

CARRIAGE SERVICES INC

Form 10-Q

August 08, 2008

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

**FORM 10-Q**

**(Mark One)**

**QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**  
**For the quarterly period ended June 30, 2008**  
**OR**

**TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**  
**For the transition period from \_\_\_\_\_ to \_\_\_\_\_**  
**Commission file number: 1-11961**

**CARRIAGE SERVICES, INC.**  
(Exact name of registrant as specified in its charter)

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

**76-0423828**  
(I.R.S. Employer Identification No.)

**3040 Post Oak Boulevard, Suite 300, Houston, TX**  
(Address of principal executive offices)

**77056**  
(Zip Code)

**Registrant's telephone number, including area code: (713) 332-8400**

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  No   
Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act. (Check one):

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

(Do not check if a smaller reporting company)

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

The number of shares of the registrant's Common Stock, \$.01 par value per share, outstanding as of August 1, 2008 was 19,465,874.

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**Table of Contents****PART I FINANCIAL INFORMATION****Item 1. Financial Statements**

**CARRIAGE SERVICES, INC.**  
**CONSOLIDATED BALANCE SHEETS**  
(in thousands, except share data)

|  | <b>December<br/>31,<br/>2007</b> | <b>June 30,<br/>2008<br/>(unaudited)</b> |
|--|----------------------------------|--|
| <b>ASSETS</b>  |                                  |  |
| Current assets:  |                                  |  |
| Cash and cash equivalents  | \$ 3,446                         | \$ 8,770                                 |
| Accounts receivable, net of allowance for doubtful accounts of \$1,142 in 2007 and \$806 in 2008                   | 16,421                           | 13,240                                   |
| Inventories and other current assets   | 13,686                           | 12,800                                   |
| Total current assets   | 33,553                           | 34,810                                   |
| Preneed cemetery trust investments   | 61,114                           | 59,900                                   |
| Preneed funeral trust investments  | 68,292                           | 69,000                                   |
| Preneed receivables, net of allowance for cancellations and doubtful accounts of \$1,159 in 2007 and \$876 in 2008 | 18,333                           | 14,100                                   |
| Receivables from preneed funeral trusts  | 15,012                           | 13,900                                   |
| Property, plant and equipment, at cost, net of accumulated depreciation of \$53,304 in 2007 and \$56,001 in 2008   | 125,608                          | 126,800                                  |
| Cemetery property  | 68,028                           | 68,800                                   |
| Goodwill   | 167,263                          | 164,500                                  |
| Deferred charges and other non-current assets  | 16,402                           | 16,000                                   |
| Cemetery perpetual care trust investments  | 37,202                           | 35,800                                   |
| Total assets   | \$ 610,807                       | \$ 604,000                               |
| <b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>  |                                  |  |
| Current liabilities:   |                                  |  |
| Current portion of senior long-term debt and capital leases obligations  | \$ 1,256                         | \$ 9,000                                 |
| Accounts payable   | 6,091                            | 6,300                                    |
| Accrued liabilities  | 14,559                           | 13,700                                   |
| Total current liabilities  | 21,906                           | 20,900                                   |
| Senior long-term debt, net of current portion  | 132,994                          | 132,600                                  |
| Convertible junior subordinated debenture due in 2029 to an affiliated trust                                       | 93,750                           | 93,700                                   |
| Obligations under capital leases, net of current portion   | 4,663                            | 4,600                                    |
| Deferred preneed cemetery revenue  | 50,610                           | 51,700                                   |
| Deferred preneed funeral revenue   | 34,277                           | 25,500                                   |
| Non-controlling interests in cemetery trust investments  | 61,114                           | 59,900                                   |
| Non-controlling interests in funeral trust investments   | 68,292                           | 69,000                                   |
| Total liabilities  | 467,606                          | 458,300                                  |
| Commitments and contingencies  |                                  |  |
| Non-controlling interests in perpetual care trust investments  | 36,301                           | 35,600                                   |
| Indefinitely redeemable convertible preferred stock  |                                  | 20,000                                   |

Stockholders' equity:

Common Stock, \$.01 par value; 80,000,000 shares authorized; 19,216,000 and 19,444,000 shares issued and outstanding at December 31, 2007 and June 30, 2008, respectively

|  |            |          |
|--|------------|----------|
|  | 192        | 19       |
| Additional paid-in capital                 | 193,006    | 194,1    |
| Accumulated deficit                        | (86,298)   | (84,3    |
| Treasury stock                             |            | (1       |
| Total stockholders' equity                 | 106,900    | 109,8    |
| Total liabilities and stockholders' equity | \$ 610,807 | \$ 604,0 |

The accompanying condensed notes are an integral part of these consolidated financial statements.

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**CARRIAGE SERVICES, INC.**  
**CONSOLIDATED STATEMENTS OF OPERATIONS**  
(unaudited and in thousands, except per share data)

|  | For the three months<br>ended June 30, |            | For the six months<br>ended June 30, |           |
|--|--|------------|--------------------------------------|-----------|
|  | 2007                                   | 2008       | 2007                                 | 2008      |
| Revenues:  |  |            |                                      |           |
| Funeral  | \$ 30,074                              | \$ 32,151  | \$ 62,148                            | \$ 69,168 |
| Cemetery   | 11,242                                 | 10,548     | 21,328                               | 20,448    |
|  | 41,316                                 | 42,699     | 83,476                               | 89,616    |
| Field costs and expenses:                              |  |            |                                      |           |
| Funeral  | 19,020                                 | 21,548     | 38,180                               | 43,243    |
| Cemetery   | 7,463                                  | 7,843      | 13,762                               | 14,911    |
| Depreciation and amortization                          | 1,939                                  | 2,151      | 4,044                                | 4,271     |
| Regional and unallocated funeral and cemetery costs    | 1,780                                  | 1,407      | 3,598                                | 3,474     |
|  | 30,202                                 | 32,949     | 59,584                               | 65,899    |
| Gross profit   | 11,114                                 | 9,750      | 23,892                               | 23,717    |
| Corporate costs and expenses:                          |  |            |                                      |           |
| General, administrative and other                      | 3,516                                  | 4,780      | 7,001                                | 8,428     |
| Home office depreciation and amortization              | 346                                    | 394        | 711                                  | 804       |
|  | 3,862                                  | 5,174      | 7,712                                | 9,232     |
| Interest and other:                                    |  |            |                                      |           |
| Interest expense                                       | (4,587)                                | (4,556)    | (9,205)                              | (9,176)   |
| Interest income and other, net                         | 430                                    | 51         | 875                                  | 142       |
|  | (4,157)                                | (4,505)    | (8,330)                              | (9,034)   |
| Income from continuing operations before income taxes  | 3,095                                  | 71         | 7,850                                | 5,451     |
| Provision for income taxes                             | (1,192)                                | (28)       | (3,022)                              | (2,153)   |
| Net income from continuing operations                  | 1,903                                  | 43         | 4,828                                | 3,298     |
| Income (loss) from discontinued operations, net of tax | 52                                     | (1,426)    | 548                                  | (1,391)   |
| Net income (loss)                                      | 1,955                                  | (1,383)    | 5,376                                | 1,907     |
| Preferred stock dividend                               |  | 3          |                                      | 3         |
| Net income (loss) available to common stockholders     | \$ 1,955                               | \$ (1,386) | \$ 5,376                             | \$ 1,904  |

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|   |         |           |         |         |
|---|---------|-----------|---------|---------|
| Basic earnings (loss) per common share:                                     |         |           |         |         |
| Continuing operations   | \$ 0.10 | \$        | \$ 0.26 | \$ 0.17 |
| Discontinued operations   |         | (0.07)    | 0.03    | (0.07)  |
| Net income (loss)   | \$ 0.10 | \$ (0.07) | \$ 0.29 | \$ 0.10 |
| Diluted earnings (loss) per common share:                                   |         |           |         |         |
| Continuing operations   | \$ 0.10 | \$        | \$ 0.25 | \$ 0.17 |
| Discontinued operations   |         | (0.07)    | 0.03    | (0.07)  |
| Net income (loss)   | \$ 0.10 | \$ (0.07) | \$ 0.28 | \$ 0.10 |
| Weighted average number of common and common equivalent shares outstanding: |         |           |         |         |
| Basic   | 18,963  | 19,436    | 18,864  | 19,390  |
| Diluted   | 19,442  | 19,844    | 19,364  | 19,807  |

The accompanying condensed notes are an integral part of these consolidated financial statements.

