

NOVASTAR FINANCIAL, INC.

Audit Committee Charter

I. Mission

The Audit Committee of NovaStar Financial, Inc. (“NovaStar”) is a standing committee of the Board of Directors (“Board”). The purpose of the Audit Committee is to assist the Board in fulfilling its oversight responsibility relating to:

- i. The integrity of NovaStar’s financial statements and financial reporting process and its system of internal accounting and financial controls;
- ii. The performance of the internal audit function;
- iii. The performance of the external independent auditors, which would include an evaluation of the independent auditor’s qualifications and independence.
- iv. Novastar’s compliance with legal and regulatory requirements, including disclosure controls and procedures;
- v. The preparation of an Audit Committee report to be included in NovaStar’s annual proxy statement; and
- vi. The fulfillment of the other responsibilities set out herein

While the Audit Committee has the responsibilities and powers set forth in this Charter, it is not the duty of the Audit Committee to plan or conduct audits or determine that NovaStar’s financial statements and disclosures are complete and accurate and are in accordance with generally accepted accounting principles (“GAAP”) and applicable rules and regulations. These are the responsibilities of management and the external independent auditors.

II. Organization and Authority

- A. The Audit Committee shall be comprised of at least three members of the Board, and the members shall meet the independence, experience, and expertise requirements of the New York Stock Exchange and other applicable laws and regulations, including the Sarbanes-Oxley Act of 2002 (“Sarbanes-Oxley”).
- B. At least one member of the Audit Committee will be a financial expert as defined by the Securities and Exchange Commission.
- C. Audit Committee members shall not simultaneously serve on the audit committees of more than two other public companies.
- D. The members of the Audit Committee shall be appointed by the Board of Directors at the annual organizational meeting of the Board and shall serve for such term or terms as the Board may determine. The members of the Committee may be removed by the Board in its discretion. Unless a Chair is elected by the

- full Board, the members of the Audit Committee may designate a Chair by majority vote of the full Audit Committee membership.
- E. The Board of Directors shall review the background of all members at least annually and make the determination as to whether the members are independent and financially literate and at least one member has the appropriate level of financial expertise.
 - F. The members of the Audit Committee shall have the sole authority to select, evaluate, appoint, and replace the independent auditors (subject to stockholder ratification) and shall approve in advance all audit engagement fees and terms and all non-audit engagements with the independent auditors. The independent auditors shall report directly to the Audit Committee. The Audit Committee shall consult with management, but shall not delegate these responsibilities.
 - G. The Audit Committee shall have the authority, to the extent it deems necessary or appropriate, to retain special legal, accounting, or other consultants to advise the Committee. NovaStar shall provide funding, as determined by the Audit Committee, for payment of compensation to the independent auditors and to any advisors employed by the audit committee.
 - H. The Audit Committee shall have the sole authority to commit NovaStar to an exit or disposal plan, or otherwise dispose of a long-lived asset or terminate employees under a plan of termination described in paragraph 8 of FASB Statement of Financial Accounting Standards No. 146, under which material charges will be incurred under GAAP.
 - I. The Audit Committee shall have the sole authority to conclude that a material charge for impairment to one or more of NovaStar's assets, including without limitation, impairments of securities or goodwill, is required under GAAP.
 - J. The Audit Committee shall have the sole authority to take definitive action to cause the listing of a class of the common equity of NovaStar to be withdrawn from the New York Stock Exchange.
 - K. The Audit Committee shall have the sole authority to conclude that any previously issued financial statements should no longer be relied upon because of an error in such financial statements as addressed in Accounting Principles Board Opinion No. 20.

III. Responsibilities

The Audit Committee shall have the following duties and responsibilities:

A. Communication and Assessment

- 1) Meet as often as the Audit Committee determines is necessary to fulfill its duties and responsibilities, but not less frequently than quarterly.

- 2) Meet separately, periodically, with management, internal audit, and external independent auditors.
- 3) Regularly report to the Board on the Audit Committee's activities.
- 4) Annually review and evaluate its own performance.
- 5) Review and assess the adequacy of this Charter annually and recommend any proposed changes to the Board for approval.

B. Financial Statement and Disclosure Matters

- 1) Review and discuss with management and the external independent auditors the annual audited financial statements, including disclosures made in "Management's Discussion and Analysis of Financial Conditions and Results of Operations," and recommend to the Board whether the audited financial statements should be included in NovaStar's Form 10-K.
- 2) Review and discuss with management and the external independent auditors NovaStar's quarterly financial statements prior to the filing of its Form 10-Q, including the results of the external independent auditors' reviews of the quarterly financial statements.
- 3) Discuss generally NovaStar's earnings press releases, as well as financial information and earnings guidance provided to analysts and rating agencies to the extent required by applicable law or listing standards. The Audit Committee need not discuss in advance each earnings release or each instance in which NovaStar may provide earnings guidance.
- 4) Discuss with management and the external independent auditors significant financial reporting issues and judgments made in connection with the preparation of the NovaStar's financial statements, including any significant changes in the NovaStar's selection or application of accounting principles, any major issues as to the adequacy of NovaStar's internal controls and any special steps adopted in light of material control deficiencies.
- 5) Review and discuss with management all Section 302 and 906 certifications required by Sarbanes-Oxley and receive a disclosure from the Chief Executive Officer and Chief Financial Officer during their certification process for the 10-K and 10-Q's about (1) any significant deficiencies in design or operation of internal controls or material weaknesses therein and (2) any fraud, whether or not material, involving management or other employees who have a significant role in NovaStar's internal controls.
- 6) Review and discuss periodically oral or written reports from the external independent auditors on, among other things, certain:
 - Critical accounting policies and practices to be used;
 - Alternative treatments of financial information within GAAP;
 - Other material written communications between the independent auditors and management, such as any management letter and Novastar's response to such letter or schedule of unadjusted differences;
 - Difficulties encountered in the course of the audit work, including any restrictions on the scope of activities or access to requested information, any significant disagreements with management, and communications between the audit team and the audit firm's national office with respect to difficult auditing or accounting issues presented by the engagement; and

