4191096

Preferred Holdings Limited

Report and financial statements

31 December 2003

ERNST & YOUNG

Registered No: 4191096

Directors
J A Webster
G Patellis
A Attia
G M Fraser

Secretary
Clifford Chance Secretaries (CCA) Limited
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London
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Auditors
Ernst & Young LLP
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Directors' report

The directors present their report and the financial statements for the year ended 31 December 2003.

Principal activities

The principal activity of the Company and Group is the provision of loans secured on properties in the United Kingdom. The Company holds the entire share capital of Preferred Group Limited.

Future prospects

The directors are confident that the Company is well placed to continue its activities.

Business review

On 12 December 2003, the whole of the issued share capital of Preferred Holdings Limited was acquired by Lehman Brothers Holdings PLC.

Going concern

The directors believe that the Group is a going concern and accordingly have prepared the financial statements on this basis.

Results and dividends

The results of the Group for the year are shown in the consolidated profit and loss account on page 7. The directors do not recommend the payment of a dividend (2002 – nil).

Directors and their interests

J A Webster and G Patellis all served throughout the year. A Attia and G M Fraser were appointed on 12 December 2003.

G J Folwell, S E Khadhouri, O J Clarke and P E Hopes resigned as directors on 12 December 2003. D J Pitocco resigned as a director on 31 May 2004.

P E Hopes resigned as company secretary on 12 December 2003. Clifford Chance Secretaries Limited were appointed as company secretary on 12 December 2003 and resigned on 1 November 2004. Clifford Chance Secretaries (CCA) Limited were appointed as company secretary on 1 November 2004.

The beneficial interests of the directors, and of their families, in the shares of the Company are set out below.

	31 December 2003 Ordinary shares of 10p each	*31 December 2002 Ordinary shares of 10p each*
D J Pitocco	–	9,334
P E Hopes	–	9,333
J A Webster	–	9,333
G Patellis	–	2,000
G Folwell	–	2,000

	31 December 2003		*31 December 2002*	
	A Ordinary shares of 1p each	*B Ordinary shares of 1p each*	*A Ordinary shares of 1p each*	*B Ordinary shares of 1p each*
O J Clarke	–	–	919	–
D J Pitocco	–	–	–	642

On acquisition of the company on 12 December 2003, Lehman Brothers Holdings PLC purchased all of the directors' interests.

Directors' report

Financial instruments

The Group's financial instruments comprise mortgages, borrowings, cash and liquid resources, and various items (such as trade debtors and trade creditors) that arise directly from its operations.

The Group also enters into derivative transactions (principally interest rate swaps, caps and currency swaps) to manage the interest rate and currency risks arising within the securitised mortgage vehicles.

It is, and has been throughout the year under review, the Group's policy that no trading in financial instruments shall be undertaken.

The main risks arising from the Group's financial instruments are credit risk, interest rate risk, currency risk and liquidity risk. The directors review and agree policies for managing each of these risks and they are summarised below. These policies have remained unchanged from 2002.

Credit risk

Credit risk is principally the risk that borrowers will not be able to meet their obligations as they fall due, allied to the risk that property values will fall to the extent that borrowers' failure to meet obligations is translated into losses.

The Group has established detailed, documented credit policies, which are used to define, monitor and control the quality of new lending through analysis of new origination, existing portfolios and the wider marketplace. These policies control the approval of new origination sources, the approval of new products, the underwriting criteria development, underwriting and collection mandates and the criteria and processes for arrears collection, litigation and repossession.

The ongoing credit risk of the mortgage portfolio (and particularly in respect of accounts in arrears) is closely monitored by the directors.

Interest rate risk

Interest rate risk exists where assets and liabilities have interest rates set under different bases or which reset at different times. The Group minimises its exposure to interest rate risk by ensuring that the interest rate characteristics of its assets and liabilities are similar. Where this is not possible the Group considers the use of derivative financial instruments to mitigate any residual interest rate risk.

Foreign exchange risk

Foreign exchange risk exists where loan notes are denominated in a currency which is different to the underlying sterling mortgage loans. The Group minimises its exposure to foreign currency risk by ensuring that the currency characteristics of its assets and liabilities are similar, where this is not possible the Group considers the use of derivative financial instruments to mitigate any foreign exchange risk.

Liquidity risk

The Group's policy is to manage liquidity risk by matching the timing of the cash receipts from mortgage assets with those of the cash payments due on the sources of financing, which include loan notes, funding facilities and subordinated loans.

Directors' report

Auditors

Deloitte & Touche LLP resigned as auditors on 12 December 2003 and the directors appointed Ernst & Young LLP.

A resolution to reappoint Ernst & Young LLP as auditors will be put to the members at the next Annual General Meeting.

Approved by the board of directors and signed on behalf of the board.

Director

Date 28th September 2005

Statement of directors' responsibilities in respect of the financial statements

Company law requires the directors to prepare financial statements for each financial year which give a true and fair view of the state of affairs of the Company and of the Group and of the profit or loss of the Group for that period. In preparing those financial statements, the directors are required to:

- select suitable accounting policies and then apply them consistently;
- make judgements and estimates that are reasonable and prudent; and
- prepare the financial statements on the going concern basis unless it is inappropriate to presume that the Group will continue in business.