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**CARRIAGE SERVICES, INC**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**  
**(unaudited and in thousands)**

|   | <b>For the six months<br/>ended June 30,</b> |             |
|---|--|-------------|
|   | <b>2007</b>                                  | <b>2008</b> |
| Cash flows from operating activities:   |  |             |
| Net income  | \$ 5,376                                     | \$ 1,904    |
| Adjustments to reconcile net income to net cash provided by operating activities:   |  |             |
| (Income) loss from discontinued operations  | (548)  | 1,391       |
| Depreciation and amortization   | 4,755  | 5,075       |
| Amortization of deferred financing costs  | 357  | 357         |
| Provision for losses on accounts receivable   | 1,476  | 1,769       |
| Loss on sale or disposition of business assets  | 36   |             |
| Stock-based compensation expense  | 628  | 903         |
| Deferred income taxes   | 2,720  | 2,101       |
| Other   | 41   | (29)        |
| Changes in operating assets and liabilities that provided (required) cash, net of effects from acquisitions and dispositions: |  |             |
| Accounts receivable   | (473)  | 1,462       |
| Inventories and other current assets  | 244  | (314)       |
| Deferred charges and other  | (911)  | 60          |
| Preneed funeral and cemetery trust investments  | (9,621)                                      | 5,680       |
| Accounts payable and accrued liabilities  | (1,906)                                      | (1,249)     |
| Deferred preneed funeral and cemetery revenue   | 1,836  | (6,721)     |
| Non-controlling interests in preneed funeral and cemetery trusts  | 6,122  | (535)       |
| Net cash provided by operating activities of discontinued operations  | 248  | 154         |
| <br>Net cash provided by operating activities   | <br>10,380                                   | <br>12,008  |
| Cash flows from investing activities:   |  |             |
| Acquisitions  | (28,902)                                     |             |
| Maturities of corporate investments   | 10,303                                       |             |
| Capital expenditures  | (5,600)                                      | (7,259)     |
| Withdrawal of restricted cash   | 2,888  |             |
| Net cash provided by investing activities of discontinued operations  | 2,525  | 1,029       |
| <br>Net cash used in investing activities   | <br>(18,786)                                 | <br>(6,230) |
| Cash flows from financing activities:   |  |             |
| Payments on senior long-term debt and obligations under capital leases  | (530)  | (734)       |
| Proceeds from the exercise of stock options and employee stock purchase plan  | 730  | 367         |
| Dividend on redeemable preferred stock  |  | (3)         |
| Purchase of treasury stock  |  | (90)        |
| Net cash used in financing activities of discontinued operations  | (272)  |             |
| <br>Net cash used in financing activities   | <br>(72)                                     | <br>(460)   |



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|  |           |          |
|--|-----------|----------|
| Net increase (decrease) in cash and cash equivalents | (8,478)   | 5,318    |
| Cash and cash equivalents at beginning of period     | 22,820    | 3,446    |
| Cash and cash equivalents at end of period           | \$ 14,342 | \$ 8,764 |

The accompanying condensed notes are an integral part of these consolidated financial statements.

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**CARRIAGE SERVICES, INC.  
CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
(unaudited)**

**1. BASIS OF PRESENTATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

(a) The Company

Carriage Services, Inc. ( Carriage or the Company ) is a leading provider of death care services and merchandise in the United States. As of June 30, 2008, the Company owned and operated 136 funeral homes in 25 states and 32 cemeteries in 11 states.

(b) Principles of Consolidation

The accompanying consolidated financial statements include the Company and its subsidiaries. All significant intercompany balances and transactions have been eliminated.

(c) Interim Condensed Disclosures

The information for the three and six month periods ended June 30, 2007 and 2008 is unaudited, but in the opinion of management, reflects all adjustments which are normal, recurring and necessary for a fair presentation of financial position and results of operations as of and for the interim periods presented. Certain information and footnote disclosures, normally included in annual financial statements, have been condensed or omitted. The accompanying consolidated financial statements have been prepared consistent with the accounting policies described in our annual report on Form 10-K for the year ended December 31, 2007, and should be read in conjunction therewith.

(d) Cash Equivalents

The Company considers all highly liquid investments purchased with an original maturity of three months or less to be cash equivalents.

(e) Use of Estimates

The preparation of the consolidated financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses. On an on-going basis, we evaluate estimates and judgments, including those related to revenue recognition, realization of accounts receivable, intangible assets, property and equipment and deferred tax assets. We base our estimates on historical experience, third party data and assumptions that we believe to be reasonable under the circumstances. The results of these considerations form the basis for making judgments about the amount and timing of revenues and expenses, the carrying value of assets and the recorded amounts of liabilities. Actual results may differ from these estimates and such estimates may change if the underlying conditions or assumptions change. Historical performance should not be viewed as indicative of future performance, as there can be no assurance the margins, operating income and net earnings as a percentage of revenues will be consistent from year to year.

(f) Business Combinations

Tangible and intangible assets acquired and liabilities assumed are recorded at fair value and goodwill is recognized for any difference between the price of the acquisition and our fair value determination. We customarily estimate our purchase costs and other related transactions known at closing of the acquisition. To the extent that information not available to us at the closing date subsequently becomes available during the allocation period we may adjust goodwill, assets, or liabilities associated with the acquisition.

(g) Discontinued Operations

In accordance with the Company's strategic portfolio optimization model, non-strategic businesses are reviewed to determine whether the business should be sold and proceeds redeployed elsewhere. A marketing plan is then developed for those locations which are identified as held for sale. When the Company receives a letter of intent and financing commitment from the buyer and the sale is expected to occur within one year, the location is no longer reported within the Company's continuing operations. The assets and liabilities associated with the location are reclassified as held for sale on the balance sheet and the operating results, as well as impairments, are presented on a comparative basis in the discontinued operations section of the consolidated statements of operations, along with the income tax effect.

**Table of Contents****(h) Stock Plans and Stock-Based Compensation**

The Company has stock-based employee compensation plans in the form of restricted stock, performance units, stock option and employee stock purchase plans, which are described in more detail in Note 18 to the consolidated financial statements in our Form 10-K for the year ended December 31, 2007. The Company accounts for stock-based compensation under SFAS No. 123R, Share-Based Payment ( FAS No. 123R ). The Company adopted FAS No. 123R in the first quarter of 2006, using the modified prospective application method. FAS No. 123R requires companies to recognize compensation expense in an amount equal to the fair value of the share-based awards issued to employees over the period of vesting and applies to all transactions involving issuance of equity by a company in exchange for goods and services, including employee services. The fair value of options or awards containing options is determined using the Black-Scholes valuation model.

**(i) Fair Value Measurements**

FAS 157, which the Company adopted effective January 1, 2008, defines fair value as the price that would be received in the sale of an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. FAS 157 requires disclosure of the extent to which fair value is used to measure financial assets and liabilities, the inputs utilized in calculating valuation measurements, and the effect of the measurement of significant unobservable inputs on earnings, or changes in net assets, as of the measurement date.

FASB Staff Position No. FAS 157-2 (FSP 157-2), issued in February 2008, delayed the effective date of FAS No. 157 for nonfinancial assets and nonfinancial liabilities, except for items that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually), until fiscal years beginning after November 15, 2008. We adopted FAS No. 157 effective January 1, 2008, with the exceptions allowed under FSP 157-2, the adoption of which has not affected our financial position or results of operations but did result in additional required disclosures, which are provided in Note 18.

In February 2007, the FASB issued Statement No. 159, The Fair Value Option for Financial Assets and Financial Liabilities Including an Amendment of FASB Statement No. 115 ( FAS No. 159 ). FAS No. 159 permits entities to choose to measure many financial instruments and certain other items at fair value that are not currently required to be measured at fair value. FAS No. 159 is effective for fiscal years beginning after November 15, 2007. We have not elected to apply the provisions of Statement No. 159 to any additional financial instruments; therefore, the adoption of Statement No. 159 effective January 1, 2008 has not affected our financial position or results of operations.