- Responsibilities, budget and staffing of the Internal Audit Department.
- 7) Discuss with the external independent auditors the matters required to be discussed in Statement on Auditing Standards No. 61 relating to the conduct of the audit.
 - 8) Review and discuss with management and the independent auditors, at least annually:
 - Developments and issues with respect to reserves.
 - Regulatory and accounting initiatives as well as off-balance sheet structures, and their effect on Novastar's financial statements.
 - Accounting principles used in the preparation of NovaStar's financial statements (Specifically those polices for which management is required to exercise discretion or judgment regarding the implementation thereof)
 - 9) Review with management its evaluation of NovaStar's internal control structure and procedures for financial reporting and review periodically, but in no event less frequently than quarterly, management's conclusions about the effectiveness of such internal controls and procedures, including any significant deficiencies in, or material non-compliance with such controls and procedures. Review external independent auditor's attestation on management's assertion as required by Section 404 of Sarbanes-Oxley.
 - 10) Discuss with management NovaStar's major financial risk exposures and the steps management has taken to monitor and control such exposures, including NovaStar's risk assessment and management policies.
 - 11) Establish and evaluate going forward, procedures for the receipt, retention, and treatment of complaints received by NovaStar regarding accounting, internal accounting controls, and auditing matters, and the confidential, anonymous submission by employees of NovaStar of concerns regarding questionable accounting or auditing matters.

C. Oversight of NovaStar's Relationship with the External Independent Auditors

- 1) Receive and discuss a report from the external independent auditors at least annually regarding:
 - The external independent auditor's internal quality-control procedures;
 - Any material issues raised by the most recent quality-control review, or peer review (if applicable), of the external independent auditors or by any inquiry or investigation by governmental professional authorities within the preceding five years respecting one or more independent audits carried out by the external independent auditors;
 - Any steps taken to deal with any such issues; and
 - All relationships between the external independent auditors and NovaStar, in order to assess the independent auditors' independence.
- 2) Approve guidelines for the retention of the external independent auditors for any non-audit services and determine procedures for the approval of the audit and non-audit services in advance. In accordance with such procedures, the Audit Committee shall approve in advance any audit or non-audit services provided to NovaStar by the external independent auditors, all as required by applicable law and listing standards. Pre-approval may be delegated to one or more members of the Audit Committee.

- 3) Review and discuss the scope and plan of the external independent audit.
- 4) Evaluate the qualifications, performance and independence of the external independent auditors, including whether the provisions of non-audit services is compatible with maintaining the auditor's independence, and taking into account the opinions of management and internal audit. This shall include a review and discussion of the annual communications as to independence delivered by the external independent auditors (Independent Standards Board no. 1-“Independence Discussions with Audit Committees.”) This evaluation should include a review of and evaluation of the lead partner of the external independent auditor, and a review to ensure the lead auditor partner is meeting the regular rotation requirements. To assure continuing auditor independence the Audit Committee shall consider whether there should be a regular rotation of the audit firm itself. The Audit Committee shall present its conclusions to the Board, and if so determined by the Audit Committee, recommend that the Board take additional action to satisfy itself of the qualifications, performance and independence of the auditors.
- 5) Set clear hiring policies for NovaStar's hiring of employees or former employees of the independent auditors which guidelines shall meet the requirements of applicable law and listing standards.

D. Oversight of Internal Audit Services

- 1) Review and discuss the appointment and replacement of the Chief Auditor.
- 2) Review and discuss internal audit's findings that been reported to management, management's responses and the progress of the related corrective action plans.
- 3) Review and evaluate the adequacy of the work performed by the Chief Auditor and Internal Audit Services and ensure internal audit is independent and has adequate resources to fulfill its duties, including implementation of the annual audit plan.

E. Oversight of Compliance

- 1) Review periodically with management, including the General Counsel, and the independent auditors, any correspondence with, or other action by, regulators or governmental agencies, any material legal affairs of NovaStar and NovaStar's compliance with the applicable law and listing standards.
- 2) Review and discuss reports from management on an annual and/or as needed basis relating to; fiduciary compliance; compliance with HUD requirements; compliance with individual state banking regulators; tax developments and issues; fraud and operating losses; technology and information security; business resumption planning; and NovaStar and subsidiaries.