stanwich Financial Services Corp. (“SFSC”). The Company purchased and retired \$4,000,000 of subordinated debt held by SFSC in exchange for payment of \$3,920,000, and purchased and retired \$4,000,000 of senior secured debt held by LLCP in exchange for payment of \$4,200,000. The LLCP debt by its terms called for a prepayment penalty of 3% (or \$120,000); the additional 2% (or \$80,000) paid in connection with its February 2001 prepayment was absorbed by SFSC.

In March 2002, the Company and LLCP entered into an additional series of agreements under which LLCP provided additional funding to enable the Company to acquire MFN Financial Corporation. Under the March 2002 agreements, the Company borrowed \$35 million from LLCP as a Bridge Note (Bridge Note) and approximately \$8.5 million (“Term C”) on a deemed principal amount of approximately \$11.2 million. The Bridge Note requires principal payments of \$2.0 million a month, which began in June 2002, with a final balloon payment in the amount of \$17.0 million, which was made pursuant to the terms of the Bridge Note in February 2003. The Term C Note repayment schedule is based on the performance of a certain securitized pool. As the subordinated Note of the pool is repaid from the Trust, principal payments are due on the Term C Note. The maturity date of the Term C Note is March 2008. Interest is due monthly on the Bridge Note at a rate of 13.5% per annum and on the Term C Note at a rate of 12.0% per annum. In connection with the March 2002 agreements and the acquisition of MFN, the Company paid LLCP a structuring fee of \$1.75 million and an investment banking fee of \$1.0 million, and paid LLCP's out-of-pocket expenses of approximately \$315,000. In addition, the Company paid LLCP certain other fees and interest amounting to \$426,181. Approximately \$1.4 million of the fees and other amounts paid to LLCP were deferred as financing costs and are being amortized over the life of the related debt. The remaining fees and other costs were included in the purchase price of MFN. At December 31, 2003, there was \$5.1 million principal outstanding on the Term C.

At the time of the MFN Merger, MFN had outstanding \$22.5 million in principal amount of senior subordinated debt, which was due and repaid in full on March 23, 2002. Such debt bore interest at the rate of 11.00% per annum, payable quarterly in arrears. At the time of the TFC Merger, TFC had outstanding \$6.3 million in principal amount of subordinated debt, which the Company assumed as part of the TFC Merger. Such debt bears interest at the rate of 13.25% per annum payable monthly in arrears, requires monthly amortization and is due in June 2005.

On February 3, 2003, the Company borrowed \$25.0 million from 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 has paid the fees to extend the maturity to January 2004. Interest on the Term D Note is payable monthly at rates that averaged 4.79% per annum through June 30, 2003, and 12.0% per annum thereafter. In a separate transaction, the Bridge Note issued to LLCP in connection with the acquisition of MFN, in an original principal amount of \$35.0 million, was due on February 28, 2003. The outstanding principal balance of \$17.0 million was paid in February 2003. In addition, the maturity of the Term B Note was extended in October 2003 from November 2003 to January 2004. As of December 31, 2003, the outstanding principal balances of the Term B Note and the Term C Note were \$19.8 million and \$5.3 million, respectively. 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 Term B Note and the Term D Note were extended to December 15, 2005 and the coupons on 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.

LLCP holds approximately 22.1% of the Company's outstanding common shares. SFSC is an affiliate of Charles E. Bradley, Sr., the Company's former chairman and father of the company's current chairman and Chief Executive Officer, and SFSC and Mr. Bradley, Sr. together hold approximately 14.6% of the Company's outstanding common shares.

The Company must comply with certain affirmative and negative covenants related to debt facilities, which require, among other things, that the Company maintain certain financial ratios related to liquidity, net worth, capitalization, investments, acquisitions, restricted payments and certain dividend restrictions. The Company was in compliance with all of its debt covenants with respect to non-securitization related debt as of December 31, 2003. The Company was in violation of four covenants related to securitization debt as of December 31, 2003, including maximum leverage, minimum equity, maximum financial loss and interest coverage. As of December 31, 2003, the Company had received a waiver of such non-compliance from the controlling party. In March 2004, each of these financial covenants was amended with the controlling party such that all breaches have been cured.

In July 2000, the Board of Directors authorized the purchase of up to \$5,000,000 of outstanding debt and equity securities of the Company, inclusive of the mandatory annual purchase or redemption of \$1,000,000 of the Company's outstanding "RISRS" subordinated debt securities, due 2006. In October 2002, the Board of Directors authorized the purchase of an additional \$5,000,000 of outstanding debt or equity securities. As of December 31, 2003, the Company had purchased \$4.0 million in principal amount of the RISRS, and \$3.9 million of its common stock, representing 2,141,037 shares.

### **Forward-looking Statements**

This report on Form 10-K 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 18.1% to 22.1% cumulatively over the lives of the related Contracts, that charge-offs as a percentage of original balances will approximate 15.9% to 23.1% cumulatively over the lives of the related Contracts, with recovery rates approximating 2.2% to 5.3% 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 one special-purpose affiliated entity in the case of CPS, or a different special-purpose affiliated entity in the case of TFC. 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 and results of operations. In addition, the Company is currently in breach of a covenant under one of its warehouse facilities to maintain \$75 million in additional minimum warehouse borrowing capacity. The Company has until June 20, 2004 to cure such breach prior to it becoming an event of default under one warehouse facility and four term securitizations. While the Company is currently in discussions with several parties about a replacement facility and believes that it will be successful in replacing the facility within the required time frame, there can be no assurances that it will do so. If the Company is unsuccessful in these efforts, the Note Insurer will have the right to declare an event of default. Remedies available to the Note Insurer in such event include, among other things, transferring the servicing rights to the portfolio that it insures to another servicer and trapping excess cash releases to the Company from its warehouse facility and four term securitizations that it insures. To the extent that the Note Insurer were to pursue either of these remedies, it would have a material adverse effect on the liquidity and operations of the Company.

*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 and overcollateralization, 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 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, defaults or net losses related to the Contracts in the pool are below certain predetermined levels. In the event delinquencies, defaults or net 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 and financial condition.

*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 securitized 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 probable 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.

*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 taken 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 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, could have a material adverse effect on the Company's financial condition and results of operations.

*Dependence on Dealers.* The Company is dependent upon establishing and maintaining relationships with unaffiliated Dealers to supply it with Contracts. During the year ended December 31, 2003, 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 and results of operations.

*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 and results of operations.

### **New Accounting Pronouncements**

The Company will adopt in future periods new accounting pronouncements. For information on how adoption has affected and will affect the Financial Statements, see Note 1 of Notes to Consolidated Financial Statements.

## **ITEM 7A. 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 through its outstanding indebtedness and to a lesser extent its outstanding interest earning assets, and commitments to enter into new Contracts. The table below outlines the carrying values and estimated fair values of such financial instruments:

<b>Financial Instrument</b>	<b>December 31,</b>			
	<b>2003</b>		<b>2002</b>	
	<b>Carrying Value</b>	<b>Fair Value</b>	<b>Carrying Value</b>	<b>Fair Value</b>
	<b>(In thousands)</b>			
Finance receivables, net .....	\$ 266,189	\$ 266,189	\$ 84,592	\$ 84,592
Notes payable .....	3,330	3,330	673	673
Securitization trust debt.....	245,118	245,118	71,630	71,630
Senior secured debt .....	49,965	49,965	50,072	50,072
Subordinated debt.....	35,000	35,506	36,000	32,800
Related party debt.....	17,500	17,763	17,500	15,400

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 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA**

This report includes Consolidated Financial Statements, notes thereto and an Independent Auditors' Report, at the pages indicated below. Certain unaudited quarterly financial information is included in the Notes to Consolidated Financial Statements, as Note 18.

#### **ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE**

None

## INDEX TO FINANCIAL STATEMENTS

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## INDEPENDENT AUDITORS' REPORT

The Board of Directors

Consumer Portfolio Services, Inc.:

We have audited the accompanying consolidated balance sheets of Consumer Portfolio Services, Inc. and subsidiaries (the "Company") as of December 31, 2003 and 2002, and the related consolidated statements of operations, comprehensive income (loss), shareholders' equity, and cash flows for each of the years in the three-year period ended December 31, 2003. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Consumer Portfolio Services, Inc. and subsidiaries as of December 31, 2003 and 2002, and the results of their operations and their cash flows for each of the years in the three-year period ended December 31, 2003, in conformity with accounting principles generally accepted in the United States of America.

/s/ KPMG LLP

Orange County, California

March 15, 2004

## CONSUMER PORTFOLIO SERVICES, INC. AND SUBSIDIARIES

### CONSOLIDATED BALANCE SHEETS

(In thousands, except share and per share data)

	<u>December 31,</u> <u>2003</u>	<u>December 31,</u> <u>2002</u>
<b>ASSETS</b>		
Cash .....	\$ 33,209	\$ 32,947
Restricted cash .....	67,277	18,912
Finance receivables .....	302,078	110,420
Less: Allowance for finance credit losses .....	<u>(35,889)</u>	<u>(25,828)</u>
Finance receivables, net .....	266,189	84,592
Servicing fees receivable .....	3,942	3,407
Residual interest in securitizations .....	111,702	127,170
Furniture and equipment, net .....	826	1,612
Deferred financing costs .....	1,529	1,671
Deferred interest expense .....	—	2,695
Other assets .....	7,796	12,442
	<u>\$ 492,470</u>	<u>\$ 285,448</u>
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
<b>Liabilities</b>		
Accounts payable & accrued expenses .....	\$ 22,920	\$ 18,132
Warehouse lines of credit .....	33,709	—
Tax liabilities, net .....	2,768	8,800
Capital lease obligation .....	—	67
Notes payable .....	3,330	673
Securitization trust debt .....	245,118	71,630
Senior secured debt .....	49,965	50,072
Subordinated debt .....	35,000	36,000
Related party debt .....	17,500	17,500
	<u>410,310</u>	<u>202,874</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; 20,588,924 and 20,528,270 shares issued and outstanding at December 31, 2003 and December 31, 2002, respectively .....	64,397	63,929
Retained earnings .....	20,992	20,597
Comprehensive loss – minimum pension benefit obligation, net .....	(2,426)	(1,594)
Deferred compensation .....	<u>(803)</u>	<u>(358)</u>
	<u>82,160</u>	<u>82,574</u>
	<u>\$ 492,470</u>	<u>\$ 285,448</u>

See accompanying Notes to Consolidated Financial Statements.

## CONSUMER PORTFOLIO SERVICES, INC. AND SUBSIDIARIES

### CONSOLIDATED STATEMENTS OF OPERATIONS

(In thousands, except per share data)

	Year Ended December 31,		
	2003	2002	2001
Revenues:			
Gain on sale of contracts, net.....	\$ 6,369	\$ 16,444	\$ 32,765
Interest income.....	58,164	48,644	17,205
Servicing fees.....	17,058	14,621	10,666
Other income.....	19,343	13,605	1,940
	100,934	93,314	62,576
Expenses:			
Employee costs .....	37,141	37,778	23,994
General and administrative .....	21,271	20,131	12,645
Interest .....	23,861	23,925	14,335
Provision for credit losses.....	11,390	—	—
Marketing.....	5,380	6,253	7,096
Occupancy .....	3,930	4,027	3,167
Depreciation and amortization .....	1,000	1,138	1,019
	103,973	93,252	62,256
Income (loss) before income taxes (benefit).....	(3,039)	62	320
Income tax expense (benefit).....	(3,434)	(2,934)	—
Income before extraordinary item.....	395	2,996	—
			320
Extraordinary item, unallocated negative goodwill .....	—	17,412	—
Net income.....	\$ 395	\$ 20,408	\$ 320
Earnings per share before extraordinary item:			
Basic .....	\$ 0.02	\$ 0.15	\$ 0.02
Diluted .....	0.02	0.14	0.02
Earnings per share, extraordinary item:			
Basic .....	\$ —	\$ 0.87	\$ —
Diluted .....	—	0.83	—
Earnings per share after extraordinary item:			
Basic .....	\$ 0.02	\$ 1.03	\$ 0.02
Diluted .....	0.02	0.97	0.02
Number of shares used in computing earnings per share:			
Basic .....	20,263	19,902	19,480
Diluted .....	21,578	20,987	21,018

See accompanying Notes to Consolidated Financial Statements.