**2. RECENTLY ISSUED ACCOUNTING STANDARDS**

In December 2007, the FASB issued FAS No. 141(revised 2007), Business Combinations ( FAS No. 141R ). FAS No. 141R requires the acquiring entity to recognize the assets acquired, the liabilities assumed and any non-controlling interest in the acquiree at the acquisition date, measured at the fair values as of that date. Goodwill is measured as a residual of the fair values at acquisition date. Acquisition related costs are recognized separately from the acquisition. This statement is effective as of the beginning of the first fiscal year that begins after December 15, 2008. The Company is currently evaluating the impact, if any, of the adoption of FAS No. 141R will have on its consolidated financial statements.

In December 2007, the FASB issued Statement No. 160, Noncontrolling Interests in Consolidated Financial Statements , an amendment of ARB No. 51 ( FAS No. 160 ). FAS No. 160 requires that non-controlling interests in a subsidiary be reported as equity in the consolidated financial statements, the attributable net income be identified and presented on the face of the consolidated statement of income and changes in the ownership be accounted for consistently. The statement also includes requirements when an interest is deconsolidated. Disclosure should be sufficient to clearly identify and distinguish between the interests of the reporting entity and that of the non-controlling interest owners. This statement is effective as of the beginning of the first fiscal year that begins after December 15, 2008. The Company is currently evaluating the impact, if any, of the adoption of FAS No. 160 will have on its consolidated financial statements.

**3. CHANGE IN ACCOUNTING FOR INCOME TAX UNCERTAINTIES**

In June 2006, FASB issued FASB Interpretation No. 48 Accounting for Uncertainty in Income Taxes ( FIN 48 ). FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with FASB Statement No. 109, Accounting for Income Taxes. FIN 48 prescribes how tax benefits for

uncertain tax positions are to be recognized, measured, and derecognized in financial statements; requires certain disclosures of uncertain tax matters; specifies how reserves for uncertain tax position should be classified on the balance sheet; and provides transition and interim period guidance, among other provisions. FIN 48 is effective for fiscal years beginning after December 15, 2006 and was adopted by the Company at the beginning of the first quarter of 2007. The Company has reviewed its income tax positions and identified certain tax deductions, primarily related to business acquisitions that are not certain. The cumulative effect of adopting FIN 48 has been recorded as a reduction to the 2007 opening balance of Retained Earnings and an increase in noncurrent liabilities in the amount of \$0.2 million to the January 1, 2007 retained earnings balance.

The Company has unrecognized tax benefits for Federal and state income tax purposes totaling \$6.0 million as of December 31, 2007, resulting from deductions totaling \$15.2 million on Federal returns and \$13.4 million on various state returns. The effect of applying FIN 48 for the six months ended June 30, 2008 was not material to the Company's operations. The Company

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has federal and state net operating loss carryforwards exceeding these deductions, and has accounted for these unrecognized tax benefits by reducing the net operating loss carryforwards by the amount of these unrecognized deductions. In certain states without net operating loss carryforwards, the Company has previously reduced its taxes payable by deductions that are not considered more likely than not. The cumulative effect of adopting FIN 48 specifically relates to those state income tax returns.

The entire balance of unrecognized tax benefits, if recognized, would affect the Company's effective tax rate. The Company does not anticipate a significant increase or decrease in its unrecognized tax benefits during the next twelve months. The amount of penalty and interest recognized in the balance sheet and statement of operations was not material. The Company's policy with respect to potential penalties and interest is to record them as other expense and interest expense, respectively.

**4. DISCONTINUED OPERATIONS**

The Company continually reviews locations to optimize the sustainable earning power and return on invested capital of the Company. The Company's strategy, the Strategic Portfolio Optimization Model, uses strategic ranking criteria to identify disposition candidates. The execution of this strategy entails selling non-strategic businesses.

Two funeral home businesses were sold during June 2008 for approximately \$1.0 million and recognized a loss of \$2.4 million. No businesses were sold during the first quarter of 2008.

In the first quarter of 2007, the Company sold two funeral home businesses for approximately \$2.4 million and recognized a gain of \$0.7 million.

No businesses were held for sale at December 31, 2007 and June 30, 2008.

The operating results of businesses discontinued during the periods presented, as well as gains or losses on the disposal, are presented on a comparative basis in the discontinued operations section of the consolidated statements of operations, along with the income tax effect. Revenues and operating income for the businesses presented in the discontinued operations section are as follows (in thousands):

|  | For the three months<br>ended June 30, |            | For the six months<br>ended June 30, |            |
|--|--|------------|--------------------------------------|------------|
|  | 2007                                   | 2008       | 2007                                 | 2008       |
| Revenues                                   | \$ 413                                 | \$ 241     | \$ 1,042                             | \$ 477     |
| Operating income                           | \$ 33                                  | \$ 88      | \$ 163                               | \$ 144     |
| (Gain) loss on sale                        | (51)                                   | 2,369      | (728)                                | 2,369      |
| Provision (benefit) for income taxes       | 32                                     | (855)      | 343                                  | (834)      |
| Income (loss) from discontinued operations | \$ 52                                  | \$ (1,426) | \$ 548                               | \$ (1,391) |

**5. PRENEED TRUST INVESTMENTS***Preneed cemetery trust investments*

Preneed cemetery trust investments represent trust fund assets that the Company will withdraw when the merchandise or services are provided. The cost and market values associated with preneed cemetery trust investments at June 30, 2008 are detailed below (in thousands). The Company believes the unrealized losses related to trust investments are temporary in nature.

|                                 | Cost     | Unrealized<br>Gains | Unrealized<br>Losses | Market   |
|---------------------------------|----------|---------------------|----------------------|----------|
| Cash and money market accounts  | \$ 5,319 | \$                  | \$                   | \$ 5,319 |
| Fixed income securities:        |          |                     |                      |          |
| U.S. and Agency obligations     | 8,588    | 153                 | (5)                  | 8,736    |
| State and municipal obligations | 351      | 6                   |                      | 357      |
| Corporate                       | 1,659    | 25                  | (3)                  | 1,681    |

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|                                      |           |          |            |           |
|--------------------------------------|-----------|----------|------------|-----------|
| Other                                | 4         |          |            | 4         |
| Common stock                         | 18,807    | 1,116    | (2,188)    | 17,735    |
| Mutual funds:                        |           |          |            |           |
| Equity                               | 18,756    | 1,216    | (572)      | 19,400    |
| Fixed income                         | 6,778     | 170      | (435)      | 6,513     |
| Trust investments                    | \$ 60,262 | \$ 2,686 | \$ (3,203) | \$ 59,745 |
| Accrued investment income            | \$ 175    |          |            | \$ 175    |
| Trust assets                         |           |          |            | \$ 59,920 |
| Market value as a percentage of cost |           |          |            | 99.4%     |

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The estimated maturities of the fixed income securities included above are as follows (in thousands):

|                          | Cost      | Net<br>Unrealized<br>Gain | Market    |
|--------------------------|-----------|---------------------------|-----------|
| Due in one year or less  | \$ 1,695  | \$ 15                     | \$ 1,710  |
| Due in one to five years | 8,116     | 146                       | 8,262     |
| Due in five to ten years | 786       | 16                        | 802       |
| Thereafter               | 4         |                           | 4         |
|                          | \$ 10,601 | \$ 177                    | \$ 10,778 |

*Preneed funeral trust investments*

Preneed funeral trust investments represent trust fund assets that the Company expects to withdraw when the services and merchandise are provided. Such contracts are secured by funds paid by the customer to the Company. Preneed funeral receivables and trust investments are reduced by the trust investment earnings the Company has been allowed to withdraw prior to performance by the Company and amounts received from customers that are not required to be deposited into trust, pursuant to various state laws.