The directors are responsible for keeping proper accounting records which disclose with reasonable accuracy at any time the financial position of the Group and to enable them to ensure that the financial statements comply with the Companies Act 1985. They are also responsible for safeguarding the assets of the Group and hence for taking reasonable steps for the prevention and detection of fraud and other irregularities.

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Independent auditors' report

to the members of Preferred Holdings Limited

We have audited the Group's financial statements for the year ended 31 December 2003 which comprise the Consolidated Profit and Loss Account, Consolidated Balance Sheet, Company Balance Sheet, the Consolidated Cash Flow Statement and the related notes 1 to 27. These financial statements have been prepared on the basis of the accounting policies set out therein.

This report is made solely to the Company's members, as a body, in accordance with Section 235 of the Companies Act 1985. Our audit work has been undertaken so that we might state to the Company's members those matters we are required to state to them in an auditors' report and for no other purpose. To the fullest extent permitted by law, we do not accept or assume responsibility to anyone other than the Company and the Company's members as a body, for our audit work, for this report, or for the opinions we have formed.

Respective responsibilities of directors and auditors

As described in the Statement of Directors' Responsibilities the Company's directors are responsible for the preparation of the financial statements in accordance with applicable United Kingdom law and accounting standards.

Our responsibility is to audit the financial statements in accordance with relevant legal and regulatory requirements and United Kingdom Auditing Standards.

We report to you our opinion as to whether the financial statements give a true and fair view and are properly prepared in accordance with the Companies Act 1985. We also report to you if, in our opinion, the Directors' Report is not consistent with the financial statements, if the Company has not kept proper accounting records, if we have not received all the information and explanations we require for our audit, or if information specified by law regarding directors' remuneration and transactions with the Group is not disclosed.

We read the Directors' Report and consider the implications for our report if we become aware of any apparent misstatements within it.

Basis of audit opinion

We conducted our audit in accordance with United Kingdom Auditing Standards issued by the Auditing Practices Board. An audit includes examination, on a test basis, of evidence relevant to the amounts and disclosures in the financial statements. It also includes an assessment of the significant estimates and judgements made by the directors in the preparation of the financial statements, and of whether the accounting policies are appropriate to the Group's circumstances, consistently applied and adequately disclosed.

We planned and performed our audit so as to obtain all the information and explanations which we considered necessary in order to provide us with sufficient evidence to give reasonable assurance that the financial statements are free from material misstatement, whether caused by fraud or other irregularity or error. In forming our opinion we also evaluated the overall adequacy of the presentation of information in the financial statements.

Opinion

In our opinion the financial statements give a true and fair view of the state of affairs of the Company and of the Group as at 31 December 2003 and of the profit of the Group for the year then ended and have been properly prepared in accordance with the Companies Act 1985.

Ernst & Young LLP
Registered Auditor
London

25 September 2005

Consolidated profit and loss account

for the year ended 31 December 2003

	Notes	2003 £000	2002 £000
Interest receivable and similar income	2	20,792	6,432
Interest payable and similar charges	3	(16,705)	(4,829)
Net interest income		4,087	1,603
Income from securitised operations	4	17,715	9,546
Profit on sale of mortgage assets	5	2,508	1,096
Other operating income	6	8,948	5,194
Operating income		33,258	17,439
Operating expenses		(23,894)	(13,204)
Operating profit		9,364	4,235
Provision for bad and doubtful debts		(1,027)	(206)
Profit on ordinary activities before taxation		8,337	4,029
Taxation	8	(2,609)	73
Profit on ordinary activities after taxation	21	5,728	4,102
Retained profit for the year		5,728	4,102

The profit for the year was derived from continuing operations.

There were no recognised gains or losses other than the profit for the year, accordingly no statement of recognised gains and losses is given.

The notes on pages 11 to 30 form part of these financial statements.

Consolidated balance sheet

at 31 December 2003

	Notes	2003 £000	2002 £000
Fixed assets			
Intangible assets	11	7,437	7,861
Tangible assets	12	2,457	2,367
		9,894	10,228
Current assets			
Mortgage loans and other assets - securitised balances	15	574,833	451,798
Less: non recourse borrowings and other liabilities	15	(544,161)	(434,630)
		30,672	17,168
Mortgage loans - unsecuritised balances	14	487,146	142,338
		517,818	159,506
Debtors	17	23,026	29,638
Cash at bank and in hand		21,647	6,698
Total current assets		562,491	195,842
Creditors: amounts falling due within one year	18	(538,196)	(181,737)
Net current assets		24,295	14,105
Total assets less current liabilities		34,189	24,333
Creditors: amounts falling due after more than one year	19	(23,101)	(18,981)
Net assets		11,088	5,352
Capital and reserves			
Called up share capital	20	5	5
Share premium	21	490	482
Profit and loss account	21	10,593	4,865
Shareholders' funds	22	11,088	5,352

Included above within mortgages are balances due within one year and after more than one year, the analysis of which is provided in note 16.