## CONSUMER PORTFOLIO SERVICES, INC. AND SUBSIDIARIES

### CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)

(In thousands)

	<u>Year Ended December 31,</u>		
	<u>2003</u>	<u>2002</u>	<u>2001</u>
Net income .....	\$ 395	\$ 20,408	\$ 320
Other comprehensive loss:			
Minimum pension liability, net of tax .....	(832)	(1,594)	—
Comprehensive income (loss) .....	<u>\$ (437)</u>	<u>\$ 18,814</u>	<u>\$ 320</u>

See accompanying Notes to Consolidated Financial Statements.

# CONSUMER PORTFOLIO SERVICES, INC. AND SUBSIDIARIES

## CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY

(In thousands)

	Preferred Stock		Series A Preferred Stock		Common Stock	
	Shares	Amount	Shares	Amount	Shares	Amount
Balance at December 31, 2000 .....	—	\$ —	—	\$ —	19,646	\$ 62,987
Common stock issued upon exercise of options, including tax benefit .....	—	—	—	—	498	312
Purchase of common stock .....	—	—	—	—	(863)	(1,348)
Increase in deferred compensation on stock options .....	—	—	—	—	—	(77)
Amortization of stock compensation .....	—	—	—	—	—	—
Net income .....	—	—	—	—	—	—
Balance at December 31, 2001 .....	—	—	—	—	19,281	61,874
Common stock issued upon exercise of options, including tax benefit .....	—	—	—	—	1,255	893
Purchase of common stock .....	—	—	—	—	(8)	(15)
Pension benefit obligation .....	—	—	—	—	—	—
Increase in deferred compensation on stock options .....	—	—	—	—	—	1,177
Amortization of stock compensation .....	—	—	—	—	—	—
Net income .....	—	—	—	—	—	—
Balance at December 31, 2002 .....	—	—	—	—	20,528	63,929
Common stock issued upon exercise of options, including tax benefit .....	—	—	—	—	609	974
Purchase of common stock .....	—	—	—	—	(548)	(1,195)
Pension benefit obligation .....	—	—	—	—	—	—
Repurchase of warrants issued .....	—	—	—	—	—	(896)
Increase in deferred compensation on stock options .....	—	—	—	—	—	1,585
Amortization of stock compensation .....	—	—	—	—	—	—
Net income .....	—	—	—	—	—	—
Balance at December 31, 2003 .....	—	\$ —	—	\$ —	20,589	\$ 64,397

	Pension Benefit Obligation	Deferred Compensation	Retained Earnings (Deficit)	Total
Balance at December 31, 2000 .....	\$ —	\$ (734)	\$ (131)	\$ 62,122
Common stock issued upon exercise of options, including tax benefit .....	—	—	—	312
Purchase of common stock .....	—	—	—	(1,348)
Increase in deferred compensation on stock options .....	—	77	—	—
Amortization of stock compensation .....	—	280	—	280
Net income .....	—	—	320	320
Balance at December 31, 2001 .....	—	(377)	189	61,686
Common stock issued upon exercise of options, including tax benefit .....	—	—	—	893
Purchase of common stock .....	—	—	—	(15)
Pension benefit obligation .....	(1,594)	—	—	(1,594)
Increase in deferred compensation on stock options .....	—	(1,177)	—	—
Amortization of stock compensation .....	—	1,196	—	1,196
Net income .....	—	—	20,408	20,408
Balance at December 31, 2002 .....	(1,594)	(358)	20,597	82,574
Common stock issued upon exercise of options, including tax benefit .....	—	—	—	974
Purchase of common stock .....	—	—	—	(1,195)
Pension benefit obligation .....	(832)	—	—	(832)
Repurchase of warrants issued .....	—	—	—	(896)
Increase in deferred compensation on stock options .....	—	(1,585)	—	—
Amortization of stock compensation .....	—	1,140	—	1,140
Net income .....	—	—	395	395
Balance at December 31, 2003 .....	\$ (2,426)	\$ (803)	\$ 20,992	\$ 82,160

See accompanying Notes to Consolidated Financial Statements.

# CONSUMER PORTFOLIO SERVICES, INC. AND SUBSIDIARIES

## CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands)

	<b>Year Ended December 31,</b>		
	<b>2003</b>	<b>2002</b>	<b>2001</b>
Cash flows from operating activities:			
Net income .....	\$ 395	\$ 20,408	\$ 320
Adjustments to reconcile net income to net cash provided by operating activities:			
Extraordinary gain, excess of assets acquired over purchase price.....	—	(17,412)	—
Depreciation and amortization.....	1,000	1,138	1,019
Amortization of deferred financing costs .....	2,695	4,547	890
Provision for (recovery of) credit losses.....	11,916	2,639	(5,695)
NIR gains recognized .....	(4,381)	(16,873)	(9,211)
Write off of related party receivables .....	—	669	—
Loss on sale of furniture and equipment.....	—	5	—
Deferred compensation.....	1,140	1,196	280
Releases of cash from Trusts to Company.....	25,934	60,393	43,652
Initial deposits to Trusts .....	(18,736)	(16,749)	(2,477)
Net deposits to Trusts to increase Credit Enhancement.....	(20,867)	(24,236)	(24,581)
(Increase) decrease in receivables from Trusts and investment in subordinated certificates.....	33,518	8,884	(14,287)
Changes in assets and liabilities:			
Restricted cash.....	(30,641)	17,940	(6,090)
Purchases of Contracts held for sale.....	(182,045)	(463,253)	(672,281)
Amortization and liquidation of Contracts held for sale.....	283,423	566,124	693,258
Other assets .....	6,936	5,016	5,164
Accounts payable and accrued expenses .....	(3,363)	(16,113)	(3,995)
Tax asset/liability .....	(7,162)	12,570	(240)
Net cash provided by operating activities.....	<u>99,762</u>	<u>146,893</u>	<u>5,726</u>
Cash flows from investing activities:			
Net related party receivables .....	—	—	230
Purchase of Contracts held for investment .....	(175,275)	—	—
Amortization of Contracts held for investment .....	5,741	—	—
Purchase of furniture and equipment.....	(93)	(285)	(766)
Purchase of subsidiary, net of cash acquired .....	(10,181)	(29,467)	—
Net cash used in investing activities.....	<u>(179,808)</u>	<u>(29,752)</u>	<u>(536)</u>
Cash flows from financing activities:			
Proceeds from issuance of senior secured debt.....	25,000	46,242	—
Proceeds from issuance of securitization trust debt.....	154,375	—	—
Net proceeds from warehouse lines of credit.....	31,332	—	(2,003)
Repayment of securitization trust debt .....	(96,484)	(85,293)	—
Repayment of senior secured debt.....	(25,107)	(22,170)	(12,000)
Repayment of subordinated debt .....	(1,000)	(23,489)	(710)
Repayment of capital lease obligations .....	(84)	(409)	(522)
Repayment of notes payable.....	(3,664)	(917)	(824)
Repayment of related party debt.....	—	—	(4,000)
Payment of financing costs.....	(2,553)	(1,037)	(576)
Purchase of common stock .....	(1,195)	(15)	(1,348)
Repurchase of warrants issued .....	(896)	—	—
Exercise of options and warrants.....	584	324	312
Net cash provided by (used in) financing activities.....	<u>80,308</u>	<u>(86,764)</u>	<u>(21,671)</u>
Increase (decrease) in cash .....	262	30,377	(16,481)
Cash at beginning of period.....	<u>32,947</u>	<u>2,570</u>	<u>19,051</u>
Cash at end of period.....	<u>\$ 33,209</u>	<u>\$ 32,947</u>	<u>\$ 2,570</u>

See accompanying Notes to Consolidated Financial Statements.

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

	<u>Year Ended December 31,</u>		
	<u>2003</u>	<u>2002</u>	<u>2001</u>
Supplemental disclosure of cash flow information:			
Cash paid (received) during the period for:			
Interest .....	\$ 18,677	\$ 19,255	\$ 10,780
Income taxes .....	3,728	(15,565)	22
Supplemental disclosure of non-cash investing and financing activities:			
Stock compensation .....	1,140	1,196	280
Pension benefit obligation, net.....	832	1,594	—
Deferred income taxes .....	944	1,632	—
Purchase of common stock with notes .....	—	479	—

See accompanying Notes to Consolidated Financial Statements.

**CONSUMER PORTFOLIO SERVICES, INC.**  
**NOTES TO 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 in purchasing, selling and servicing retail automobile installment sale contracts ("Contracts") originated by licensed motor vehicle dealers ("Dealers") located throughout the United States. The Company specializes in 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.

**Acquisitions**

On March 8, 2002, the Company acquired MFN Financial Corporation and its subsidiaries in a merger (the "MFN Merger"). On May 20, 2003, the Company acquired TFC Enterprises, Inc. and its subsidiaries in a second merger (the "TFC Merger"). Each merger was accounted for as a purchase. MFN Financial Corporation and its subsidiaries ("MFN") and TFC Enterprises, Inc. and its subsidiaries ("TFC") were engaged in businesses similar to that of the Company: buying Contracts from Dealers, repackaging those Contracts in securitization transactions, and servicing those Contracts. MFN ceased acquiring Contracts in March 2002; TFC continues to acquire Contracts under its "TFC Programs."

**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 was 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 will 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 intended future 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 will be shown as assets of the Company on its balance sheet; (ii) the debt issued in the transactions will be shown as indebtedness of the Company; (iii) cash posted to enhance the credit of the securitization transactions will be shown as "restricted cash" on the Company's balance sheet; (iv) the servicing fee that the Company receives in connection with such receivables will be recorded as a portion of the interest earned on such receivables; (v) the Company will initially and periodically record as expense a provision for estimated credit losses on the receivables; and (vi) the portion of scheduled payments on the receivables representing interest will be recorded as revenue as accrued.

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 will result in the Company's reporting lower earnings than it would report if it were to continue to structure its securitizations to require recognition of gain on sale.

**Principles of Consolidation**

The Consolidated Financial Statements include the accounts of Consumer Portfolio Services, Inc. and its wholly-owned subsidiaries, certain of which are Special Purpose Subsidiaries ("SPS"), formed to accommodate the structures under which the Company purchases and securitizes its Contracts. The Consolidated Financial Statements also include the accounts of CPS Leasing, Inc., an 80% owned subsidiary. All significant intercompany balances and transactions have been eliminated in consolidation.

**CONSUMER PORTFOLIO SERVICES, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**Cash and Cash Equivalents**

For purposes of the statements of cash flows, the Company considers all highly liquid debt instruments with original maturities of three months or less to be cash equivalents. Cash equivalents consist of cash on hand and due from banks and money market accounts.

**Finance Receivables, net of unearned income**

Finance receivables are presented at cost. Finance receivable Contracts include automobile installment sales contracts on which interest is pre-computed and added to the amount financed. The interest on such Contracts is included in unearned finance charges. Unearned finance charges are amortized using the interest method over the remaining period to contractual maturity. Generally, payments received on finance receivables are restricted to certain securitized pools, and the related Contracts cannot be resold. Finance receivables are charged off pursuant to the controlling documents of certain securitized pools, generally before they become contractually delinquent five payments. Contracts that are deemed uncollectible prior to the maximum charge off period are charged off immediately. Management may authorize a temporary extension of payment terms if collection appears likely during the next calendar month.

The method selected to measure impairment is made on a loan-by-loan basis, unless repossession of the collateral has occurred, in which case the net realizable value is used.

**Allowance for Finance Credit Losses**

In order to estimate an appropriate allowance for losses to be incurred on finance receivables, 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 Contracts. Provision for loss 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.