The cost and market values associated with preneed funeral trust investments at June 30, 2008 are detailed below (in thousands). The Company believes the unrealized losses related to trust investments are temporary in nature.

|                                      | Cost      | Unrealized<br>Gains | Unrealized<br>Losses | Market    |
|--------------------------------------|-----------|---------------------|----------------------|-----------|
| Cash and money market accounts       | \$ 18,676 | \$                  | \$                   | \$ 18,676 |
| Fixed income securities:             |           |                     |                      |           |
| U.S. Treasury                        | 6,786     | 208                 |                      | 6,994     |
| State and municipal obligations      | 514       | 19                  |                      | 533       |
| Corporate                            | 1,447     | 23                  | (4)                  | 1,466     |
| Mortgage Backed Securities           | 3,705     | 38                  | (36)                 | 3,707     |
| Common stock                         | 15,617    | 782                 | (1,198)              | 15,201    |
| Mutual funds:                        |           |                     |                      |           |
| Equity                               | 14,603    | 1,166               | (909)                | 14,860    |
| Fixed income                         | 7,828     | 42                  | (229)                | 7,641     |
| Trust investments                    | \$ 69,176 | \$ 2,278            | \$ (2,376)           | \$ 69,078 |
| Market value as a percentage of cost |           |                     |                      | 99.9%     |

The estimated maturities of the fixed income securities included above are as follows (in thousands):

|                          | Cost     | Net<br>Unrealized<br>Gain/(Loss) | Market   |
|--------------------------|----------|----------------------------------|----------|
| Due in one year or less  | \$ 3,544 | \$ (113)                         | \$ 3,431 |
| Due in one to five years | 8,790    | 355                              | 9,145    |
| Due in five to ten years | 118      | 6                                | 124      |

\$ 12,452      \$      248      \$ 12,700

Upon cancellation of a preneed funeral or cemetery contract, a customer is generally entitled to receive a refund of the corpus and some or all of the earnings held in trust. In certain jurisdictions, the Company is obligated to fund any shortfall if the amounts deposited by the customer exceed the funds in trust including some or all investment income. As a result, when realized or unrealized losses of a trust result in the trust being under-funded, the Company assesses whether it is responsible for replenishing the corpus of the trust, in which case a loss provision would be recorded. No loss amounts have been required to be recognized for the periods presented herein.

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**Table of Contents***Trust Investment Security Transactions*

Cemetery and funeral trust investment security transactions recorded in Interest income and other, net in the Consolidated Statement of Operations (unaudited) for the three and six months ended June 30, 2007 and 2008 are as follows (in thousands):

|  | For the three months<br>ended June 30, |          | For the six months<br>ended June 30, |          |
|--|--|----------|--------------------------------------|----------|
|  | 2007                                   | 2008     | 2007                                 | 2008     |
| Investment income (loss)                                   | \$ 960                                 | \$ 1,153 | \$ 1,824                             | \$ 2,604 |
| Realized gains   | 1,102                                  | 268      | 1,480                                | 373      |
| Realized losses  | (120)                                  | (22)     | (294)                                | (132)    |
| Expenses   | (379)                                  | (911)    | (551)                                | (1,217)  |
| Increase in non-controlling interests in trust investments | (1,563)                                | (488)    | (2,459)                              | (1,628)  |
|  | \$                                     | \$       | \$                                   | \$       |

**6. RECEIVABLES FROM PRENEED FUNERAL TRUSTS**

The receivables from preneed funeral trusts represent assets in trusts which are controlled and operated by third parties in which the Company does not have a controlling financial interest (less than 50%) in the trust assets. The Company accounts for these investments at cost (in thousands).

|   | December<br>31,<br>2007 | June 30,<br>2008 |
|---|-------------------------|------------------|
| Amount due from preneed funeral trust funds | \$ 16,717               | \$ 15,495        |
| Less: allowance for contract cancellation   | (1,705)                 | (1,581)          |
|   | \$ 15,012               | \$ 13,914        |

**7. CONTRACTS SECURED BY INSURANCE**

Certain preneed funeral contracts are secured by life insurance contracts. Generally, the proceeds of the life insurance policies have been assigned to the Company and will be paid upon the death of the insured. The proceeds will be used to satisfy the beneficiary's obligations under the preneed contract for services and merchandise. The preneed funeral contracts secured by insurance totaled \$193 million at June 30, 2008, and are not included in the Company's consolidated balance sheet.

**8. CEMETERY PERPETUAL CARE TRUST INVESTMENTS**

The Company is required by state law to pay a portion of the proceeds from the sale of cemetery property interment rights into perpetual care trust funds. The cost and market values associated with the trust investments held in perpetual care trust funds at June 30, 2008 are detailed below (in thousands). The Company believes the unrealized losses related to the trust investments are temporary in nature and not material.

|                                 | Cost     | Unrealized<br>Gains | Unrealized<br>Losses | Market   |
|---------------------------------|----------|---------------------|----------------------|----------|
| Cash and money market accounts  | \$ 3,524 | \$                  | \$                   | \$ 3,524 |
| Fixed income securities:        |          |                     |                      |          |
| U.S. and Agency Obligations     | 4,760    | 89                  |                      | 4,849    |
| State and municipal obligations | 488      | 9                   |                      | 497      |
| Corporate                       | 826      | 33                  |                      | 859      |
| Mortgage backed securities      | 272      |                     |                      | 272      |

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|                                      |           |          |            |           |
|--------------------------------------|-----------|----------|------------|-----------|
| Common stock                         | 12,389    | 919      | (1,778)    | 11,530    |
| Mutual funds:                        |           |          |            |           |
| Equity                               | 8,633     | 776      | (454)      | 8,955     |
| Fixed income                         | 5,500     | 149      | (375)      | 5,274     |
| Trust investments                    | \$ 36,392 | \$ 1,975 | \$ (2,607) | \$ 35,760 |
| Accrued net investment income        | \$ 78     |          |            | 78        |
| Trust assets                         |           |          |            | \$ 35,838 |
| Market value as a percentage of cost |           |          |            | 98.5%     |

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The estimated maturities of the fixed income securities included above are as follows (in thousands):

|                          | Cost     | Net<br>Unrealized<br>Gain | Market   |
|--------------------------|----------|---------------------------|----------|
| Due in one year or less  | \$ 848   | \$ 10                     | \$ 858   |
| Due in one to five years | 3,847    | 89                        | 3,936    |
| Due in five to ten years | 1,651    | 32                        | 1,683    |
| Thereafter               |          |                           |          |
|                          | \$ 6,346 | \$ 131                    | \$ 6,477 |

Non-controlling interests in cemetery perpetual care trusts represent the corpus of those trusts plus undistributed income. The components of non-controlling interests in cemetery perpetual care trusts as of December 31, 2007 and June 30, 2008 are as follows (in thousands):

|                               | December<br>31,<br>2007 | June 30,<br>2008 |
|-------------------------------|-------------------------|------------------|
| Trust assets, at market value | \$ 37,202               | \$ 35,838        |
| Pending withdrawals of income | (901)                   | (176)            |
| Non-controlling interests     | \$ 36,301               | \$ 35,662        |

*Trust Investment Security Transactions*

Perpetual care trust investment security transactions recorded in Interest income and other, net in the Consolidated Statement of Operations (unaudited) for the three and six months ended June 30, 2007 and 2008 are as follows (in thousands).

|  | For the three months<br>ended June 30, |       | For the six months<br>ended June 30, |       |
|--|--|-------|--------------------------------------|-------|
|  | 2007                                   | 2008  | 2007                                 | 2008  |
| Undistributable realized gains   | \$ 603                                 | \$ 62 | \$ 976                               | \$ 96 |
| Undistributable realized losses  | (30)                                   | (8)   | (57)                                 | (65)  |
| Decrease (increase) in non-controlling interests in perpetual care trust investments | (573)                                  | (54)  | (919)                                | (31)  |
|  | \$                                     | \$    | \$                                   | \$    |

**9. MAJOR SEGMENTS OF BUSINESS**

Carriage conducts funeral and cemetery operations only in the United States. The following table presents revenue, pre-tax income from continuing operations and total assets by segment (in thousands):

|                                      | Funeral   | Cemetery  | Corporate | Consolidated |
|--------------------------------------|-----------|-----------|-----------|--------------|
| Revenues from continuing operations: |           |           |           |              |
| Six months ended June 30, 2008       | \$ 69,168 | \$ 20,448 | \$        | \$ 89,616    |
| Six months ended June 30, 2007       | \$ 62,148 | \$ 21,328 | \$        | \$ 83,476    |