The notes on pages 11 to 30 form part of these financial statements.

These financial statements were approved by the board of directors and were signed on its behalf by:

Director

Date 28th September 2005

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Company balance sheet
at 31 December 2003

	Notes	2003 £000	2002 £000
Fixed assets			
Investments	13	–	–
		–	–
Current assets			
Debtors	17	368	425
Cash		1	8
Total current assets		369	433
Creditors: amounts falling due within one year	18	(302)	(72)
Net current assets		67	361
Total assets less current liabilities		67	361
Creditors: amounts falling due after more than one year		–	–
Net assets		67	361
Capital and reserves			
Called up share capital	20	5	5
Share premium	21	490	482
Profit and loss account	21	(428)	(126)
Equity shareholders' funds	22	67	361

The notes on pages 11 to 30 form part of these financial statements.

These financial statements were approved by the board of directors and were signed on its behalf by:

Director

Date 28th September 2005

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Consolidated cash flow statement

for the year ended 31 December 2003

	Notes	2003 £000	2002 £000
Net cash outflow from operating activities	24(a)	60,783	43,547
Returns on investments and servicing of finance	24(b)	(38,348)	(20,884)
Taxation		(1,616)	(2)
Capital expenditure and financial investment	24(b)	(449,538)	(242,859)
Cash outflow before use of liquid resources and financing		(428,719)	(220,198)
Financing	24(b)	456,930	238,144
Increase in cash in the year		28,211	17,946

Reconciliation of net cash flow to movement in net debt (note 24(c))

	2003 £000	2002 £000
Increase in cash in the year	28,211	17,946
Cash inflow from increase in debt financing	(457,124)	(232,320)
Change in net debt arising from cash flows	(428,913)	(214,374)
Net debt at 31 December 2002	(610,207)	(395,833)
Net debt at 31 December 2003	(1,039,120)	(610,207)

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Notes to the financial statements

at 31 December 2003

1. Accounting policies

Basis of accounting

The financial statements have been prepared under the historical cost convention and in accordance with applicable accounting standards. The financial statements have been prepared on a going concern basis.

Basis of consolidation

The consolidated financial statements include the financial statements of the Company and its subsidiary undertakings made up to 31 December 2003. The acquisition method of accounting has been adopted.

Under section 230(4) of the Companies Act 1985 the Company is exempt from the requirement to present its own profit and loss account. The amount of profit for the period dealt with in the financial statements of Preferred Holdings Limited is disclosed in note 21.

Format of financial statements

As a result of the acquisition of Preferred Holdings Limited by Lehman Brothers Holdings PLC on 12 December 2003, the Company has altered the format of its financial statements to make them consistent with the format adopted by other Group companies.

The change in format did not alter the result for the year ended 31 December 2003.

Linked presentation

The Group has sold by securitisation, certain mortgages to other companies on a non-recourse basis. In accordance with the requirements of Financial Reporting Standard No 5 "Reporting the Substance of Transactions", these amounts cannot be derecognised and have been disclosed on the face of the balance sheet less any non-recourse finance, using the linked presentation basis.

Quasi-subsidiaries

Preferred Residential Securities 1 PLC, Preferred Residential Securities 2 PLC, Preferred Residential Securities 3 PLC, Preferred Residential Securities 4 PLC, Preferred Residential Securities 5 PLC and Preferred Residential Securities 6 PLC have been consolidated as quasi-subsidiaries under the linked presentation basis described above.

In addition, Preferred Funding One Limited, Preferred Funding Two Limited, Preferred Funding Four Limited and Preferred Mortgages Collections Limited have been fully consolidated as quasi-subsidiaries.

Mortgage loans

Mortgage loans are stated at cost less provision made to reduce the value of the loans to their estimated recoverable amounts. Provisions are made against mortgages when, in the opinion of the Directors, credit risk or economic risk make recovery doubtful.

Income and expense recognition

Interest receivable and insurance commissions are accounted for on an accruals basis. Fees are credited to income when they have been charged to the borrower's account. Receipts and payments of expenses are accounted for on an accruals basis.

Provisions

Specific provisions for losses on loans and advances to customers in arrears are made throughout the period and at the period-end on a case-by-case basis (calculated with reference to the probability of the loan defaulting and the value of the security held against the loan). The specific provision for properties in possession is based on the balance outstanding less a discounted valuation of the security held (with adjustments for expenses of sale).

Notes to the financial statements

at 31 December 2003

1. Accounting policies (continued)

Tangible fixed assets and depreciation

Tangible fixed assets are stated at cost less accumulated depreciation.

Depreciation is provided to write off the cost of tangible fixed assets on a straight line basis at the following rates per annum:

Office furniture, fixtures and fittings	15%
Office equipment and computer software	25%

Operating leases

Rental costs under operating leases are charged to the profit and loss account on a straight line basis over the period of the lease.