**Contract Acquisition Fees**

Upon purchase of a Contract from a Dealer, the Company generally charges or advances the Dealer an acquisition fee. For Contracts securitized in pools which were structured as sales for financial accounting purposes, the acquisition fees associated with Contract purchases were deferred until the Contracts were securitized, at which time the deferred acquisition fees were recognized as a component of the gain on sale. For Contracts securitized in pools which are structured as secured financings for financial accounting purposes, the acquisition fees associated with Contract purchases are deferred and revenue is recognized over the life of the Contracts using a method that approximates a level yield. The Company also charged the purchaser an origination fee for those Contracts that were sold on a flow basis. Those fees were recognized at the time the Contracts were sold and were also a component of the gain on sale.

**Flow Purchase Program**

Through May 2002, the Company purchased Contracts for immediate and outright resale to non-affiliated third parties. The Company sold such Contracts for a mark-up above what the Company paid the Dealer. In such sales, the Company made certain representations and warranties to the purchasers, normal in the industry, which related primarily to the legality of the sale of the underlying motor vehicle and to the validity of the security interest being conveyed to the purchaser. Those representations and warranties were generally similar to the representations and warranties given by the originating Dealer to the Company. In the event of a breach

**CONSUMER PORTFOLIO SERVICES, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

of such representations or warranties, the Company may incur liabilities in favor of the purchaser(s) of the Contracts and there can be no assurance that the Company would be able to recover, in turn, against the originating Dealer(s).

**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 December 31, 2002 the line item "Residual interest in securitizations" on the Company's Consolidated Balance Sheet includes residual interests in both term and warehouse securitizations. As of 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 in September and December 2003 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 has generally been 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 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 an account ("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 Enhancement is to be maintained will vary depending on the performance of the pools 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 various pools, 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 of the Contracts has amortized to a specified percentage of the initial aggregate balance.

**CONSUMER PORTFOLIO SERVICES, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

The prior securitizations that are treated as sales for financial accounting purposes differ from secured financings in that the Trust to which the SPS sells the Contracts meets 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 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 71.6% to 73% of the aggregate principal balance of the Contracts (that is, up to 28.4% 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 cause the transactions to be treated as secured financings for financial accounting purposes. The Contracts held by the warehouse SPSs and the promissory notes that they issue are therefore included in the Company's Consolidated Financial Statements as of 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 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 Consolidated Balance Sheet the Contracts sold and added to its 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 Consolidated Balance Sheet will reflect both securitization transactions structured as sales and others structured as secured financings.

With respect to 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 recognizes 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.

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 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.

**CONSUMER PORTFOLIO SERVICES, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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. The Company has used prepayment estimates of approximately 18.1% to 22.1% 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 15.9% to 23.1% cumulatively over the lives of the related Contracts, with recovery rates approximating 2.2% to 5.3% of the original principal balance.

Following a securitization that is structured as a sale for financial accounting purposes, interest income is recognized on the balance of the Residuals at the same rate as used for calculating the present value of the NIRs, which is 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 that is 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.

**Servicing**

The Company considers the servicing fee received on its managed portfolio held by non-consolidated subsidiaries to approximate adequate compensation. As a result, no servicing asset or liability has been recognized. Servicing fees received on its managed portfolio held by non-consolidated subsidiaries are reported as income when earned. Servicing fees received on its managed portfolio held by consolidated subsidiaries are included in interest income when earned. Servicing costs are charged to expense as incurred. Servicing fees receivable represent fees earned but not yet remitted to the Company by the trustee.

**CONSUMER PORTFOLIO SERVICES, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**Furniture and Equipment**

Furniture and equipment are stated at cost net of accumulated depreciation. The Company calculates depreciation using the straight-line method over the estimated useful lives of the assets, which range from three to five years. Assets held under capital leases and leasehold improvements are amortized over the lesser of the estimated useful lives of the assets or the related lease terms.

**Impairment of Long-Lived Assets and Long-Lived Assets to Be Disposed Of**

The Company accounts for long-lived assets in accordance with the provisions of SFAS No. 144, "Accounting for the Impairment of Long-Lived Assets." This Statement requires that long-lived assets and certain identifiable intangibles be reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to future net cash flows expected to be generated by the asset. If such assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the assets exceeds the fair value of the assets. Assets to be disposed of are reported at the lower of carrying amount or fair value less costs to sell.

**Other Income**

Other Income consists primarily of recoveries on previously charged off MFN contracts. These recoveries totaled \$12.2 million and \$10.5 million for the years ended December 31, 2003 and 2002, respectively. There were no such recoveries for the year ended December 31, 2001.

**Earnings Per Share**

The following table illustrates the computation of basic and diluted earnings per share:

	<b>Year ended December 31,</b>		
	<b>2003</b>	<b>2002</b>	<b>2001</b>
	<b>(In thousands, except per share data)</b>		
Numerator:			
Numerator for basic and diluted earnings			
per share before extraordinary item .....	\$ 395	\$ 2,996	\$ 320
Denominator:			
Denominator for basic earnings per share			
before extraordinary item — weighted average			
number of common shares outstanding during the	20,263	19,902	19,480
year .....			
Incremental common shares attributable to			
exercise of outstanding options and warrants .....	1,315	1,085	1,538
Denominator for diluted earnings			
before extraordinary item per share .....	21,578	20,987	21,018
Basic earnings per share before extraordinary item .....	<u>\$ 0.02</u>	<u>\$ 0.15</u>	<u>\$ 0.02</u>
Diluted earnings per share before extraordinary item ..	<u>\$ 0.02</u>	<u>\$ 0.14</u>	<u>\$ 0.02</u>

Incremental shares of 1.1 million related to the conversion of subordinated debt have been excluded from the calculation for the years ended December 31, 2003, 2002 and 2001, because the impact of assumed conversion of such subordinated debt is anti-dilutive.

Incremental shares of 908,000, 595,000 and 1.5 million shares related to stock options have been excluded from the calculation for the years ended December 31, 2003, 2002, and 2001, respectively, because the impact of assumed exercise is anti-dilutive. In addition, incremental shares of 2.5 million related to warrants have been excluded from the calculation for the years ended December 31, 2002 and 2001, because the impact of assumed exercise is anti-dilutive.

**CONSUMER PORTFOLIO SERVICES, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**Deferral and Amortization of Debt Issuance Costs**

Costs related to the issuance of debt are amortized on a straight-line basis over the shorter of the actual or expected term of the related debt.

**Income Taxes**

The Company and its subsidiaries file a 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 operating losses might otherwise expire.

**Purchases of Company Stock**

The Company records purchases of its own common stock at cost.

**Stock Option Plan**

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 date of grant. The Company provides the pro forma net income (loss), pro forma earnings per share, and stock based compensation plan disclosure requirements set forth in SFAS No. 123. The Company accounts for repriced options as variable awards.

The per share weighted-average fair value of stock options granted during the years ended December 31, 2003, 2002 and 2001, was \$2.09, \$1.39, and \$1.79, respectively, at the date of grant. That fair value was computed using the Black-Scholes option-pricing model with the following weighted average assumptions:

	<u>Year ended December 31,</u>		
	<u>2003</u>	<u>2002</u>	<u>2001</u>
Expected life (years).....	7.63	8.21	6.50
Risk-free interest rate .....	4.16%	4.19%	4.70%
Volatility.....	100.82%	107.56%	128.56%
Expected dividend yield .....	—	—	—

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 and earnings per share would have been reduced to the pro forma amounts indicated below.

**CONSUMER PORTFOLIO SERVICES, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

	<b>Year ended December 31,</b>		
	<b>2003</b>	<b>2002</b>	<b>2001</b>
	<b>(In thousands, except per share data)</b>		
Net income (loss)			
As reported .....	\$ 395	\$ 20,408	\$ 320
Pro forma .....	175	20,109	(1,040)
Earnings (loss) per share — basic			
As reported .....	\$ 0.02	\$ 1.03	\$ 0.02
Pro forma .....	0.01	1.01	(0.05)
Earnings (loss) per share — diluted			
As reported .....	\$ 0.02	\$ 0.97	\$ 0.02
Pro forma .....	0.01	0.96	(0.05)

Pro forma net income (loss) and earnings (loss) per share reflect only options granted in the years ended December 31, 1996 to 2003. 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, because compensation cost is reflected over the options' vesting period and compensation cost for options granted prior to 1996 is not considered.

**Segment Reporting**

Operations are managed and financial performance is evaluated on a Company-wide basis by a chief decision maker. Accordingly, all of the Company's operations are aggregated in one reportable operating segment.

**New Accounting Pronouncements**

The FASB issued Statement of Financial Accounting Standards No. 148 "Accounting for Stock-Based Compensation—Transition and Disclosure" amends FASB Statement No. 123, "Accounting for Stock-Based Compensation" ("SFAS 123") in December 2002. SFAS 148 is designed to provide alternative methods of transition for enterprises that elect to change to the SFAS 123 fair value method of accounting for stock-based employee compensation. SFAS 148 will permit two additional transition methods for entities that adopt the preferable SFAS 123 fair value method of accounting for stock-based employee compensation. Both of those methods avoid the ramp-up effect arising from prospective application of the fair value method under the existing transition provisions of SFAS 123. In addition, under the provisions of SFAS 148, the original Statement 123 prospective method of transition for changes to the fair value method will no longer be permitted in fiscal periods beginning after December 15, 2003.

SFAS 148 will also amend the disclosure requirements of SFAS 123 to require prominent disclosures in both annual and interim financial statements about the method of accounting for stock-based employee compensation and the effect of the method used on reported results. The provisions of SFAS 148 are effective for fiscal years ended after December 15, 2002. The adoption of SFAS No. 148 did not have a material effect on the Company.

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 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

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in connection with off-balance sheet securitizations and are not subject to the requirements of FIN 46R. The Company's subsidiaries that are considered variable interest entities subject to the requirements of FIN 46R, Trusts related to the Company's on-balance sheet securitizations, are currently being consolidated and are included in the Company's consolidated financial statements. The adoption of FIN 46R is not expected to have a material effect on the Company.

On April 30, 2003, the FASB issued statement of Financial Accounting Standards No. 149, "Amendment of Statement 133 on Derivative Instruments and Hedging Activities" ("SFAS 149"). The purpose of SFAS 149 is to amend and clarify financial accounting and reporting for derivative instruments and hedging activities under SFAS No.133. These amendments clarify the definition of a derivative, expand the nature of exemptions from SFAS No.133, clarify the application of hedge accounting when using certain instruments, clarify the application of paragraph 13 of SFAS No.133 to embedded derivative instruments in which the underlying is an interest rate, and modify the cash flow presentation of derivative instruments that contain financing elements. SFAS 149 is effective for derivative transactions and hedging relationships entered into or modified after June 30, 2003. The adoption of SFAS 149 did not have a material impact on the Company's financial statements.

FASB Statement No. 150, "Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity" ("SFAS 150"), was issued in May 2003. This Statement establishes standards for the classification and measurement of certain financial instruments with characteristics of both liabilities and equity. The Statement also includes required disclosures for financial instruments within its scope. For the Company, the Statement was effective for instruments entered into or modified after May 31, 2003 and otherwise will be effective as of January 1, 2004, except for mandatorily redeemable financial instruments. For certain mandatorily redeemable financial instruments, the Statement will be effective for the Company on January 1, 2005. The effective date has been deferred indefinitely for certain other types of mandatorily redeemable financial instruments. The Company adopted the provisions of SFAS 150 on July 1, 2003. The adoption of SFAS 150 did not have a material impact on the Company's consolidated financial statements.

**Use of Estimates**

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities as of the date of the financial statements, as well as the reported amounts of income and expenses during the reported periods. Specifically, a number of estimates were made in connection with determining an appropriate allowance for finance credit losses, valuing the Residuals and computing the related gain on sale on the transactions that created the Residuals, and deferred tax asset valuation allowance. Actual results could differ from those estimates depending on the future performance of the related Contracts.

**Reclassification**

Certain amounts for the prior years have been reclassified to conform to the current year's presentation.