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Income (loss) from continuing operations  
before income taxes:

|                                |           |          |            |          |
|--------------------------------|-----------|----------|------------|----------|
| Six months ended June 30, 2008 | \$ 20,353 | \$ 3,097 | \$(17,999) | \$ 5,451 |
| Six months ended June 30, 2007 | \$ 18,944 | \$ 4,606 | \$(15,700) | \$ 7,850 |

Total assets:

|                   |           |           |           |           |
|-------------------|-----------|-----------|-----------|-----------|
| June 30, 2008     | \$362,429 | \$204,883 | \$ 36,753 | \$604,065 |
| December 31, 2007 | \$371,921 | \$206,840 | \$ 32,046 | \$610,807 |

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**Table of Contents****10. SUPPLEMENTAL DISCLOSURE OF STATEMENT OF OPERATIONS INFORMATION**

The following information is supplemental disclosure for the Consolidated Statements of Operations (in thousands):

|                        | For the three months<br>ended June 30, |           | For the six months<br>ended June 30, |           |
|------------------------|--|-----------|--------------------------------------|-----------|
|                        | 2007                                   | 2008      | 2007                                 | 2008      |
| Revenues               |  |           |                                      |           |
| Goods                  |  |           |                                      |           |
| Funeral                | \$ 12,718                              | \$ 13,129 | \$ 26,136                            | \$ 28,079 |
| Cemetery               | 8,069                                  | 7,075     | 15,091                               | 13,498    |
| Total goods            | \$ 20,787                              | \$ 20,204 | \$ 41,227                            | \$ 41,577 |
| Services               |  |           |                                      |           |
| Funeral                | \$ 17,356                              | \$ 19,022 | \$ 36,012                            | \$ 41,089 |
| Cemetery               | 3,173                                  | 3,473     | 6,237                                | 6,950     |
| Total services         | \$ 20,529                              | \$ 22,495 | \$ 42,249                            | \$ 48,039 |
| Total revenues         | \$ 41,316                              | \$ 42,699 | \$ 83,476                            | \$ 89,616 |
| Cost of revenues       |  |           |                                      |           |
| Goods                  |  |           |                                      |           |
| Funeral                | \$ 10,627                              | \$ 11,419 | \$ 21,381                            | \$ 23,183 |
| Cemetery               | 5,654                                  | 5,586     | 10,249                               | 10,477    |
| Total goods            | \$ 16,281                              | \$ 17,005 | \$ 31,630                            | \$ 33,660 |
| Services               |  |           |                                      |           |
| Funeral                | \$ 8,392                               | \$ 10,129 | \$ 16,798                            | \$ 20,060 |
| Cemetery               | 1,810                                  | 2,257     | 3,514                                | 4,434     |
| Total services         | \$ 10,202                              | \$ 12,386 | \$ 20,312                            | \$ 24,494 |
| Total cost of revenues | \$ 26,483                              | \$ 29,391 | \$ 51,942                            | \$ 58,154 |

**Table of Contents****11. SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION**

The following information is supplemental disclosure for the Consolidated Statement of Cash Flows (in thousands):

|  | For the six months ended<br>June 30, |          |
|--|--------------------------------------|----------|
|  | 2007                                 | 2008     |
| Cash paid for interest and financing costs   | \$ 9,009                             | \$ 9,007 |
| Cash paid for income taxes   | 178                                  | 542      |
| Restricted common stock issued to officers and directors   | 1,234                                | 1,170    |
| Restricted common stock withheld for payroll taxes   |                                      | 93       |
| Net deposits into preneed funeral trusts   | (1,173)                              | (71)     |
| Net (deposits) withdrawals into/from preneed cemetery trusts   | (3,115)                              | 1,091    |
| Net (deposits) withdrawals into/from perpetual care trusts   | (1,030)                              | (580)    |
| Net (increase) decrease in preneed funeral receivables   | (3,898)                              | 3,737    |
| Net (increase) decrease in preneed cemetery receivables  | (756)                                | 405      |
| Net withdrawals of receivables from preneed funeral trusts   | 351                                  | 1,098    |
| Net change in preneed funeral receivables increasing (decreasing) deferred revenue                     | 3,279                                | (8,695)  |
| Net change in preneed cemetery receivables increasing (decreasing) deferred revenue                    | (1,443)                              | 1,974    |
| Net deposits in preneed funeral trust accounts increasing noncontrolling interests                     | 1,173                                | 71       |
| Net deposits (withdrawals) in cemetery trust accounts increasing (decreasing) noncontrolling interests | 3,115                                | (1,091)  |
| Net deposits in perpetual care trust accounts increasing noncontrolling interests                      | 1,834                                | 485      |
| Restricted cash investing and financing activities:  |                                      |          |
| Proceeds from the sale of available for sale securities within the funeral and cemetery trusts         | 17,706                               | 80,625   |
| Purchases of available for sale securities within the funeral and cemetery trusts                      | 32,873                               | 97,243   |

**12. DEBT**

The Company has outstanding a principal amount of \$130 million of 7.875% Senior Notes, due in 2015, and \$93.75 million of 7.00% subordinated debt payable to an unconsolidated affiliate, Carriage Services Capital Trust, due in 2029. The Company also has a \$35 million senior secured revolving credit facility (the credit facility) for which borrowings bear interest at prime or LIBOR options with the current LIBOR option set at LIBOR plus 275 basis points and is collateralized by all personal property and by funeral home real property in certain states. Interest is payable quarterly. The credit facility matures in 2010 is currently undrawn except for \$0.4 million in letters of credit that were issued and outstanding under the credit facility at June 30, 2008.

Carriage, the parent entity, has no material assets or operations independent of its subsidiaries. All assets and operations are held and conducted by subsidiaries, each of which (except for Carriage Services Capital Trust which is a single purpose entity that holds the debentures issued in connection with our TIDES) have fully and unconditionally guaranteed our obligations under the 7.875% Senior Notes. Additionally, the Company does not currently have any significant restrictions on our ability to receive dividends or loans from any subsidiary guarantor under the 7.875% Senior Notes.

**13. COMMITMENTS AND CONTINGENCIES***Litigation*

We are a party to various litigation matters and proceedings. For each of our outstanding legal matters, we evaluate the merits of the case, our exposure to the matter, possible legal or settlement strategies, and the likelihood of an unfavorable outcome. We intend to defend ourselves in the lawsuits described herein; however, if we determine that

an unfavorable outcome is probable and can be reasonably estimated, we establish the necessary accruals. We hold certain insurance policies that may reduce cash outflows with respect to an adverse outcome of certain of these litigation matters.

*Spencer Cranney, et al., v. Carriage Services, Inc., et al.*, United States District Court, District of Nevada, Case No. 2:07-cv-01587 On November 28, 2007, five former Funeral Directors filed suit for themselves and on behalf of all hourly, non-exempt employees of Carriage in the United States District Court for the District of Nevada. Plaintiffs allege violations of state wage and hour laws and the federal Fair Labor Standards Act (FLSA), as well as related tort and contract claims. Specifically, Plaintiffs allege that Carriage failed to properly compensate employees for time spent on community work, on-call time, pre-need appointments, and training, failed to provide required meal and rest breaks under California state law, and failed to maintain proper records. Carriage filed its Answer to the Complaint on January 28, 2008, denying all material allegations and asserting

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appropriate affirmative defenses. On February 29, 2008, the Court granted Plaintiffs' motion for conditional certification under the FLSA. The parties have effectuated notice of the lawsuit to all potential class members pursuant to the Court's order. The case is currently in its opt-in period, which ends on August 5. On May 20, 2008, a separate putative collective action was filed in the Southern District of Florida against Carriage. Because the Plaintiff, Omar Brown, had filed a consent form to participate in the Cranny litigation prior to bringing this action, Carriage filed a motion to dismiss or transfer the action to the District of Nevada. The motion is pending. The Company will defend these lawsuits vigorously. Because these lawsuits are in the preliminary stages, we are unable to evaluate the likelihood of an unfavorable outcome to the Company or to estimate the amount or range of any potential loss, if any, at this time.