Origination costs deferral

Third party introduction fees incurred in originating mortgages are written off over the period in which early redemption charges apply (currently 36 months from the date of completion) or the life of the mortgage loan, whichever is the shorter.

Investments

In the Company's financial statements, investments in subsidiary undertakings are stated at cost, less any necessary provision for diminution in value.

Taxation

The charge for taxation is based on the profit for the year and takes into account taxation deferred because of timing differences between the treatment of certain items for taxation and accounting purposes.

Deferred tax is recognised in respect of all timing differences that have originated but not reversed at the balance sheet date where transaction or events that result in an obligation to pay more, or a right to pay less tax in the future, have occurred at the balance sheet date.

Deferred tax assets are recognised only to the extent that the directors consider it is more likely than not that there will be suitable taxable profits from which the reversal of the underlying timing differences can be deducted. Deferred tax is measured on a non-discounted basis at the tax rates that are expected to apply in periods in which timing differences reverse, based on tax rates and laws enacted or substantively enacted at the balance sheet date.

Turnover

The Group's trade and turnover are wholly within the UK and within a single market sector. Consequently, no segmental analysis has been prepared.

Deferred consideration

Deferred consideration represents further amounts payable on the acquisition of mortgages from Preferred Mortgages Limited, a subsidiary of the company, by the Preferred Residential Securities and Preferred Funding companies. The payment of these amounts is conditional on the performance of the acquired mortgages.

Notes to the financial statements

at 31 December 2003

1. Accounting policies (continued)

Foreign exchange currency swaps

A currency swap has been entered into, in order to manage Preferred Residential 6 PLC's currency rate exposure in relation to non-sterling denominated loan notes. The derivative contracts match the expected profile of the run-off of the non-sterling denominated loan notes. The net interest paid on the loan notes is recorded on an accruals basis and included within interest payable within the income from securitised operations. Any foreign exchange gain or loss arising from the currency swaps in respect of capital and interest repayments is recorded on an accruals basis and is included in interest receivable or payable.

Pension costs

The Group pays contributions to defined contribution pension schemes that are either personal pension plans or group personal pension schemes. Such contributions are charged in the financial statements as they accrue.

2. Interest receivable

	2003	*2002*
	£000	*£000*
Mortgage interest	19,444	5,466
Bank interest	1,348	966
	20,792	6,432

3. Interest payable and similar charges

	2003	*2002*
	£000	*£000*
Loan facilities	15,173	4,216
Loan note interest	835	472
Other interest	697	141
	16,705	4,829

Notes to the financial statements

at 31 December 2003

4. Income from securitised and unsecuritised operations

(a) Securitised operations

Preferred Residential Securities 1 PLC, Preferred Residential Securities 2 PLC, Preferred Residential Securities 3 PLC, Preferred Residential Securities 4 PLC, Preferred Residential Securities 5 PLC and Preferred Residential Securities 6 PLC all hold securitised mortgage assets. The summarised profit and loss account for these companies is as follows:

	2003	*2002*
	£000	*£000*
Interest receivable	41,934	29,732
Interest payable	(23,632)	(18,257)
Other operating income	2,851	1,623
Operating expenses	(1,817)	(1,350)
Provision for bad and doubtful debts	(1,619)	(2,202)
Corporation tax charge	(2)	–
	17,715	9,546

(b) Unsecuritised operations

Prior to acquisition by Lehman Brothers Holdings PLC, Preferred Mortgages Limited a subsidiary of the company transferred mortgages on an ongoing basis to Preferred Funding One Limited, Preferred Funding Two Limited, Preferred Funding Three Limited and Preferred Funding Four Limited. On acquisition the mortgages and loan facilities within these companies were transferred to Preferred Funding Five Limited.

Preferred Funding One Limited, Preferred Funding Two Limited and Preferred Funding Four Limited are wholly owned by a charitable trust and as detailed in note 1, have been consolidated as quasi-subsidiaries. Preferred Funding Four Limited was incorporated on 15 May 2003. Preferred Funding One Limited and Preferred Funding Two Limited have traded throughout the accounting period.

Preferred Holdings Limited is not obliged to support any losses of Preferred Funding One Limited, Preferred Funding Two Limited and Preferred Funding Four Limited and does not intend to do so. The liabilities of Preferred Funding One Limited, Preferred Funding Two Limited and Preferred Funding Four Limited, are only repayable out of funds generated by the mortgage loans and there is no recourse to the Group for any shortfall.

Both Preferred Funding Three Limited and Preferred Funding Five Limited are wholly owned subsidiaries of Preferred Mortgages Limited. All of above mentioned funding companies carry out the principal activity of financing the provision of residential mortgages.