**(2) Acquisitions**

**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

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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:

	<u>December 31,</u> <u>2003</u>	<u>Activity</u>	<u>December 31,</u> <u>2002</u> <u>(In thousands)</u>	<u>Activity</u>	<u>March 8,</u> <u>2001</u>
Severance payments and consulting contracts.....	\$ —	\$ 571	\$ 571	\$ 2,644	\$ 3,215
Facilities closures (1).....	1,889	106	1,995	157	2,152
Termination of contracts, leases, services and other obligations.....	—	323	323	274	597
Acquisition expenses accrued but unpaid.....	—	51	51	199	\$ 250
Total liabilities assumed.....	<u>\$ 1,889</u>	<u>\$ 1,051</u>	<u>\$ 2,940</u>	<u>\$ 3,274</u>	<u>\$ 6,214</u>

(1) For the period from March 8, 2002 to December 31, 2002 the activity resulting in a net charge of \$157,000, includes charges against liability of \$1.4 million, and the “reclassification” of an existing accrual for offices closed prior to the Merger Date of approximately \$1.2 million.

(2) Approximately \$1.9 million of remaining accrual is recorded in the Consolidated Balance Sheet of the Company at December 31, 2003. 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 Consolidated Balance Sheet and Consolidated Statement of Operations as of and for the years ended December 31, 2003 and 2002, include the balance sheet accounts of MFN Financial Corporation as of December 31, 2003 and 2002 and the results of operations subsequent to March 8, 2002, the merger date.

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

	<u>March 8, 2002</u> <u>(In thousands)</u>
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,

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interests in securitized pools of such Contracts, and the facilities for originating and servicing such Contracts. The 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 intends to continue 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 were \$4.5 million. These costs include the following:

	<u>December 31,</u> <u>2003(1)</u>	<u>Activity</u>	<u>May 20,</u> <u>2001</u>
		(In thousands)	
Severance payments and consulting contracts .....	\$ 2,326	\$ 357	\$ 2,683
Facilities closures .....	1,231	190	1,421
Other obligations .....	234	206	440
Total liabilities assumed.....	<u>\$ 3,791</u>	<u>\$ 753</u>	<u>\$ 4,544</u>

(1) 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 payable to stockholders of TFC was approximately \$21.6 million. The recipients of the total merger consideration had no material relationship 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 Consolidated Balance Sheet and Consolidated Statement of Operations as of and for the year ended December 31, 2003, include the balance sheet accounts of TFC Enterprises, Inc. as of December 31, 2003 and the results of operations subsequent to May 20, 2003, the merger date. The Company has recorded certain purchase accounting adjustments on its 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.

	<u>May 20, 2003</u> <u>(In thousands)</u>
Cash .....	\$ 13,545
Restricted cash .....	17,723
Finance Contracts, net .....	125,108
Other assets .....	<u>4</u>
Total assets acquired.....	<u>156,878</u>
Securitization trust debt .....	115,597
Notes Payable .....	6,32
Capital lease obligations .....	<u>11,217</u>
Accounts payable and other liabilities .....	<u>133,152</u>
Total liabilities assumed .....	<u>133,152</u>
Purchase price.....	<u>\$ 23,726</u>

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**Pro Forma Results of Operations**

Selected unaudited pro forma combined results of operations for the years ended December, 2003 and 2002, assuming the MFN Merger and TFC Merger occurred on January 1, 2003 and 2002, are as follows:

<b>Pro Forma Presentation (Unaudited)</b>	<b>Year Ended December 31,</b>	
	<b>2003</b>	<b>2002</b>
	<b>(In thousands)</b>	
Total revenue .....	\$ 107,598	\$ 130,212
Net income (loss) before Merger-related expenses and extraordinary item .....	824	(1,695)
Net income (loss) .....	824	(1,695)
Basic net income (loss) per share before Merger-related expenses and extraordinary item .....	\$ 0.04	\$ (0.09)
Extraordinary item (loss) .....	<u>—</u>	<u>—</u>
Basic net income per share .....	<u>\$ 0.04</u>	<u>\$ (0.09)</u>
Diluted net income (loss) per share before Merger-related expenses and extraordinary item .....	\$ 0.04	\$ (0.08)
Extraordinary item .....	<u>—</u>	<u>—</u>
Diluted net income (loss) per share .....	<u>\$ 0.04</u>	<u>\$ (0.08)</u>

**(3) Restricted Cash**

Restricted cash comprised the following components:

	<b>December 31,</b>	
	<b>2003</b>	<b>2002</b>
Securitization trust accounts .....	\$ 60,550	\$ 11,881
Litigation reserve .....	5,503	5,503
Note purchase facility reserve .....	1,074	968
Other .....	150	560
Total restricted cash .....	<u>\$ 60,550</u>	<u>\$ 18,912</u>

Certain of the Company's operating agreements require that the Company establish cash reserves for the benefit of the other parties to the agreements, in case those parties are subject to any claims or exposure. In addition, certain of these agreements require that the Company establish amounts in reserve related to outstanding litigation.

**(4) Finance Receivables**

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

	<b>December 31,</b>	<b>December 31,</b>
	<b>2003</b>	<b>2002</b>
	<b>(In thousands)</b>	
Finance Receivables		
Automobile		
Simple interest .....	\$ 178,679	\$ 31,372
Pre-compute or "Rule of 78's", net of unearned interest .....	<u>133,339</u>	<u>79,094</u>
Finance Receivables, net of unearned interest .....	312,018	110,466
Less: Unearned acquisition fees and discounts .....	<u>(9,940)</u>	<u>(46)</u>
Finance Receivables .....	<u>\$ 302,078</u>	<u>\$ 110,420</u>

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The following table presents the contractual maturities of Finance Receivables, net of unearned income, as of December 31, 2003:

	<u>Amount</u>	<u>%</u>
	<b>(Dollars in thousands)</b>	
Due within one year.....	\$ 23,329	7.48%
Due within two years.....	38,876	12.46%
Due within three years.....	38,890	12.49%
Due within four years.....	46,319	14.84%
Due within five years.....	128,880	41.31%
Due after five years.....	<u>35,624</u>	<u>11.42%</u>
Total.....	<u>\$ 312,018</u>	<u>100.00%</u>

The following table presents a summary of the activity for the allowance for credit losses, for the years ended December 31, 2003 and 2002:

	<u>December 31,</u>	
	<u>2003</u>	<u>2002</u>
	<b>(In thousands)</b>	
Balance at beginning of year.....	\$ 25,828	\$ —
Addition to allowance for credit losses due to acquisition of TFC.....	24,271	—
Addition to allowance for credit losses due to acquisition of MFN.....	—	59,261
Provision for credit losses.....	11,667	2,639
Net charge offs.....	(25,950)	(35,732)
Net amount transferred from allowance for repossessed assets.....	<u>73</u>	<u>(340)</u>
Balance at end of year.....	<u>\$ 35,889</u>	<u>\$ 25,828</u>

**(5) Residual Interest in Securitizations**

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

	<u>December 31,</u>	
	<u>2003</u>	<u>2002</u>
	<b>(In thousands)</b>	
Cash, commercial paper, United States government securities and other qualifying investments (Spread Account).....	\$ 35,693	\$ 27,218
Receivable from Trusts.....	20,959	33,214
Overcollateralization.....	38,548	59,366
Investment in subordinated certificates.....	<u>16,502</u>	<u>7,372</u>
Residual interest in securitizations.....	<u>\$ 111,702</u>	<u>\$ 127,170</u>

The following table presents the estimated remaining undiscounted credit losses included in the fair value estimate of the Residuals as a percentage of the Company's managed portfolio held by non-consolidated subsidiaries subject to recourse provisions:

	<u>December 31,</u>		
	<u>2003</u>	<u>2002</u>	<u>2001</u>
	<b>(In thousands)</b>		
Undiscounted estimated credit losses.....	\$ 47,935	\$ 54,363	\$ 16,210
Managed portfolio held by non-consolidated subsidiaries.....	<u>425,534</u>	<u>478,136</u>	<u>281,493</u>
Undiscounted estimated credit losses as percentage of managed portfolio held by non consolidated subsidiaries.....	<u>11.3%</u>	<u>11.4%</u>	<u>5.8%</u>

The key economic assumptions used in measuring all residual interest in securitizations as of December 31, 2003 and 2002 are included in the table below. The pre-tax discount rate remained constant at 14%.

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	<u>2003</u>	<u>2002</u>
Prepayment speed (Cumulative).....	18.1% - 22.1%	19.8% - 22.9%
Credit losses (Cumulative) .....	11.8% - 18.0%	10.0% - 15.4%

Static pool losses are calculated by summing the actual and projected future credit losses and dividing them by the original balance of each pool of assets.

Key economic assumptions and the sensitivity of the current fair value of residual cash flows to immediate 10% and 20% adverse changes in those assumptions are as follows:

	<u>December 31,</u> <u>2003</u> <u>(Dollars in</u> <u>thousands)</u>
Carrying amount/fair value of residual interest in securitizations .....	\$ 111,702
Weighted average life in years.....	3.74
Prepayment Speed Assumption (Cumulative).....	18.1% - 22.1%
Estimated fair value assuming 10% adverse change .....	\$ 110,938
Estimated fair value assuming 20% adverse change .....	110,116
Expected Credit Losses (Cumulative) .....	11.8% - 18.0%
Estimated fair value assuming 10% adverse change .....	\$ 100,907
Estimated fair value assuming 20% adverse change .....	90,312
Residual Cash Flows Discount Rate (Annual).....	14.0%
Estimated fair value assuming 10% adverse change .....	\$ 109,594
Estimated fair value assuming 20% adverse change .....	107,477

These sensitivities are hypothetical and should be used with caution. As the figures indicate, changes in fair value based on 10% and 20% percent variation in assumptions generally cannot be extrapolated because the relationship of the change in assumption to the change in fair value may not be linear. Also, in this table, the effect of a variation in a particular assumption on the fair value of the retained interest is calculated without changing any other assumption; in reality, changes in one factor may result in changes in another (for example, increases in market rates may result in lower prepayments and increased credit losses), which could magnify or counteract the sensitivities.

The following table summarizes the cash flows received from (paid to) securitization Trusts:

	<u>For the Year Ended December 31,</u>		
	<u>2003</u>	<u>2002</u>	<u>2001</u>
	(In thousands)		
Releases of cash from Spread Accounts.....	\$ 25,934	\$ 60,393	\$ 43,652
Servicing fees received.....	17,039	13,761	10,208
Net deposits to increase Credit Enhancement .....	(20,867)	(24,236)	(24,581)
Initial funding of Credit Enhancement .....	(18,736)	(16,749)	(2,477)
Purchase of delinquent or foreclosed assets .....	(45,747)	(34,365)	(37,620)
Repurchase of trust assets.....	—	(97,946)	(2,936)

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The following table presents the historical loss and delinquency amounts for the serviced portfolio:

	<u>Total Principal Amount of Contracts</u>		<u>Principal Amount of Contracts 60 Days or More Past Due</u>		<u>Net Credit Losses for the Year Ended</u>	
	<u>At December 31,</u>				<u>December 31,</u>	
	<u>2003</u>	<u>2002</u>	<u>2003</u>	<u>2002</u>	<u>2003</u>	<u>2002</u>
	(In thousands)					
Contracts held by non- consolidated subsidiaries .....	\$ 425,534	\$ 478,136	\$ 13,969	\$ 14,835	\$ 40,096	\$ 15,605
Contracts held by consolidated subsidiaries .....	<u>315,598</u>	<u>117,075</u>	<u>16,176</u>	<u>6,017</u>	<u>4,210</u>	<u>29,566</u>
Total managed portfolio .....	<u>\$ 741,132</u>	<u>\$ 595,211</u>	<u>\$ 30,145</u>	<u>\$ 20,852</u>	<u>\$ 44,306</u>	<u>\$ 45,171</u>

**(6) Furniture and Equipment**

The following table presents the components of furniture and equipment:

	<u>December 31,</u>	
	<u>2003</u>	<u>2002</u>
	(In thousands)	
Furniture and fixtures .....	\$ 2,994	\$ 2,994
Computer equipment .....	4,034	3,980
Leasing assets .....	673	729
Leasehold improvements .....	637	637
Other fixed assets .....	<u>50</u>	<u>17</u>
	8,388	8,357
Less: accumulated depreciation and amortization	<u>(7,562)</u>	<u>(6,745)</u>
	<u>\$ 826</u>	<u>\$ 1,612</u>

Depreciation expense totaled \$878,000, \$1.0 million and \$1.0 million for the years ended December 31, 2003, 2002 and 2001, respectively.