*Means v. Carriage Cemetery Services, Inc., et al.*, Indiana Superior Court, Marion County, Indiana, Case No. 49D12-0704-PL-016504. On April 20, 2007, Plaintiff Cecilia Means ( Plaintiff ) filed a putative class action alleging that one or more of the current and past owners of Grandview Cemetery in Madison, Indiana including the Carriage subsidiaries that owned the cemetery from January 1997 until February 2001 and one or more of the bank trustees who served as trustee of Grandview Cemetery's Pre-Arrangement Trust Fund (the Grandview Trust Fund ), improperly withdrew funds from the Grandview Trust Fund. Carriage denies all material allegations because the subject withdrawals occurred in a period other than during Carriage's ownership, and filed a motion for summary judgment with respect to Plaintiff's claims against it. Plaintiff, in turn, has also filed a motion to certify a class. The Court has suspended the briefing schedule on Plaintiff's motion to certify and the hearing on Carriage's motion for summary judgment while the parties explore the possibility of settlement. The Company will defend this lawsuit vigorously. Because the lawsuit is in its preliminary stages, we are unable to evaluate the likelihood of an unfavorable outcome to the Company or to estimate the amount or range of any potential loss, if any, at this time.

*Leathermon, et al. v. Grandview Memorial Gardens, Inc., et al.*, United States District Court, Southern District of Indiana, Case No. 4:07-cv-137. On August 17, 2007, five plaintiffs ( Plaintiffs ) filed a putative class action against the current and past owners of Grandview Cemetery in Madison, Indiana including the Carriage subsidiaries that owned the cemetery from January 1997 until February 2001 on behalf of all individuals who purchased cemetery and burial goods and services at Grandview Cemetery. Plaintiffs claim that the cemetery owners performed burials negligently, breached plaintiffs' contracts, and made misrepresentations regarding the cemetery. On October 15, 2007, the case was removed from Jefferson County Circuit Court, Indiana to the Southern District of Indiana. The Company has filed its answer denying the claims and will defend this action vigorously. Because the lawsuit is in its preliminary stages, we are unable to evaluate the likelihood of an unfavorable outcome to the Company or to estimate the amount or range of any potential loss, if any, at this time.

*Kendall v. Carriage Funeral Holdings, Inc., et al.*, Indiana Circuit Court, Jefferson County, Indiana, Case No. 39C01-0707-CT-386 (filed July 27, 2007); *Lapine Hillard, et al. v. Carriage Funeral Holdings, Inc., et al.*, Indiana Circuit Court, Jefferson County, Case No. 39C01-0708-CT-398 (filed August 7, 2007); *Lawson v. Carriage Funeral Holdings, Inc.*, Indiana Circuit Court, Jefferson County, Indiana, Case No. 39C01-0708-CT-429 (filed August 17, 2007); *Wiley, et al. v. Carriage Funeral Holdings, Inc., et al.*, Indiana Circuit Court, Jefferson County, Indiana, Case No. 39C01-0706-CT-287 (filed June 6, 2007). In these individual actions, Plaintiffs allege improper handling of remains or improper burial practices by Vail-Holt Funeral Home in Madison, Indiana and/or Grandview Memorial Gardens, Inc. Carriage has denied these allegations because these burials all occurred before Carriage owned Grandview Cemetery and Vail-Holt Funeral Home. Carriage has moved to dismiss Plaintiffs' claims with respect to the funeral home because, among other reasons, Carriage assumed only Vail-Holt's assets, and not its liabilities, under the Asset Purchase Agreement. Carriage has also moved to dismiss certain claims with respect to Grandview Cemetery because Plaintiffs released Grandview Cemetery from contractual liability pursuant to an exculpatory clause. The court has not yet ruled on Carriage's motions. The Company will defend these actions vigorously. Because the lawsuit is in its preliminary stages, we are unable to evaluate the likelihood of an unfavorable outcome to the Company or to estimate the amount or range of any potential loss, if any, at this time.

**14. REDEEMABLE PREFERRED STOCK**

During the second quarter of 2008 the Company issued 20,000 shares of a newly designated series of mandatorily redeemable convertible preferred stock (the Preferred Stock ) to a key employee in exchange for certain intellectual



property rights. The preferred stock has a liquidation value of \$10 per share and is convertible at any time prior to February 22, 2013 into the Company's common stock on a one-for-one basis. If not converted into the Company's common stock, the preferred stock is subject to mandatory redemption on February 22, 2013. Dividends accrue on a cumulative basis at the rate of 7% per year, payable quarterly.

**15. SHARE REPURCHASE PROGRAM**

During June 2008, the Board of Directors approved the repurchase of up to an aggregate of \$5 million of the Company's common stock. The repurchase will be made in the open market or through privately negotiated transactions subject to market conditions, normal trading restrictions and other relevant factors. Through June 30, 2008, the Company repurchased 17,900 shares of common stock at an aggregate cost of \$121,766 and an average cost per share of \$6.80.

**Table of Contents****16. STOCK-BASED COMPENSATION***Stock options and employee stock purchase plan*

No stock options were awarded during the six months ended June 30, 2008. For the second quarter of 2008, employees purchased a total of 16,800 shares of common stock through the employee stock purchase plan ( ESPP ) at a weighted average price of \$5.61 per share. The Company recorded pre-tax stock-based compensation expense for the ESPP and for vesting of stock options totaling \$31,000 and \$42,000 for the three months ended June 30, 2007 and 2008, and \$70,000 and \$108,000 for the six months ended June 30, 2007 and 2008, respectively. As of March 31, 2008, all outstanding stock options had vested.

The fair value of the right (option) to purchase shares under the ESPP during 2007 and 2008, respectively, is estimated on the date of grant to the four quarterly purchase dates using the Black-Sholes option-pricing model with the following weighted average assumptions:

| <b>Employee Stock Purchase Plan</b> | 2007                          | 2008                          |
|-------------------------------------|-------------------------------|-------------------------------|
| Dividend yield                      | None                          | None                          |
| Expected volatilities               | 23.65%                        | 39.48%                        |
| Risk-free interest rate             | 4.94%, 4.91%, 4.96%,<br>5.00% | 3.26%, 3.32%, 3.25%,<br>3.17% |
| Expected life (in years)            | 0.25, .50, .75, 1             | 0.25, .50, .75, 1             |

Expected volatilities are based on the historical volatility during the previous twelve months of the underlying common stock. The risk-free rate for the quarterly purchase periods is based on the U.S. Treasury yields in effect at the time of grant (January 1).

*Common stock grants*

The Company granted 155,428 shares of restricted common stock to certain officers and employees during the first quarter of 2008 and none in the second quarter. The restricted stock vests in 25% increments over four years. The Company recorded \$317,000 and \$616,000 in pre-tax compensation expense for the six months ended June 30, 2007 and 2008, respectively, related to the vesting of previous restricted stock awards. As of June 30, 2008, there was \$2.7 million of total unrecognized compensation costs related to unvested restricted stock awards, which is expected to be recognized over a weighted average period of approximately 3.0 years.

Directors may elect to receive all or a portion of their fees in stock. During the three months ended June 30, 2007 and 2008, the Company issued unrestricted common stock to directors totaling 11,658 and 19,111 shares, respectively, in lieu of payment in cash for their fees, the value of which totaled \$93,000 and \$137,000, respectively, and is included in general, administrative and other expenses. During the six months ended June 30, 2007 and 2008, the Company issued unrestricted common stock to directors totaling 14,200 and 22,394 shares, respectively, in lieu of payment in cash for their fees, the value of which totaled \$111,000 and \$162,000, respectively.

**17. RELATED PARTY TRANSACTIONS**

The Company engaged a law firm in which one of its partners is the spouse of the Company's Vice President and General Counsel. The firm was used for various legal matters during the period. During the six months ended June 30, 2008, the Company paid the law firm \$277,000.