Notes to the financial statements

at 31 December 2003

4. Income from securitised and unsecuritised operations (continued)

The summarised profit and loss account for Preferred Funding One Limited, Preferred Funding Two Limited and Preferred Funding Four Limited for the period ending 31 December 2003, were as follows:

	2003 £000	2002 £000
Interest receivable	14,816	7,413
Interest payable	(10,593)	(5,360)
Net interest income	4,223	2,053
Other operating income	494	141
Operating expenses	(4,710)	(2,193)
Operating profit	7	1
Taxation	–	–
Profit after taxation	7	1

Operating expenses includes the provision of deferred consideration payable to Preferred Mortgages Limited, of which the Company is parent, of £4,314,685 (2002 - £1,540,566).

5. Profit on sale of mortgage assets

During the year Preferred Mortgages Limited sold mortgage assets of £68,952,000 (2002 - £24,873,000) recognising a profit of £2,508,000 (2002 - £1,096,000).

6. Other operating income

	2003 £000	2002 £000
Commissions and fee income	8,948	5,194

Commissions and fee income includes redemption fee income, insurance commission income and sundry fee income.

7. Profit on ordinary activities before taxation

Profit on ordinary activities before taxation is stated after charging:

	2003 £000	2002 £000
Auditors' remuneration:		
Audit services - audit fees	115	25
- non-audit fees	5	15
Depreciation of tangible fixed assets	870	452
Amortisation of goodwill	424	424
Operating lease rentals in respect of:		
Land and buildings	564	328
Other	111	65

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Notes to the financial statements

at 31 December 2003

8. Taxation

(a) Tax charge for the year

	2003 £000	2002 £000
UK corporation tax at 30%	2,493	3
Total current tax for year (note 8b)	2,493	3
Deferred taxation		
Adjustment to deferred tax assets arising in earlier periods	–	(1,591)
Origination and reversal of timing differences	116	1,515
Total deferred tax	116	(76)
Total current tax	2,609	(73)

(b) Factors affecting tax charge for the year

The tax assessed on the profit on ordinary activities for the period is lower than the companies rate of corporation tax in the UK, currently 30% (2002: 30%). The differences are explained below:

	2003 £000	2002 £000
Profit before taxation	8,337	4,029
Expected tax charge at 30%	2,501	1,209
Expenditure not qualifying for tax relief	225	10
Capital allowances in excess of depreciation	34	(75)
Non deductible goodwill	128	127
Other timing differences	(142)	–
Utilisation of tax losses	(154)	(1,268)
Starting rate of tax	(4)	–
Consolidation adjustments	(95)	–
Total current tax	2,493	3

(c) Deferred tax

The deferred tax asset can be analysed as follows:

	2003 £000	2002 £000
Capital allowances in excess of depreciation	(40)	(74)
Tax losses	–	150
	(40)	76

Notes to the financial statements

at 31 December 2003

8. Taxation (continued)

The deferred tax asset can be analysed as follows:

	2003	2002
	£000	£000
Balance at 1 January	76	–
(Debit)/credit to profit and loss account	(116)	76
	(40)	76

9. Directors' emoluments

Directors' emoluments are as follows:

	2003	2002
	£000	£000
Salaries	1,046	737
Other	67	67
Aggregate remuneration	1,113	804
Remuneration of the Chairman	25	25
Remuneration of the highest paid director	533	333

None of the directors are members of a company pension scheme, but during the year, the Group has made contributions to personal pensions plans for the directors totalling £13,525 (2002 - £12,941).

Highest paid director

The highest paid director in 2003, was D J Pitocco (2002 - D J Pitocco).

	2003	2002
	£000	£000
Total emoluments	533	333
Contributions to personal pension plan	–	–

Notes to the financial statements

at 31 December 2003

10. Employees

The average number of employees, including directors, during the year was 208 (2002 - 143) and they were employed in the following areas of the business:

	2003 No.	2002 No.
Sales and marketing	25	18
Administration	183	125
	208	143

The costs incurred in respect of these employees were:

	2003 £000	2002 £000
Salaries	6,131	3,580
Pension costs	176	127
Social security costs	658	446
	6,965	4,153

Pension costs represent contributions made by the Group to the personal pension plans or group personal pension schemes of certain employees.

11. Intangible fixed assets

	Goodwill 2003 £000	Goodwill 2002 £000
Cost:		
At 1 January 2003 and 31 December 2003	8,498	8,498
Accumulated amortisation		
At 1 January 2003	637	213
Charge for year	424	424
At 31 December 2003	1,061	637
Net book value		
At end of year	7,437	7,861
At start of year	7,861	8,285

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Notes to the financial statements

at 31 December 2003

12. Tangible fixed assets

Group

	Office equipment £000	*Fixtures and furniture £000*	*Total £000*
Cost			
At 1 January 2003	3,054	375	3,429
Additions	747	213	960
At 31 December 2003	3,801	588	4,389
Depreciation:			
At 1 January 2003	881	181	1,062
Charge for the year	803	67	870
At 31 December 2003	1,684	248	1,932
Net book value			
At 31 December 2003	2,117	340	2,457
At 31 December 2002	2,173	194	2,367

The Company has no tangible fixed assets.