**(7) 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. In addition, CPS completed two such term securitization transactions in 2003. The debt issued in these transactions is shown on the Company's balance sheet as "Securitization Trust Debt," and the components of such debt are summarized in the following table:

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<u>Series:</u>	<u>Issue Date</u>	<u>Initial Principal</u>	<u>Outstanding Principal at December 31, 2003</u>	<u>Outstanding Principal at December 31, 2002</u>	<u>Interest Rate Range</u>
(Dollars in thousands)					
CPS2003-D	December 16, 2003	\$ 71,250	\$ 71,250	\$ —	1.76 – 3.56 %
CPS2003-C	September 30, 2003	83,125	77,928	—	1.55 – 3.99 %
TFC2003-1	May 20, 2003	52,365	37,114	—	2.69 %
TFC2002-2	October 9, 2002	62,589	25,436	—	2.95 %
TFC2002-1	March 19, 2002	64,552	12,403	—	4.23 %
MFN2001-A	June 28, 2001	<u>301,000</u>	<u>20,987</u>	<u>71,630</u>	4.05 – 5.07 %
		<u>\$ 634,881</u>	<u>\$ 245,118</u>	<u>\$ 71,630</u>	

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. Principal and interest payments are guaranteed by financial guaranty insurance policies.

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 December 31, 2003, the Company was in default of four financial covenants, including maximum leverage, minimum equity, maximum financial loss and interest coverage. As of December 31, 2003, the Company had received a waiver on these covenant breaches from the controlling party. On March 15, 2004, each of these financial covenants was amended with the controlling party such that all breaches have been cured.

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 December 31, 2003, restricted cash under the various agreements totaled approximately \$60.6 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 amortization of 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.

On March 15, 2004 a wholly-owned, bankruptcy remote consolidated subsidiary of the Company issued \$44 million of asset-backed notes secured by its retained interest in eight term securitization transactions. The notes, which have an interest rate of 10% per annum and a final maturity in October 2009, are required to be repaid from the distributions on the underlying retained interests. In connection with the issuance of the notes, the Company incurred and capitalized issuance costs of \$1.2 million.

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**(8) Debt**

On December 20, 1995, the Company issued \$20.0 million in rising interest subordinated redeemable securities due January 1, 2006 (the "Notes"). The Notes are unsecured general obligations of the Company. Interest on the Notes is payable on the first day of each month, commencing February 1, 1996, at an interest rate of 10.0% per annum. The interest rate increases 0.25% on each January 1 for the first nine years and 0.50% in the last year. In connection with the issuance of the Notes, the Company incurred and capitalized issuance costs of \$1.1 million. The Notes are subordinated to certain existing and future indebtedness of the Company as defined in the indenture agreement. The Company is required to redeem on an annual basis, subject to certain adjustments, \$1.0 million of the aggregate principal amount of the Notes through the operation of a sinking fund on or before of January 1, 2000, 2001, 2002, 2003, 2004 and 2005. The Company may at its option elect to redeem the Notes from the registered holders of the Notes, in whole or in part at 100% of their principal amount, plus accrued interest to and including the date of redemption. During each of the years 1999 through 2003, the Company redeemed \$1.0 million of principal amount of the notes in conjunction with the requirements of the related sinking fund agreement. The balance outstanding of the Notes at December 31, 2003 and 2002, was \$15.0 million and \$16.0 million, respectively.

On April 15, 1997, the Company issued \$20.0 million in subordinated participating equity notes ("PENs") due April 15, 2004. The PENs are unsecured general obligations of the Company. Interest on the PENs is payable on the fifteenth of each month, commencing May 15, 1997, at an interest rate of 10.5% per annum. In connection with the issuance of the PENs, the Company incurred and capitalized issuance costs of \$1.2 million. The Company recognizes interest and amortization expense related to the PENs using the effective interest method over the expected redemption period. The PENs are subordinated to certain existing and future indebtedness of the Company as defined in the indenture agreement. The Company may at its option elect to redeem the PENs from the registered holders, in whole but not in part, at any time on or after April 15, 2000, at 100% of their principal amount, subject to limited conversion rights, plus accrued interest to and including the date of redemption. At maturity, upon the exercise by the Company of an optional redemption, or upon the occurrence of a "Special Redemption Event," each holder will have the right to convert into common stock of the Company ("Common Stock"), 25% of the aggregate principal amount of the PENs held by such holder at the conversion price of \$10.15 per share of Common Stock. "Special Redemption Events" are certain events related to a change in control of the Company.

In November 1998, the Company issued \$25.0 million of subordinated promissory notes due November 30, 2003, to an affiliate of Levine Leichtman Capital Partners, Inc., Levine Leichtman Capital Partners II, L.P. ("LLCP"), and received the proceeds (net of \$1.3 million of capitalized issuance costs), of approximately \$23.7 million. The Company also issued warrants to purchase up to 3,450,000 shares of common stock at \$3.00 per share, exercisable through November 30, 2005 (See Note 13). The debt bears interest at 13.5% per annum, and may not be prepaid without penalty prior to November 1, 2002. Simultaneously with the consummation of that transaction, certain affiliates of the Company, who had lent the Company an aggregate of \$5.0 million on a short-term basis in August and September 1998, agreed to subordinate their indebtedness to the indebtedness in favor of LLCP, to extend the maturity of their debt until June 2004, and to reduce their interest rate from 15% to 12.5%. Such affiliates received in return the option to convert such debt into an aggregate of 1,666,667 shares of common stock at the rate of \$3.00 per share through maturity at June 30, 2004. Additionally, SFSC also agreed to subordinate \$6.0 million, or 40%, of its related party loan in favor of LLCP (See Note 13.).

In April 1999, the Company issued an additional \$5.0 million of subordinated promissory notes due April 30, 2004, to the same affiliate of LLCP as noted above, and received proceeds (net of \$312,000 of capitalized issuance costs) of \$4.7 million. The Company also issued warrants to purchase 1,335,000 shares of the Company's common stock at \$0.01 per share to LLCP, exercisable through April 2009. The debt bears interest at 14.5% per annum, and may be prepaid without penalty at anytime. As part of the purchase agreement, the interest rate on the previously issued LLCP notes was increased to 14.5% per annum, and the warrant to

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purchase 3,450,000 shares of the Company's common stock at \$3.00 per share was exchanged for a warrant to purchase 3,115,000 shares at a price of \$0.01 per share.

In March 2000, the Company issued \$16.0 million of senior secured debt to LLC ("Term B"). The proceeds from the issuance were used to repay in full all amounts owed under the Senior Secured Line. As part of the agreement, all of LLC's existing debt of \$30.0 million was restructured as senior secured debt, making the Company's aggregate principal indebtedness to LLC equal to \$46.0 million. The \$16.0 million bears interest at 12.5% per annum and the interest rate on the \$30.0 million is unchanged at 14.5% per annum. As part of the agreement, all prior defaults were either waived or cured. As of December 31, 2000, the amount outstanding of the \$16.0 million portion of senior secured debt was \$8.0 million. The outstanding balance on the \$16.0 million LLC debt was repaid during the first quarter of 2001. In addition, during the first quarter of 2001, the Company made a \$4.0 million principal prepayment on the remaining outstanding LLC debt, incurring \$200,000 in prepayment penalties and waiver fees. The outstanding balance of Term B debt at December 31, 2003 was \$19.8 million.

In March 2002, the Company and LLC entered into an additional series of agreements under which LLC provided additional funding to enable the Company to acquire MFN Financial Corporation. Under the March 2002 agreements, the Company borrowed \$35 million from LLC as a Bridge Note (Bridge Note) and approximately \$8.5 million ("Term C") on a deemed principal amount of approximately \$11.2 million. The Bridge Note requires principal payments of \$2.0 million a month, which began in June 2002, with a final balloon payment in the amount of \$17.0 million, which was made pursuant to the terms of the Bridge Note in February 2003. The Term C Note repayment schedule is based on the performance of a certain securitized pool. As the subordinated Note of the pool is repaid from the Trust, principal payments are due on the Term C Note. The maturity date of the Term C Note is March 2008. Interest is due monthly on the Bridge Note at a rate of 13.5% per annum and on the Term C Note at a rate of 12.0% per annum. In connection with the March 2002 agreements and the acquisition of MFN, the Company paid LLC a structuring fee of \$1.75 million and an investment banking fee of \$1.0 million, and paid LLC's out-of-pocket expenses of approximately \$315,000. In addition, the Company paid LLC certain other fees and interest amounting to \$426,181. Approximately \$1.4 million of the fees and other amounts paid to LLC were deferred as financing costs and are being amortized over the life of the related debt. The remaining fees and other costs were included in the purchase price of MFN. At December 31, 2003, there was \$5.1 million principal outstanding on the Term C note.

On February 3, 2003, the Company borrowed \$25.0 million from LLC, 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 has paid the fees to extend the maturity to January 2004. Interest on the Term D Note is payable monthly at rates that averaged 4.79% per annum through June 30, 2003, and 12.0% per annum thereafter. In a separate transaction, the Bridge Note issued to LLC in connection with the acquisition of MFN, in an original principal amount of \$35.0 million, was due on February 28, 2003. The outstanding principal balance of \$17.0 million was paid in February 2003. In addition, the maturity of the Term B Note was extended in October 2003 from November 2003 to January 2004. As of December 31, 2003, the outstanding principal balances of the Term B Note and the Term C Note were \$19.8 million and \$5.3 million, respectively. 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 Term B Note and the Term D Note were extended to December 15, 2005 and the coupons on both notes were decreased to 11.75% per annum. The Company paid LLC fees equal to \$921,000 for these amendments, which will be amortized over the remaining life of the notes.

During the year ended December 31, 1997 the Company acquired CPS Leasing, Inc. At December 31, 2003 and 2002, CPS Leasing, Inc., had borrowings to banks of \$74,000 and \$673,000, respectively.

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At the time of the MFN Merger, MFN had outstanding \$22.5 million in principal amount of senior subordinated debt, which was due and repaid in full on March 23, 2002. Such debt bore interest at the rate of 11.00% per annum, payable quarterly in arrears. At the time of the TFC Merger, TFC had outstanding \$6.3 million in principal amount of subordinated debt, which the Company assumed as part of the TFC Merger. Such debt bears interest at the rate of 13.25% per annum payable monthly in arrears, requires monthly amortization and is due in June 2005.

The Company must comply with certain affirmative and negative covenants related to debt facilities, which require, among other things, that the Company maintain certain financial ratios related to liquidity, net worth, capitalization, investments, acquisitions, restricted payments and certain dividend restrictions. The Company was in compliance with all of its debt covenants with respect to non-securitization related debt as of December 31, 2003. The Company was in violation of four covenants related to securitization debt as of December 31, 2003, including maximum leverage, minimum equity, maximum financial loss and interest coverage. The Company has received a waiver of such non-compliance from the controlling party. On March 15, 2004, each of these financial covenants was amended with the controlling party such that all breaches have been cured.

The following table summarizes the amount of senior secured, subordinated and related party debt maturing over the next 5 years and thereafter as of December 31, 2003:

	<b>Principal Amount</b>
	<b>(In thousands)</b>
2004.....	\$ 83,328
2005.....	—
2006.....	14,000
2007.....	—
2008.....	5,137
Thereafter.....	—
Total.....	\$ 102,465

**(9) Shareholders' Equity**

**Common Stock**

Holders of common stock are entitled to such dividends as the Company's Board of Directors, in its discretion, may declare out of funds available, subject to the terms of any outstanding shares of preferred stock and other restrictions. In the event of liquidation of the Company, holders of common stock are entitled to receive, pro rata, all of the assets of the Company available for distribution, after payment of any liquidation preference to the holders of outstanding shares of preferred stock. Holders of the shares of common stock have no conversion or preemptive or other subscription rights and there are no redemption or sinking fund provisions applicable to the common stock.