**18. FAIR VALUE MEASUREMENTS**

FAS 157, which the Company adopted effective January 1, 2008, defines fair value as the price that would be received in the sale of an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. FAS 157 requires disclosure of the extent to which fair value is used to measure financial assets and liabilities, the inputs utilized in calculating valuation measurements, and the effect of the measurement of significant unobservable inputs on earnings, or changes in net assets, as of the measurement date. FAS 157 establishes a three-level valuation hierarchy based upon the transparency of inputs utilized in the measurement and valuation of financial assets or liabilities as of the measurement date:

Level 1 unadjusted quoted prices for identical assets or liabilities in active markets;

Level 2 quoted prices for similar assets and liabilities in active markets, quoted prices for identical or similar assets or liabilities in markets that are not active, and inputs other than quoted market prices that are observable or that can be corroborated by observable market data by correlation; and

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Level 3 unobservable inputs based upon the reporting entity's internally developed assumptions which market participants would use in pricing the asset or liability.

The Company evaluated its financial assets and liabilities for those financial assets and liabilities that met the criteria of the disclosure requirements and fair value framework of FAS 157. The Company identified investments in fixed income securities, common stock and mutual funds presented within the preneed and perpetual trust investments categories on the consolidated balance sheets as having met such criteria.

The Company accounts for its investments under SFAS No. 115, Accounting for Certain Investments in Debt and Equity Instruments (as amended), which established standards of financial accounting and reporting for investments in equity instruments that have readily determinable fair values and for all investments in debt securities. Accordingly, the Company designates these investments as available-for-sale and measures them at fair value.

The table below presents information about our assets measured at fair value (in thousands) on a recurring basis and indicates the fair value hierarchy of the valuation techniques utilized by us to determine the fair values as of June 30, 2008. These assets have previously been measured at fair value in accordance with existing generally accepted accounting principles, and our accounting for these assets and liabilities was not impacted by our adoption of Statement No. 159. Certain fixed income and other securities are reported at fair value using Level 2 inputs. For these securities, the Company uses pricing services and dealer quotes. As of June 30, 2008, we did not have any assets that had fair values determined by Level 3 inputs and no liabilities measured at fair value.

|                         | <b>Fair Value Measurements (in 000s) Using</b>                   |  |  | <b>June 30,<br/>2008</b> |
|-------------------------|--|--|--|--------------------------|
|                         | <b>Quoted<br/>Prices in<br/>Active<br/>Markets<br/>(Level 1)</b> | <b>Significant<br/>Other<br/>Observable<br/>Inputs<br/>(Level 2)</b> | <b>Significant<br/>Unobservable<br/>Inputs<br/>(Level 3)</b> |                          |
| Assets:                 |  |  |  |                          |
| Fixed income securities | \$24,589   | \$ 5,366   | \$   | \$29,955                 |
| Common stock            | 44,466   |  |  | 44,466                   |
| Mutual funds and other  | 62,421   | 222  |  | 62,643                   |

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**Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations**  
**Forward-Looking Statements**

In addition to historical information, this Quarterly Report contains forward-looking statements within the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. These forward-looking statements include any projections of earnings, revenues, asset sales, acquisitions, cash balances and cash flow, debt levels or other financial items; any statements of the plans, strategies and objectives of management for future operations; any statements regarding future economic conditions or performance; any statements of belief; and any statements of assumptions underlying any of the foregoing. Forward-looking statements may include the words *may*, *will*, *estimate*, *intend*, *believe*, *expect*, *project*, *forecast*, *plan*, *anticipate* and other similar words.

**Cautionary Statements**

We caution readers that the following important factors, among others, in some cases have affected, and in the future could affect, our actual consolidated results and could cause our actual consolidated results in the future to differ materially from the goals and expectations expressed herein and in any other forward-looking statements made by or on behalf of us. For further information regarding risks associated with our business and the death care industry, see Item 1A Risk Factors in our Annual Report filed on Form 10-K for the year ended December 31, 2007.

*Risks related to our business*

- (1) Marketing and sales activities by existing and new competitors could cause us to lose market share and lead to lower revenues and margins.
- (2) Our ability to generate preneed sales depends on a number of factors, including sales incentives and local and general economic conditions.
- (3) Price competition could also reduce our market share or cause us to reduce prices to retain or recapture market share, either of which could reduce revenues and margins.
- (4) Our ability to execute our growth strategy is highly dependent upon our ability to successfully identify suitable acquisition candidates and negotiate transactions on favorable terms.
- (5) Increased or unanticipated costs, such as insurance, taxes or litigation, may have a negative impact on our earnings and cash flows.
- (6) Improved performance in our funeral and cemetery segments is highly dependent upon successful execution of our Standards Operating Model.
- (7) The success of our businesses is typically dependent upon one or a few key employees for success because of the localized and personal nature of our business.
- (8) Earnings from and principal of trust funds and insurance contracts could be reduced by changes in financial markets and the mix of securities owned.
- (9) Covenant restrictions under our debt instruments may limit our flexibility in operating and growing our business.

*Risks related to the death care industry*

- (1) Declines in the number of deaths in our markets can cause a decrease in revenues. Changes in the number of deaths are not predictable from market to market or over the short term.
- (2) The increasing number of cremations in the United States could cause revenues to decline because we could lose market share to firms specializing in cremations. In addition, direct cremations produce minimal revenues for cemetery operations and lower funeral revenues.
- (3) If we are not able to respond effectively to changing consumer preferences, our market share, revenues and profitability could decrease.
- (4) Because the funeral and cemetery businesses are high fixed-cost businesses, changes in revenues can have a disproportionately large effect on cash flow and profits.
- (5) Changes or increases in, or failure to comply with, regulations applicable to our business could increase costs or decrease cash flows.

**Table of Contents****OVERVIEW***General*

We operate two types of businesses: funeral homes, which account for approximately 75% of our revenues, and cemeteries, which account for approximately 25% of our revenues. Funeral homes are principally service businesses that provide funeral services (burial and cremation) and sell related merchandise, such as caskets and urns. Cemeteries are primarily a sales business that sells interment rights (grave sites and mausoleums) and related merchandise, such as markers and outer burial containers. As of June 30, 2008, we operated 136 funeral homes in 25 states and 32 cemeteries in 11 states within the United States. Substantially all administrative activities are conducted or coordinated through our home office in Houston, Texas.

We have implemented several significant long-term initiatives in our operations designed to improve operating and financial results by growing market share and increasing profitability. We introduced a more decentralized, entrepreneurial and local operating model that included operating and financial standards developed from our best operations, along with an incentive compensation plan to reward business managers for successfully meeting or exceeding the standards. The model essentially eliminated the use of financial budgets in favor of the standards. The operating model and standards, which we refer to as *Being the Best*, focus on the key drivers of a successful operation, organized around three primary areas—market share, people and operating and financial metrics. The model and standards are the measures by which we judge the success of each business. To date, the *Being the Best* operating model and standards have driven significant changes in our organization, leadership and operating practices. In certain businesses we have determined that the business managers do not possess the characteristics to succeed in this type of culture, and we have been actively recruiting new managers who do. *Being the Best* is not something that occurs easily and quickly, but we believe execution of the model produced improved results in 2007 and should result in improving sustainable earnings in 2008 and beyond.

*Funeral Operations*

Factors affecting our funeral operating results include: demographic trends in terms of population growth and average age, which impact death rates and number of deaths; establishing and maintaining leading market share positions supported by strong local heritage and relationships; effectively responding to increasing cremation trends by packaging complementary services and merchandise; controlling salary and merchandise costs; and exercising pricing leverage related to our at-need business to increase average revenues per contract. In simple terms, volume and price are the two variables that affect funeral revenues. The average revenue per contract is influenced by the mix of traditional and cremation services because our average cremation service revenue is approximately 33% of the average revenue earned from a traditional burial service. Funeral homes have a relatively fixed cost structure. Thus, small changes in revenues, up or down, normally cause significant changes to our profitability.