13. Fixed asset investments

Company

	Shares in subsidiary undertakings £
Cost	
At 31 December 2002 and 31 December 2003	1
Net book value	
At 31 December 2002 and 31 December 2003	1

Subsidiary undertakings	*Country of registration and operation*	*Activity*	*Portion of ordinary shares held*
Preferred Group Limited	England and Wales	Investment holding company	100%
Preferred Mortgages Limited*	England and Wales	Provision of loans secured on properties	100%
Yellow Brick Road Direct Mortgages Limited*	England and Wales	Dormant	100%
Preferred Home Loans Limited*	England and Wales	Dormant	100%

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Notes to the financial statements

at 31 December 2003

13. *Fixed asset investments (continued)*

With the exception of the companies marked with an asterisk, all shareholdings are in the name of Preferred Holdings Limited. All subsidiaries have been included in the consolidation.

The following information is presented in the financial statements of Preferred Group Limited for the year ended 31 December 2003:

	2003
	£000
Aggregate capital and reserves	(1,576)
(Loss) for the year	(1,050)

The following information is presented in the consolidated financial statements of Preferred Mortgages Limited, a subsidiary of Preferred Group Limited, for the year ended 31 December 2003:

	2003
	£000
Aggregate capital and reserves	20,888
Profit for the year	7,506

14. Mortgage loans – unsecuritised balances

Group

	Mortgages	*Mortgage loss provision*	*Total*
	£000	*£000*	*£000*
At beginning of the year	142,789	(451)	142,338
Net movement	345,835	(1,027)	344,808
At end of the year	488,624	(1,478)	487,146

Notes to the financial statements

at 31 December 2003

14. Mortgage loans – unsecuritised balances (continued)

The summarised balance sheets as at 31 December 2003 prior to consolidation adjustments for Preferred Funding One Limited, Preferred Funding Two Limited and Preferred Funding Four Limited were as follows:

	2003	*2002*
	£000	*£000*
Current assets		
Debtors:		
Amounts falling due after one year	3,411	142,231
Amounts falling due within one year	14,490	26,241
Cash at bank and in hand	7,120	2,341
	25,021	170,813
Creditors: amounts falling due within one year	(25,009)	(170,808)
Net assets	12	5
Capital and reserves		
Called up share capital	–	–
Profit and loss account	12	5
	12	5

15. Mortgage loans – securitised balances

(a) Consolidation using link presentation

During the year the Group securitised £282.6m mortgages within Preferred Residential Securities 6 PLC, which is owned by a charitable trust. As at 31 December 2003 the Group had securitised mortgages of £537.5m within the six special purpose companies, Preferred Residential Securities 1 PLC, Preferred Residential Securities 2 PLC, Preferred Residential Securities 3 PLC, Preferred Residential Securities 4 PLC, Preferred Residential Securities 5 PLC and Preferred Residential Securities 6 PLC. These special purpose companies are consolidated within the financial statements of the Group on a linked presentation basis, in accordance with FRS5. The consolidated results of those companies are detailed in note 4. All of the companies invest in residential mortgage loans secured by first or second charges.

Notes to the financial statements

at 31 December 2003

15. *Mortgage loans – securitised balances (continued)*

The summary consolidated balance sheet of these six companies is as follows:

	2003	*2002*
	£000	*£000*
Mortgage loans (note 15(b))	537,524	434,781
Debtors due within one year	1,923	2,716
Cash at bank	35,386	14,301
Total assets	574,833	451,798
Mortgaged Backed Loan Notes (note 15(c))	541,981	433,120
Other creditors:		
Due within one year	846	1,510
Due after one year	1,334	–
Total liabilities	544,161	434,630
Net securitised assets	30,672	17,168

The Group is not obliged to support any losses of the securitisation companies and does not intend to do so. The providers of finance have given notice in writing that they will seek repayment of the finance, both principle and interest, only to the extent that sufficient funds are generated by the securitised assets and they will not seek any other form of recourse from the Group.

The priority and amount of claims on the proceeds generated by the assets are determined in accordance with a strict priority of payments. The Group is entitled to additional deferred consideration and/or residual income, in addition to the non-recourse consideration already received, depending upon the performance of the securitised assets.

(b) Analysis of securitised mortgage balances

	Mortgages	*Mortgage loss provision*	*Total*
	£000	*£000*	*£000*
Group			
At beginning of the year	438,812	(4,031)	434,781
Net movement	104,362	(1,619)	102,743
At end of the year	543,174	(5,650)	537,524

(c) Analysis of non recourse borrowings

	2003	*2002*
	£000	*£000*
Capital value of borrowings	541,981	433,120
Interest payable on borrowings	1,156	1,055
	543,137	434,175

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at 31 December 2003

16. **Mortgage loans:** amounts falling due within one and after one year

	Group 2003 £000	*Group 2002 £000*
Securitised mortgages	537,524	434,781
Non-securitised mortgages	487,146	142,338
	1,024,670	577,119
Amounts falling due within one year	201,975	398,059
Amounts falling due after one year	822,695	179,060
	1,024,670	577,119