The Company is required to comply with various operating and financial covenants defined in the agreements governing the warehouse lines, senior debt, subordinated debt, and related party debt. The covenants restrict the payment of certain distributions, including dividends (See Note 8.).

Included in common stock at December 31, 2003 and 2002, is additional paid in capital of \$1,585,000 and \$1,770,000 related to the valuation of certain stock options as required by Financial Interpretation No. 44 ("FIN 44") or the valuation of conditionally granted options as required under Accounting Principals Board Opinion No. 25 ("APB 25"). Included in compensation expense for December 31, 2003 and 2002, is \$1,141,000 and \$1,196,000 related to the amortization of deferred compensation expense and valuation of stock options.

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**Stock Purchases**

During 2000, the Company's Board of Directors authorized the Company to purchase up to \$5 million of Company securities. In October 2002, the Board of Directors authorized the purchase of an additional \$5 million of outstanding debt or equity securities. As of December 31, 2003, the Company had purchased \$4.0 million in principal amount of the Notes, and \$3.9 million of its common stock, representing 2,141,037 shares.

**Options and Warrants**

In 1991, the Company adopted and its sole shareholder approved the 1991 Stock Option Plan (the "1991 Plan") pursuant to which the Company's Board of Directors may grant stock options to officers and key employees. The Plan, as amended, authorizes grants of options to purchase up to 2,700,000 shares of authorized but unissued common stock. Stock options are granted with an exercise price equal to the stock's fair market value at the date of grant. Stock options have terms that range from 7 to 10 years and vest over a range of 0 to 7 years. In addition to the 1991 Plan, in fiscal 1995, the Company granted 60,000 options to certain directors of the Company that vest over three years and expire nine years from the grant date. The Plan terminated in December 2001, without affecting the validity of the outstanding options.

In July 1997, the Company adopted and its shareholders approved the 1997 Long-Term Incentive Plan (the "1997 Plan") pursuant to which the Company's Board of Directors may grant stock options, restricted stock and stock appreciation rights to employees, directors or employees of entities in which the Company has a controlling or significant equity interest. Options that have been granted under the 1997 Plan have in all cases been granted at an exercise price equal to the stock's fair market value at the date of the grant, with terms of 10 years and vesting over 5 years. In 2001, the shareholders of the Company approved an amendment to the 1997 Plan providing that an aggregate maximum of 3,400,000 shares of the Company's common shares may be subject to awards under the 1997 Plan. In 2003, the shareholders of the Company approved an amendment to the 1997 Plan to further increase the aggregate maximum number of shares that may be granted within the Plan to 4,900,000 shares.

In October 1998, the Company's Board of Directors approved a plan to cancel and reissue certain stock options previously granted to key employees of the Company. All options granted prior to October 22, 1998, with an option price greater than \$3.25 per share, were repriced to \$3.25 per share. In conjunction with the repricing, a one-year period of non-exercisability was placed on all repriced options, which period ended on October 21, 1999.

In October 1999, the Company's Board of Directors approved a plan to cancel and reissue certain stock options previously granted to key employees of the Company. All options granted prior to October 29, 1999, with an option price greater than \$0.625 per share, were repriced to \$0.625 per share. In conjunction with the repricing, a six-month period of non-exercisability was placed on all repriced options, which period ended on April 29, 2000.

At December 31, 2003, there were a total of 146,631 additional shares available for grant under the 1997 Plan and the 1991 Plan. Of the options outstanding at December 31, 2003, 2002 and 2001, 1,168,042, 920,101, and 1,715,767, respectively, were then exercisable, with weighted-average exercise prices of \$1.71, \$1.30, and \$0.84, respectively.

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Stock option activity during the periods indicated is as follows:

	<u>Number of Shares</u>	<u>Weighted Average Exercise Price</u>
	(In thousands, except per share data)	
Balance at December 31, 2000 .....	3,501	\$ 0.86
Granted .....	1,097	2.53
Exercised .....	501	0.63
Canceled .....	<u>275</u>	<u>1.05</u>
Balance at December 31, 2001 .....	3,822	1.35
Granted .....	1,804	1.55
Exercised .....	1,254	0.64
Canceled .....	<u>340</u>	<u>1.63</u>
Balance at December 31, 2002 .....	4,032	1.64
Granted .....	1,013	2.46
Exercised .....	609	0.93
Canceled .....	<u>564</u>	<u>1.69</u>
Balance at December 31, 2003 .....	<u>3,872</u>	<u>\$ 1.96</u>

During 2002, the Company's Board of Directors approved a program whereby officers of the Company would be loaned amounts sufficient to enable them to exercise certain of their outstanding options. See Note 13.

At December 31, 2003, the range of exercise prices, the number, weighted-average exercise price and weighted-average remaining term of options outstanding and the number and weighted-average price of options currently exercisable are as follows:

<u>Options Outstanding</u>			<u>Options Exercisable</u>		
<u>Range of Exercise Prices (per share)</u>	<u>Number Outstanding</u>	<u>Weighted Average Remaining Term (Years)</u>	<u>Weighted Average Exercise Price Per Share</u>	<u>Number Exercisable</u>	<u>Weighted Average Exercise Price Per Share</u>
(In thousands, except term and per share data)					
\$ 0.63 - \$ 0.63 .....	301	4.44	\$ 0.63	168	\$ 0.63
\$ 0.69 - \$ 1.50 .....	1,245	8.45	\$ 1.49	322	\$ 1.47
\$ 1.54 - \$ 2.39 .....	1,175	7.79	\$ 1.80	502	\$ 1.77
\$ 2.50 - \$ 3.28 .....	929	8.93	\$ 2.69	131	\$ 2.59
\$ 4.25 - \$ 4.25 .....	222	7.05	\$ 4.25	45	\$ 4.25

On November 17, 1998, in conjunction with the issuance of a \$25.0 million subordinated promissory note to an affiliate of LLCP, the Company issued warrants to purchase up to 3,450,000 shares of common stock at \$3.00 per share, exercisable through November 30, 2005. In April 1999, in conjunction with the issuance of \$5.0 million of an additional subordinated promissory note to an affiliate of LLCP, the Company issued additional warrants to purchase 1,335,000 shares of the Company's common stock at \$0.01 per share to LLCP. As part of the purchase agreement, the existing warrants to purchase 3,450,000 shares at \$3.00 per share were exchanged for warrants to purchase 3,115,000 shares at a price of \$0.01 per share. The aggregate value of the warrants, \$12.9 million, which is comprised of \$3.0 million from the original warrants issued in November 1998 and \$9.9 million from the repricing and additional warrants issued in April 1999, is reported as deferred interest expense to be amortized over the expected life of the related debt, five years. As of December 31, 2003, 1,000 warrants remained unexercised. Such warrants, and the 4,449,000 shares of common stock have, upon the exercise of such warrants, not been registered for public sale. However, the holder has the right to require the Company register the warrants and common stock for public sale in the future.

Also in November 1998, the Company entered into an agreement with the Note Insurer of its asset-backed securities. The agreement committed the Note Insurer to provide insurance for the securitization of \$560.0 million in asset-backed securities, of which \$250.0 million remained at December 31, 1998. The agreement

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provides for a 3% initial Spread Account deposit. As consideration for the agreement, the Company issued warrants to purchase up to 2,525,114 shares of common stock at \$3.00 per share, subject to anti-dilution adjustments. The warrants were fully exercisable on the date of grant and expired in December 2003. In November 2003, the Company purchased the warrants from the Note Insurer for \$896,415.

**(10) Gain on Sale of Contracts**

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

	<b>Year ended December 31,</b>		
	<b>2003</b>	<b>2002</b>	<b>2001</b>
	(In thousands)		
Gain on sale of Contracts .....	\$ 4,381	\$ 17,480	\$ 25,803
Deferred acquisition fees and discounts .....	4,590	5,285	2,816
Expenses related to sales .....	(2,076)	(3,682)	(1,549)
(Provision for) recovery of credit losses.....	(526)	(2,639)	5,695
Net gain on sale of Contracts.....	\$ 6,369	\$ 16,444	\$ 32,765

**(11) Interest Income**

The following table presents the components of interest income:

	<b>Year ended December 31,</b>		
	<b>2003</b>	<b>2002</b>	<b>2001</b>
	(In thousands)		
Interest on Finance Receivables .....	\$ 40,380	\$ 32,851	\$ 2,249
Residual interest income.....	16,178	15,392	14,648
Other interest income.....	1,606	401	308
Net interest income.....	\$ 58,164	\$ 48,644	\$ 17,205

**(12) Income Taxes**

Income taxes consist of the following:

	<b>Year ended December 31,</b>		
	<b>2003</b>	<b>2002</b>	<b>2001</b>
	(In thousands)		
Current:			
Federal .....	\$ 2,781	\$ (11,295)	\$ 366
State .....	356	(715)	(126)
	3,137	(12,010)	240
Deferred:			
Federal .....	(25,345)	10,867	(277)
State .....	(4,141)	1,428	485
Change in valuation allowance.....	22,915	(3,219)	(448)
	(6,571)	9,076	(240)
Income tax benefit .....	\$ (3,434)	\$ (2,934)	\$ —

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The Company's effective tax expense benefit for the years ended December 31, 2003, 2002 and 2001, differs from the amount determined by applying the statutory federal rate of 35% to income (loss) before income taxes as follows:

	<b>Year ended December 31,</b>		
	<b>2003</b>	<b>2002</b>	<b>2001</b>
	<b>(In thousands)</b>		
Expense (benefit) at federal tax rate.....	\$ (1,064)	\$ 6,116	\$ 112
California franchise tax, net of federal income tax benefit.....	(2,460)	459	233
Other.....	92	(196)	103
Negative Goodwill.....	—	(6,094)	—
Debt Forgiveness.....	(22,917)	—	—
Valuation allowance.....	22,915	(3,219)	(448)
	<u>\$ (3,434)</u>	<u>\$ (2,934)</u>	<u>\$ —</u>

The tax effected cumulative temporary differences that give rise to deferred tax assets and liabilities as of December 31, 2003 and 2002, are as follows:

	<b>December 31,</b>	
	<b>2003</b>	<b>2002</b>
	<b>(In thousands)</b>	
<b>Deferred Tax Assets:</b>		
Accrued liabilities.....	\$ 11,185	\$ 2,760
Furniture and equipment.....	1,465	2,335
Equity investment.....	82	82
NOL carryforwards and BILs.....	31,397	36,979
Minimum tax credit.....	481	334
Provision for loan loss.....	(2,125)	1,383
Pension Accrual.....	1,617	1,063
Other.....	461	110
Total deferred tax assets.....	<u>44,563</u>	<u>45,046</u>
Valuation allowance.....	<u>(37,363)</u>	<u>(8,563)</u>
	7,200	36,483
<b>Deferred Tax Liabilities:</b>		
NIRs.....	(6,789)	(13,568)
Debt Forgiveness.....	—	(29,629)
Total deferred tax liabilities.....	<u>(6,789)</u>	<u>(43,197)</u>
Net deferred tax asset (liability).....	<u>\$ 411</u>	<u>\$ (6,714)</u>

As part of the MFN Merger, CPS acquired certain net operating losses, debt forgiveness, as discussed below, and built in loss assets. Moreover, MFN has undergone an ownership change for purposes of Internal Revenue Code ("IRC") section 382. In general, IRC section 382 imposes an annual limitation on the ability of a loss corporation (i.e., a corporation with a net operating loss ("NOL") carryforward, credit carryforward, or certain built-in losses ("BILs")) to utilize its pre-change NOL carryforwards or BILs to offset taxable income arising after an ownership change. During 1999, MFN recorded an extraordinary gain from the discharge of indebtedness related to the emergence from Bankruptcy. This gain was not taxable under IRC section 108. In accordance with the rules under IRC section 108, MFN has reduced certain tax attributes including unused net operating losses and tax basis in certain MFN assets. Deferred taxes have been provided for the estimated tax effect of the future reversing timing differences related to the discharge of indebtedness gain as reduced by the tax attributes. Additionally, the Company has established a valuation allowance of \$8.6 million against MFN's deferred tax assets, as it is not more than likely that these amounts will be realized in the future. In determining the possible future realization of deferred tax assets, future taxable income from the following sources are taken into account: (a) 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 years in which net operating losses might otherwise expire.