17. **Debtors:** amounts due within one year

Group

	2003 £000	*2002 £000*
Deferred origination costs	14,344	7,656
Deferred taxation	–	76
Other debtors	8,249	21,010
Prepayments and accrued income	433	896
	23,026	29,638

Company

	2003 £000	*2002 £000*
Amounts owed by related companies	368	425

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at 31 December 2003

18. Creditors: amounts falling due within one year

Group

	2003	*2002*
	£000	*£000*
Loan facility	505,523	166,949
Loan finance	16,947	12,791
Bank overdraft	8,243	420
Social security and other taxes	560	174
Trade creditors	850	422
Other creditors	2,574	561
Deferred tax	40	–
Corporation tax	878	1
Accruals and deferred income	2,223	419
Amounts owed to parent company	358	–
	538,196	181,737

Company

	2003	*2002*
	£000	*£000*
Amounts owed to related companies	285	70
Accruals and deferred income	17	2
	302	72

19. Creditors: amounts falling due after more than one year

	2003	*2002*
	£000	*£000*
Finance lease	368	166
Unsecured 'A' loan stock (see note 26)	–	14,965
Unsecured 'B' loan stock (see note 26)	–	3,850
Parent company loan	22,733	–
	23,101	18,981

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20. Called up share capital

		2003	2002
		£	£
Authorised			
16,868	Deferred shares of 1p each	169	–
36,949	Ordinary shares of 10p each	3,695	3,702
124,963	A ordinary shares of 1p each	1,250	1,379
32,215	B ordinary shares of 1p each	322	355
10,001	C ordinary shares of 1p each	100	100
1,291	D ordinary shares of 10p each	129	–
		5,665	5,536

		2003	2002
		£	£
Issued:			
16,868	Deferred shares of 1p each	169	–
30,638	Ordinary shares of 10p each	3,064	3,200
124,963	A ordinary shares of 1p each	1,250	1,329
27,214	B ordinary shares of 1p each	272	292
7,001	C ordinary shares of 1p each	70	70
1,291	D ordinary shares of 10p each	129	–
		4,954	4,891

On 3 January 2003, 4,989 ordinary A shares of 1p each and 1,262 ordinary B shares of 1p each were allotted.

On 12 December 2003, the entire share capital of Preferred Holdings Limited was acquired by Lehman Brothers Holdings PLC. As part of the acquisition agreement, 71 ordinary 10p shares, 12,899 A ordinary 1p shares and 3,259 B ordinary 1p shares were converted to 16,868 Deferred 1p shares. Also, 1,291 ordinary 10p shares were converted to 1,291 D ordinary 10p shares.

On 5 May 2004, the existing issued and authorised share capital was redenominated whereby the Class A ordinary shares of 1p, the Class B ordinary shares of 1p and the Class C ordinary shares of 1p were each redenominated to Class X ordinary shares of 1p each. Similarly, the Class D ordinary shares of 10p were denominated as ordinary shares of 10p each.

On 5 May 2004, a resolution was passed to increase the Company's authorised share capital from £5,665 to £10,000.

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21. Statement of movement on reserves

Group

	Share premium account £000	*Profit and loss account £000*	*Total £000*
Balance at 1 January 2003	482	4,865	5,347
Premium on shares issued in the year	8	–	8
Retained profit for the year	–	5,728	5,728
Balance at 31 December 2003	490	10,593	11,083

Company

	Share premium account £000	*Profit and loss account £000*	*Total £000*
Balance at 1 January 2003	482	(126)	356
Premium on shares issued in the year	8	–	8
Retained profit for the year	–	(302)	(302)
Balance at 31 December 2003	490	(428)	62

22. Reconciliation of movements in shareholders' funds

Group

	2003 £000	*2002 £000*
Profit for the financial year	5,728	4,102
Issue of shares (share premium)	8	22
Net addition to shareholders' funds	5,736	4,124
Opening shareholders' funds	5,352	1,228
Closing shareholders' funds	11,088	5,352

Company

	2003 £000	*2002 £000*
Loss for the financial year	(302)	(56)
Issue of shares (share premium)	8	22
Net addition to shareholders' funds	(294)	(34)
Opening shareholders' funds	361	395
Closing shareholders' funds	67	361

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23. Operating lease commitments

The charge payable in the next year in respect of operating leases is as follows:

	2003 £000	2002 £000
Land and buildings		
Leases terminating between 1 and 2 years	419	–
Leases terminating between 2 and 5 years	–	290
Other		
Leases terminating in less than 12 months	29	15
Leases terminating between 1 and 2 years	5	29
Leases terminating between 2 and 5 years	8	5

24. Cash flow statement

(a) Reconciliation of operating profit to net cash inflow from operating activities

	2003 £000	2002 £000
Operating profit after provision	8,337	4,029
Depreciation of fixed assets	870	452
Interest – loan facilities	15,173	4,216
Interest – mortgage backed loan notes	21,643	16,055
Interest – other	1,532	613
Amortisation of goodwill	424	424
Origination costs	(6,688)	(7,656)
Finance lease	202	(7,134)
Provision	1,027	26
Other debtors	14,017	31,031
Other creditors	4,246	1,491
Net cash inflow from operating activities	60,783	43,547

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24. Cash flow statement (continued)

(b) Analysis of cash flows for headings netted in the cash flow statement

	2003 *£000*	*2002* *£000*
Returns on investments and servicing of finance		
Interest paid on mortgage backed floating rate notes	(21,643)	(16,055)
Interest paid on loan facilities and other interest	(16,705)	(4,829)
	(38,348)	(20,884)
Capital expenditure and financial investment		
Payments to acquire tangible fixed assets	(960)	(2,264)
Payments to acquire mortgages	(448,578)	(240,595)
	449,538	242,859
Financing		
Issue of ordinary shares	8	22
Issue of loan notes	109,916	95,296
Increase in bank facility	338,574	128,790
(Decrease)/increase in loan finance	(14,659)	14,036
Increase in loan from parent company	23,091	–
	456,930	238,144

(c) Analysis of net debt

	2002 *£000*	*Cash flow* *£000*	*2003* *£000*
Cash in hand	20,999	36,034	57,033
Bank overdraft	(420)	(7,823)	(8,243)
	20,579	28,211	48,790
Parent company loan	–	(23,091)	(23,091)
Non recourse facilities	(432,065)	(109,916)	(541,981)
Other loan facilities	(198,721)	(324,117)	(522,838)
	(610,207)	(428,913)	(1,039,120)

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25. Financial instruments

As explained on page 3 the Company and Group uses financial instruments in its normal course of business. The following numerical analysis gives an indication of the significance of these instruments to the Company and Group.

(a) Interest rate risk profile of financial liabilities

	Total *£000*	*Total variable rate* *£000*	*Total fixed rate* *£000*	*Weighted average interest rate* *%*	*Weighted average time for which rate is fixed* *Years*
2003					
Interest rate and currency profile	1,095,427	1,095,427	–	–	–
2002					
Interest rate and currency profile	631,040	631,040	–	–	–

(b) Interest rate risk profile of financial assets

	Total *£000*	*Total variable rate* *£000*	*Total fixed rate* *£000*	*Weighted average interest rate* *%*	*Weighted average time for which rate is fixed* *Years*
2003					
Interest rate and currency profile	1,081,702	1,080,420	1,282	6.66	0.75
2002					
Interest rate and currency profile	598,110	578,025	20,085	7.20	0.26

All financial assets are denominated in pounds sterling.

The rates of interest receivable and payable on variable rate financial instruments are set with reference to the London Interbank Offered Rate.

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25. Financial instruments (continued)

(c) Foreign currency risk

With the exception of the mortgage backed loan notes in Preferred Residential Securities 6 PLC, all financial instruments are denominated in sterling. The mortgage backed loan notes were issued in the following tranches in Preferred Residential Securities 6 PLC:

GBP denominated mortgage backed loan notes due 2035 – Class A1 (Notional GBP 232,000,000)
EUR denominated mortgage backed loan notes due 2035 – Class A2 (Notional EUR 50,000,000)
GBP denominated mortgage backed loan notes due 2035 – Class M1 (Notional GBP 27,500,000)
EUR denominated mortgage backed loan notes due 2035 – Class M2 (Notional EUR 8,000,000)

A currency swap has been entered into, in order to manage the Company's currency rate exposure in relation to non-sterling denominated loan notes. At 31 December 2003 the notional value of swaps held was £40,971,389 and the unrecognised positive fair value was £522,978.

(d) Fair value of financial instruments

	Book value 2003 £000	*Fair value 2003 £000*	*Book value 2002 £000*	*Fair value 2002 £000*
Non-securitised operations				
Cash and deposits	21,647	21,647	6,698	6,698
Mortgage loans	487,146	487,146	142,338	142,338
Loan facilities	505,523	505,523	166,949	166,949
Bank overdraft	8,243	8,243	420	420
Loan finance	16,947	16,947	12,791	12,791
Parent company loan	22,733	22,733	–	–
Loan notes	–	–	18,815	18,815
Securitised operations				
Mortgage loans	537,524	537,524	434,781	434,781
Cash and deposits	35,386	35,386	14,301	14,301
Mortgage Backed Loan Notes	541,981	541,981	433,120	433,120

26. *Related party transactions*

In accordance with Financial Reporting Standard No. 8 "Related Party Transactions", transactions between the Company, other group undertakings and investee related parties of the Company have not been disclosed in these financial statements.

Amounts owed to the shareholders of Preferred Holdings Limited during the year are £23,091,000 (2002 - £nil) and are included within creditors (note 19). All loan stock (note 19) is held by related parties of the shareholders, or the shareholders themselves.

27. Parent company and ultimate controlling party

The Company's parent company is Lehman Brothers Holdings PLC. The smallest and largest group in which the results of the Company are consolidated is that headed by Lehman Brothers Holdings Inc., incorporated in the United States of America. The consolidated financial statements of this Group are available from 745 Seventh Avenue, New York, USA.

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