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As part of the TFC Merger, CPS acquired certain built in loss assets. Moreover, TFC has undergone an ownership change for purposes of Internal Revenue Code (“IRC”) section 382. In general, IRC section 382 imposes an annual limitation on the ability of a loss corporation (i.e., a corporation with a net operating loss (“NOL”) carryforward, credit carryforward, or certain built-in losses (“BILs”)) to utilize its pre-change NOL carryforwards or BILs to offset taxable income arising after an ownership change. Additionally, the Company has established a valuation allowance of \$5.9 million against TFC’s deferred tax assets, as it is not more than likely that these amounts will be realized in the future. In determining the possible future realization of deferred tax assets, future taxable income from the following sources are taken into account: (a) 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 years in which net operating losses might otherwise expire.

As of December 31, 2003, the Company has net operating loss carryforwards for federal and state income tax purposes of \$29 million and \$8 million, respectively, which are available to offset future taxable income, if any, subject to IRC section 382 limitations, through 2021 and 2013, respectively. In addition, the Company has an alternative minimum tax credit carry forward of approximately \$481,000, which is available to reduce future federal regular income taxes, if any, over an indefinite period.

The Company’s tax returns are open for audits by various tax authorities. Therefore, from time-to-time there may be differences in opinions with respect to the tax treatment accorded to certain transactions. When, and if, such differences occur and become probable and estimatable, such amounts will be recognized. The Company filed its tax returns on a fiscal year ending March 31 through March 31, 2002. It changed its tax fiscal year to a calendar year effective December 31, 2002.

**(13) Related Party Transactions**

**Related Party Receivables**

As of December 31, 2001, the Company had receivables of \$669,000 from CARSUSA, Inc. (“CARSUSA”), which owned and operated a Mitsubishi automobile dealership in Southern California, and is owned by Charles E. Bradley, Sr. and Charles E. Bradley, Jr. During 2002, CARSUSA became insolvent, sold its assets to an unaffiliated party, partially paid its secured creditors, and wound up its business. The Company determined that the receivable was uncollectible, and wrote down its value to zero. The writedown-related expense of \$669,000 is reflected in the Company’s Consolidated Statement of Operations for the year ended December 31, 2002 in general and administrative expenses. The Company purchased seven and 16 Contracts from CARSUSA, with an aggregate principal balance of approximately \$99,996 and \$233,431, respectively, in 2002 and 2001. The Company did not purchase any contracts from CARSUSA in 2003.

**CPS Leasing, Inc. Related Party Direct Lease Receivables**

Included in other assets recorded in the Company’s Consolidated Balance Sheet are direct lease receivables due to CPS Leasing, Inc. from related parties, primarily companies affiliated with the Company’s former Chairman of the Board of Directors. Such related party direct lease receivables totaled approximately \$1.9 million and \$2.2 million at December 31, 2003 and 2002, respectively.

**Related Party Debt**

In June 1997 the Company borrowed \$15.0 million on an unsecured and subordinated basis from Stanwich Financial Services Corp. (“SFSC”), an affiliate of Charles E. Bradley, Sr., the former Chairman of the Company’s Board of Directors. This loan (“RPL”) is due 2004, and has a fixed rate of interest of 9% per annum, payable monthly beginning July 1997. The Company may pre-pay the RPL without penalty at any time after three years. At maturity or repayment of the RPL, the holder thereof will have an option to convert 20%

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of the principal amount into common stock of the Company, at a conversion rate of \$11.86 per share. The balance of the RPL at December 31, 2003 and 2002, was \$15.0 million.

During 1998, the Company borrowed an additional \$4 million on an unsecured basis from SFSC. This loan (“RPL2”) is due 2004, and has a fixed rate of interest of 12.5% per annum payable monthly beginning December 1998. The Company had the right to pre-pay the RPL2, without penalty, at any time after June 12, 2000. At maturity or repayment of the RPL2, the holder thereof would have the option to convert the entire principal balance of the note, or a portion thereof, into common stock of the Company, at a conversion rate of \$3 per share. The balance of the RPL2 was repaid during the first quarter of 2001.

During 1998, the Company borrowed \$1.0 million on an unsecured basis from John G. Poole, a director of the Company. The terms of this note (“RPL3”) are the same as the RPL2. The balance of the RPL3 at December 31, 2003 and 2002 was \$1.0 million.

During 1999, the Company borrowed \$1.5 million on an unsecured basis from SFSC. This loan (“RPL4”) is due 2004, has a fixed rate of interest of 14.5% per annum payable monthly beginning October 1999. In conjunction with the issuance of the RPL4, the Company issued warrants to purchase 103,500 shares of the Company’s common stock at a price of \$0.01 per share. The balance of the RPL4 at December 31, 2003 and 2002 was \$1.5 million.

**Loans to Officers to Exercise Certain Stock Options**

During 2002, the Company’s Board of Directors approved a program under which officers of the Company would be advanced amounts sufficient to enable them to exercise certain of their outstanding options. Such loans were available for a limited period of time, and available only to exercise previously repriced options. The loans bear interest at a rate of 5.50% per annum, and are due in 2007. At December 31, 2003, there was \$458,531 outstanding related to these loans. Such amounts have been recorded as contra-equity in the Shareholders’ Equity section of the Company’s Consolidated Balance Sheet.

**(14) Commitments and Contingencies**

**Leases**

The Company leases its facilities and certain computer equipment under non-cancelable operating leases, which expire through 2008. Future minimum lease payments at December 31, 2003, under these leases are as follows:

	<u>Operating</u> (In thousands)
2004 .....	\$ 4,511
2005 .....	4,3
2006 .....	3,5
2007 .....	2,7
2008 .....	1,7
Thereafter .....	<u>—</u>
Total minimum lease payments .....	<u>\$ 16,948</u>

Rent expense for the years ended December 31, 2003, 2002 and 2001, was \$3.9 million, \$4.0 million, and \$2.6 million, respectively.

The Company’s facility lease contains certain rental concessions and escalating rental payments, which are recognized as adjustments to rental expense and are amortized on a straight-line basis over the term of the lease.

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During 2003, 2002 and 2001, the Company received \$169,777, \$140,537 and \$270,486, respectively, of sublease income, which is included in occupancy expense. Future minimum sublease payments totaled \$587,854 at December 31, 2003.

**Litigation**

*Stanwich Litigation.* CPS is currently a defendant in a class action (the “Stanwich Case”) pending in the California Superior Court, Los Angeles County. The plaintiffs in that case are persons entitled to receive regular payments (the “Settlement Payments”) under out-of-court settlements reached with third party defendants. Stanwich Financial Services Corp. (“Stanwich”), an affiliate of the former Chairman of the Board of Directors of CPS, is the entity that is obligated to pay the Settlement Payments. Stanwich has defaulted on its payment obligations to the plaintiffs and in June 2001 filed for reorganization under the Bankruptcy Code, in the federal Bankruptcy Court of Connecticut. CPS is also a defendant in certain cross-claims brought by other defendants in the case, which assert claims of equitable and/or contractual indemnity against CPS.

In November 2001, one of the defendants in the Stanwich Case, Jonathan Pardee, asserted claims for indemnity against CPS in a separate action, which is now pending in federal district court in Rhode Island. CPS has filed counterclaims in the Rhode Island federal court against Mr. Pardee. CPS is defending this matter and pursuing its counterclaims vigorously.

In February 2002, CPS entered into a term sheet with Stanwich, the plaintiffs in the Stanwich Case and others, which provides for CPS’s release upon its repayment of the amounts concededly owed to Stanwich, all of which amounts have been recorded in CPS’s financial statements as indebtedness.

The California court in December 2003 preliminarily approved a settlement of the Stanwich Case. That settlement will result in CPS being released from all claims pending in the California court, other than an alleged contractual indemnity in favor of one of the financial institution co-defendants. As to that institution, CPS has an agreement in principle to settle its cross-claim. The court-approved settlement requires of CPS only that it repay the amounts it concededly owes to Stanwich, all of which amounts have been recorded in CPS’s financial statements as indebtedness.

Investors should consider that any adverse judgment against CPS in the Stanwich Case (or the related case in Rhode Island) for indemnification, in an amount materially in excess of any liability already recorded in respect thereof, could have a material adverse effect on the ability of CPS to perform its servicing and indemnification obligations.

*Other Litigation.* On November 15, 2000, Denise and Gary Lang filed a lawsuit against CPS in South Carolina Common Pleas Court, Beaufort County, alleging that they, and a purported nationwide class, were harmed by an alleged failure to refer, in the notice given after repossession of their vehicle, to the right to purchase the vehicle by tender of the full amount owed under the retail installment contract. They sought damages in an unspecified amount. CPS filed a counterclaim to recover any delinquent amounts owed by the members of the putative class in the event that the class were to be certified. In February 2004, CPS reached an agreement to settle that case on a class basis for payment of attorneys’ fees and other immaterial consideration.

On September 26, 2001, Maggie Chandler, Bobbie Mike and Mary Ann Benford each commenced a lawsuit against subsidiaries of MFN (now subsidiaries of CPS) in three different state courts in Mississippi. A similar case was filed in December 2002 in a fourth Mississippi court. Plaintiffs in all four cases alleged deceptive practices related to various loans and the related purchase and sale of insurance, and sought unspecified damages. In September 2003, the defendant subsidiaries reached an agreement in principle to settle all such cases, and any similar cases that might be brought by other clients of the same plaintiff law firms.

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**(15) Employee Benefits**

The Company sponsors a pretax savings and profit sharing plan (the “401(k) Plan”) qualified under section 401(k) of the Internal Revenue Code. Under the 401(k) Plan, eligible employees are able to contribute up to 15% of their compensation (subject to stricter limitation in the case of highly compensated employees). The Company, may, at its discretion, match 100% of employees’ contributions up to \$1,000 per employee per calendar year. The Company’s contributions to the 401(k) Plan were \$213,045 for the year ended December 31, 2000. The Company did not make a matching contribution in 2003, 2002 or 2001, other than to employees eligible for the MFN Financial Corporation Retirement Savings Plan. Such contribution amounted to \$250,682 for the period from the Merger Date through December 31, 2002. The MFN Financial Corporation Retirement Savings Plan was merged into the Company’s 401(k) Plan in February 2003.

The Company also sponsors the MFN Financial Corporation Pension Plan (“the Plan”). The Plan benefits were frozen June 30, 2001. The following table sets forth the plan’s benefit obligations, fair value of plan assets, and funded status at December 31, 2003 and 2002:

	<u>December 31,</u>	
	<u>2003</u>	<u>2002</u>
	(Dollars in thousands)	
<b>Change in Projected Benefit Obligation</b>		
Projected benefit obligation, beginning of year.....	\$ 13,743	\$ 12,223
Service cost.....	—	—
Interest cost.....	902	853
Settlements.....	0	(826)
Actuarial gain.....	1,578	2,964
Benefits paid.....	(1,200)	(1,471)
Projected benefit obligation, end of year.....	<u>\$ 15,023</u>	<u>\$ 13,743</u>

The accumulated benefit obligation for the pension plan was \$15.0 million and \$13.7 million at December 31, 2003 and 2002, respectively.

<b>Change in Plan Assets</b>		
Fair value of plan assets, beginning of year.....	\$ 9,906	\$ 12,013
Return on assets.....	1,001	(636)
Employer contribution.....	1,546	—
Benefits paid.....	(1,200)	(1,471)
Fair value of plan assets, end of year.....	<u>\$ 11,253</u>	<u>\$ 9,906</u>

**Reconciliation of accrued pension cost and total amount recognized**

Funded status of the plan.....	\$ (3,770)	\$ (3,836)
Unrecognized loss.....	4,136	2,771
Unrecognized transition asset.....	(80)	(115)
Unrecognized prior service cost.....	—	—
Accrued pension cost.....	<u>\$ 286</u>	<u>\$ (1,180)</u>

Weighted average assumptions used to determine benefit obligations at December 31, 2003 and 2002 were as follows:

**Weighted average assumptions as of December 31, 2002**

Discount rate.....	6.25%	6.50%
Expected return on plan assets.....	9.00%	9.00%
Rate of compensation increase.....	N/A	N/A

The Company’s overall expected long-term rate of return on assets is 9.00% per annum. The expected long-term rate of return is based on the weighted average of historical returns on individual asset

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categories, which are described in more detail below.

**Amounts recognized in Consolidated Balance Sheet**

Prepaid benefit cost .....	\$ 286	\$ —
Accrued minimum pension obligation.....	(4,055)	(3,836)
Intangible asset .....	—	—
Accumulated other comprehensive income, pretax .....	4,055	2,656
Net amount recognized .....	<u>\$ 286</u>	<u>\$ (1,180)</u>

**Total cost**

Service cost.....	\$ —	\$ —
Interest cost.....	902	853
Expected return on assets .....	(872)	(1,052)
Amortization of unrecognized loss .....	98	—
Amortization of transition obligation .....	(35)	(25)
Amortization of prior service cost .....	—	—
Net periodic pension income .....	93	(224)
Loss due to settlement .....	—	224
Total benefit income.....	<u>\$ 93</u>	<u>\$ —</u>

**Accumulated Benefit Obligation and Fair Value of Assets**

Projected Benefit Obligation .....	\$ (15,023)	\$ (13,743)
Accumulated Benefit Obligation .....	(15,023)	(13,743)
Fair Value of Assets .....	11,253	9,906
Unfunded Accumulated Benefit Obligation .....	<u>\$ (3,770)</u>	<u>\$ (3,837)</u>

**The weighted average asset allocation of the Company's pension benefits at December 31, 2003 and 2002 were as follows:**

Plan Assets	Plan Assets at December 31,	
	2003	2002
Asset Category .....		
Equity securities .....	61.73%	—
Fixed income securities .....	29.14%	—
CPS stock .....	9.07%	5.27%
Cash .....	0.06%	94.73%
Total.....	<u>100.00%</u>	<u>100.00%</u>

The Company's investment policies and strategies for the pension benefits plan utilize a target allocation of 70% equity securities and 30% fixed income securities. The Company's investment goals are to maximize returns subject to specific risk management policies. The Company addresses risk management and diversification by the use of a professional investment advisor and several sub-advisors which invest in domestic and international equity securities and domestic fixed income securities. Each sub-advisor focuses its investments within a specific sector of the equity or fixed income market. For the sub-advisors focused on the equity markets, the sectors are differentiated by the market capitalization and the relative valuation of the underlying issuer. For the sub-advisors focused on the fixed income markets, the sectors are differentiated by the credit quality and the maturity of the underlying fixed income investment. The investments made by the sub-advisors are readily marketable and can be sold to fund benefit payment obligations as they become payable.

**(16) Fair Value of Financial Instruments**

The following summary presents a description of the methodologies and assumptions used to estimate the fair value of the Company's financial instruments. 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

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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 December 31, 2003 and 2002, the amounts that will actually be realized or paid at settlement or maturity of the instruments could be significantly different. The estimated fair values of financial assets and liabilities at December 31, 2003 and 2002, were as follows:

<u>Financial Instrument</u>	<u>December 31,</u>			
	<u>2003</u>		<u>2002</u>	
	<u>Carrying Value or Notional Amount</u>	<u>Fair Value</u>	<u>Carrying Value or Notional Amount</u>	<u>Fair Value</u>
	(In thousands)			
Cash.....	\$ 33,209	\$ 33,209	\$ 32,947	\$ 32,947
Restricted cash.....	67,277	67,277	18,912	18,912
Finance receivables, net.....	266,189	266,189	84,592	84,592
Residual interest in securitizations .....	111,702	111,702	127,170	127,170
Notes payable .....	3,330	3,330	673	673
Securitization trust debt.....	245,118	245,118	71,630	71,630
Senior secured debt.....	49,965	49,965	50,072	50,072
Subordinated debt.....	35,000	35,506	36,000	32,800
Related party debt.....	17,500	17,763	17,500	15,400

**Cash and Restricted Cash**

The carrying value equals fair value.

**Finance Receivables, net**

The carrying value approximates fair value because the related interest rates are estimated to reflect current market conditions for similar types of instruments.

**Residual Interest in Securitizations**

The fair value is estimated by discounting future cash flows using credit and discount rates that the Company believes reflect the estimated credit, interest rate and prepayment risks associated with similar types of instruments.

**Commitments**

The fair value of commitments to purchase contracts from Dealers is determined by purchase commitments from investors and prevailing market rates.

**Notes Payable, Securitization Trust Debt and Senior Secured Debt**

The carrying value approximates fair value because the related interest rates are estimated to reflect current market conditions for similar types of secured instruments.

**Subordinated Debt**

The fair value is based on a market quote.

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**Related Party Debt**

The fair value is based on the fair value of subordinated debt, as the terms and structure are similar.

**(17) 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, customer payments of principal and interest on finance receivables, fees for origination of Contracts, 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.

Contracts are purchased from Dealers for a cash price 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 revolving warehouse credit facilities. As of December 31, 2003, the Company had \$225 million in warehouse credit capacity, in the form of a \$125 million facility, a \$75 million facility and a \$25 million facility. The first two warehouse facilities provide funding for Contracts purchased under CPS' programs while the third facility provides funding for Contracts purchased under TFC's programs. On February 21, 2004, the \$75 million facility expired and, as a result, the Company's current warehouse credit capacity is \$150 million. These facilities are independent of each other and provide funding equal to 71-73% of the principal balance of the Contracts pledged, subject to collateral tests and certain other conditions and covenants.

On February 21, 2004 the CPS Funding LLC \$75 million revolving warehouse credit facility expired. One of the covenants within the Company's \$125 million warehouse credit facility and four of the six term securitizations insured by one Note Insurer requires that the Company maintain additional warehouse facilities with minimum borrowing capacity of \$75.0 million. With the expiration of the CPS Funding LLC facility described above, the Company is in breach of such covenant. The Company has until June 20, 2004 to cure such breach prior to it becoming an event of default under this warehouse facility and four term securitizations. While the Company is currently in discussions with several parties about a replacement facility and believes that it will be successful in replacing the facility within the required time frame, there can be no assurances that it will do so. If the Company is unsuccessful in these efforts, the Note Insurer will have the right to declare an event of default. Remedies available to the Note Insurer in such event include, among other things, transferring the servicing rights to the portfolio that it insures to another servicer and trapping excess cash releases to the Company from its warehouse facility and four term securitizations that it insures. To the extent that the Note Insurer was to follow either of these remedies, it would have a material adverse effect on the liquidity and the operations of the Company.

Through May 2002, the Company's Contract purchasing program consisted of both (i) flow purchases for immediate resale to non-affiliates and (ii) purchases for the Company's own account made on other than a flow basis, funded primarily by advances under a revolving warehouse credit facility. Flow purchases allowed the

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Company to purchase Contracts with minimal demands on liquidity. The Company's revenues from the resale of flow purchase Contracts, however, were materially less than those that may be received by holding Contracts to maturity or by selling Contracts in securitization transactions. During the year ended December 31, 2003 the Company purchased \$357.3 million of Contracts for its own account, compared to \$282.2 million for its own account and \$181.1 million of Contracts on a flow basis in 2002. For the year ended December 31, 2001, the Company purchased \$134.4 million of Contracts for its own account and \$537.9 million on a flow basis. The Company's flow purchase program ended in May 2002.

The \$125 million warehouse facility is 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 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 accrue interest at a rate of one-month commercial paper plus 1.18% per annum. This facility expires on April 4, 2004. The Company is currently in discussions with the related parties to renew such facility.

The \$75 million warehouse facility which expired on February 21, 2004, 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 Company is currently in discussions with several parties regarding a replacement facility.

The \$25 million warehouse facility is 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 may be advanced to TFC 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 1.75% per annum. This facility was entered into as part of the TFC Merger on May 20, 2003 and has a 364-day term. The Company is currently in discussions with the related parties to renew such facility.

These facilities are independent of each other. Two different financial institutions purchase the notes issued by these facilities, and three different insurers insure the notes. Up through June 30, 2003, sales of Contracts to the special purpose subsidiaries ("SPS") related to the first two facilities had been treated as sales for financial accounting purposes. The Company, therefore, removed these securitized Contracts and related debt from its Consolidated Balance Sheet and recognized a gain on sale in the Company's Consolidated Statement of Operations. Indebtedness related to Contracts funded by the third facility, however, were on the Company's Consolidated Balance Sheet and no gain on sale has ever been recognized in the Company's 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 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.

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 and other Credit Enhancement in excess of their respective requisite levels. There can be no assurance that collections from the related Trusts will continue to generate sufficient cash.

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Certain of the Company's securitization transactions and the warehouse credit facilities contain various financial covenants requiring certain minimum financial ratios and results. The Company was in violation of four of these covenants as of December 31, 2003, including maximum leverage, minimum equity, maximum financial loss and interest coverage. As of December 31, 2003 the Company had received a waiver of such non-compliance from the controlling party. On March 15, 2004, each of these financial covenants was amended with the controlling party such that all breaches have been cured.

The Servicing Agreements of the Company's securitization transactions and warehouse credit facilities are terminable by the insurers of certain of the Trust's obligations ("Note Insurers") in the event of certain defaults by the Company and under certain other circumstances. Were a Note Insurer in the future to exercise its option to terminate the Servicing 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 Servicing Agreements.

**(18) Selected Quarterly Data (Unaudited)**

	<u>Quarter Ended March 31,</u>	<u>Quarter Ended June 30,</u>	<u>Quarter Ended September 30,</u>	<u>Quarter Ended December 31,</u>
	(In thousands, except per share data)			
2003				
Revenues .....	\$ 22,547	\$ 23,715	\$ 26,487	\$ 28,184
Income (loss) before income taxes .....	2,354	3,132	(2,852)	(5,674)
Net income (loss) .....	6,278	2,642	(2,852)	(5,674)
Income (loss) per share:				
Basic .....	\$ 0.31	\$ 0.13	\$ (0.14)	\$ (0.28)
Diluted .....	0.29	0.12	(0.14)	(0.28)
2002				
Revenues .....	\$ 13,136	\$ 27,216	\$ 26,040	\$ 25,560
Income (loss) before income taxes and extraordinary item .....	(6,775)	1,279	2,240	3,318
Extraordinary item .....	17,412	—	—	—
Net income .....	16,431	739	1,300	1,938
Income (loss) per share before extraordinary item:				
Basic .....	\$ (0.05)	\$ 0.04	\$ 0.07	\$ 0.09
Diluted .....	(0.05)	0.04	0.06	0.09
Extraordinary item per share:				
Basic .....	\$ 0.90	\$ —	\$ —	\$ —
Diluted .....	0.90	—	—	—
Income per share:				
Basic .....	\$ 0.85	\$ 0.04	\$ 0.07	\$ 0.09
Diluted .....	0.85	0.04	0.06	0.09
2001				
Revenues .....	\$ 17,325	\$ 16,320	\$ 14,271	\$ 14,089
Income (loss) before income taxes .....	306	241	253	(480)
Net income (loss) .....	186	241	253	(360)
Income (loss) per share:				
Basic .....	\$ 0.01	\$ 0.01	\$ 0.01	\$ (0.01)
Diluted .....	0.01	0.01	0.01	(0.01)