Our same store volumes have declined gradually each year from 22,395 in 2003 to 20,912 in 2007 (compound annual decline of 1.7%) consistent with a period of weak death rates nationally and the loss of market share primarily in our Central Region funeral operations. We experienced higher volumes during the first two quarters of 2008 compared to the first two quarters of 2007 primarily because of a more significant flu season during the first quarter of 2008. Our same store funeral operations have increased revenue steadily from \$107.1 million in 2003 to \$114.1 million in 2007 (compound annual increase of 1.6%) because we have been able to increase the average revenue per funeral through expanded service offerings and packages. The percentage of funeral services involving cremations has increased from 30.7% for 2003 to 35.8% for 2007, an average increase of 1.3% per year. We expect same store portfolio volumes to stabilize and our average revenue per funeral to increase over time as we seek to provide increased services to our client families in order to offset weak death rates and higher cremation rates.

*Cemetery Operations*

The cemetery operating results are affected by the size and success of our sales organization. Approximately 50% of our cemetery revenues relate to preneed sales of interment rights and mausoleums and related merchandise and services. We believe that changes in the level of consumer confidence (a measure of whether consumers will spend for discretionary items) also affect the amount of cemetery revenues. Approximately 10% of our cemetery revenues are attributable to investment earnings on trust funds and finance charges on installment contracts. Changes in the capital markets and interest rates affect this component of our cemetery revenues.

Our same store cemetery financial performance from 2003 through 2007 was characterized by increasing revenues but slightly declining field level profit margins. Revenues and profits on a same store basis have declined for the first half of 2008 compared to the first half of 2007 in part, we believe, from the negative impact of the economy on the consumer and in part due to turnover in sales personnel at certain large parks. Our goal is to build broader and deeper teams of sales leaders and counselors in our larger and more strategically located cemeteries that can sustain consistent, modest growth in preneed property sales over time and to diversify and substantially increase our cemetery operating and financial results. Additionally, a portion of our capital expenditures in 2008 is designed to expand our cemetery product offerings.

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*Acquisitions*

Our growth strategy includes the execution of the Strategic Portfolio Optimization Model. The goal of that model is to build concentrated groups of businesses in ten to fifteen strategic markets. We assess acquisition candidates using six strategic ranking criteria. These criteria enable us to determine the price we are willing to pay for a particular acquisition candidate. Those criteria are:

Size of business

Size of market

Competitive standing

Demographics

Strength of brand

Barriers to entry

In general terms, our price expectations range from four to five times pre-tax earnings before depreciation for tuck-ins to six to seven times pre-tax earnings before depreciation for businesses that rank very high in the ranking criteria. We derive the pre-tax earnings amounts used in the pricing based primarily on the size and product mix of the target business applied to our standards-based operating model. During 2007 we completed seven acquisitions. The consideration paid in each of the acquisitions was cash. We have not incurred any debt to buy these businesses. The number of completed acquisitions during 2007 was greater than expected. We have not acquired any businesses to date in 2008. Our five year goal is to acquire approximately \$10 million of annualized revenue each year.

*Financial Highlights*

Net income from continuing operations for the three months ended June 30, 2008 totaled \$43,000 compared to net income from continuing operations of \$1.9 million for the second quarter of 2007, or \$0.10 per diluted share. The variance between the two periods was primarily due to pre-tax declines of \$1.2 million in gross profit from our same store funeral operations and \$1.0 million from our same store cemetery operations, along with an increase of \$1.3 million in corporate general and administrative expenses. Acquired businesses provided an increase in pre-tax gross profit of \$0.7 million, equal to approximately \$0.02 per diluted share.

We sold two funeral homes at a loss during the three months ended June 30, 2008. The loss from discontinued operations for the three months ended June 30, 2008 was \$1.4 million, equal to \$0.07 per diluted share. During the six months ended June 30, 2007, the Company completed the sale of two funeral home businesses, resulting in a pre-tax gain of \$0.7 million.

**CRITICAL ACCOUNTING POLICIES AND ESTIMATES**

The preparation of the consolidated financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses. On an on-going basis, we evaluate estimates and judgments, including those related to revenue recognition, realization of accounts receivable, intangible assets, property and equipment and deferred tax assets. We base our estimates on historical experience, third party data and assumptions that we believe to be reasonable under the circumstances. The results of these considerations form the basis for making judgments about the amount and timing of revenues and expenses, the carrying value of assets and the recorded amounts of liabilities. Actual results may differ from these estimates and such estimates may change if the underlying conditions or assumptions change. Historical performance should not be viewed as indicative of future performance, as there can be no assurance the margins, operating income and net earnings as a percentage of revenues will be consistent from year to year.

Management's discussion and analysis of financial condition and results of operations are based upon our consolidated financial statements presented herewith, which have been prepared in accordance with accounting principles generally accepted in the United States excluding certain year end adjustments because of the interim nature of the consolidated financial statements. Our significant accounting policies are more fully described in Note 1 to the



Consolidated Financial Statements included in our Annual Report on Form 10-K for the year ended December 31, 2007. We believe the following critical accounting policies affect our more significant judgments and estimates used in the preparation of our consolidated financial statements.

*Funeral and Cemetery Operations*

We record the sales of funeral and cemetery merchandise and services when the merchandise is delivered or service is performed. Sales of cemetery interment rights are recorded as revenue in accordance with the retail land sales provisions of Statement of Financial Accounting Standards (FAS) No. 66, Accounting for Sales of Real Estate . This method generally provides for the recognition of revenue in the period in which the customer's cumulative payments exceed 10% of the contract price related to the real estate. Costs related to the sales of interment rights, which include property and other costs related to cemetery development activities, are charged to operations using the specific identification method in the period in which the sale of the interment right is recognized as revenue. Revenues to be recognized and cash flow from the delivery of merchandise and performance of services related to preneed contracts that were acquired in acquisitions are typically lower than those originated by us.

Allowances for bad debts and customer cancellations are provided at the date that the sale is recognized as revenue. In addition, we monitor changes in delinquency rates and provide additional bad debt and cancellation reserves when warranted.

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When preneed funeral services and merchandise are funded through third-party insurance policies, we earn a commission on the sale of the policies. Insurance commissions earned by the Company are recognized as revenues when the commission is no longer subject to refund, which is usually one year after the policy is issued. Preneed selling costs consist of sales commissions that we pay our sales counselors and other direct related costs of originating preneed sales contracts and are expensed as incurred.

*Goodwill*

The excess of the purchase price over the fair value of net identifiable assets acquired, as determined by management in transactions accounted for as purchases, is recorded as goodwill. Many of the acquired funeral homes have provided high quality service to families for generations. The resulting loyalty often represents a substantial portion of the value of a funeral business. Goodwill is typically not associated with or recorded for the cemetery businesses. In accordance with SFAS No. 142, *Goodwill and Other Tangible Assets*, we review the carrying value of goodwill at least annually on reporting units (aggregated geographically) to determine if facts and circumstances exist which would suggest that this intangible asset might be carried in excess of fair value. Fair value is determined by discounting the estimated future cash flows of the businesses in each reporting unit at the Company's weighted average cost of capital less debt allocable to the reporting unit and by reference to recent sales transactions of similar businesses. The calculation of fair value can vary dramatically with changes in estimates of the number of future services performed, inflation in costs, and the Company's cost of capital, which is impacted by long-term interest rates. If impairment is indicated, then an adjustment will be made to reduce the carrying amount of goodwill to fair value.

*Income Taxes*

The Company and its subsidiaries file a consolidated U.S. Federal income tax return and separate income tax returns in the states in which we operate. We record deferred taxes for temporary differences between the tax basis and financial reporting basis of assets and liabilities, in accordance with SFAS 109, *Accounting for Income Taxes* and account for uncertain tax positions in accordance with FASB Interpretation No. 48 *Accounting for Uncertainty in Income Taxes* an interpretation of FASB No. 109. The Company records a valuation allowance to reflect the estimated amount of deferred tax assets for which realization is uncertain. Management reviews the valuation allowance at the end of each quarter and makes adjustments if it is determined that it is more likely than not that the tax benefits will be realized.

*Stock Compensation Plans*

The Company has stock-based employee compensation plans in the form of restricted stock, performance unit, stock option and employee stock purchase plans. The Company accounts for stock-based compensation under Statement of Financial Accounting Standards No. 123R, *Share-Based Payment* ( FAS No. 123R ). FAS No. 123R requires companies to recognize compensation expense in an amount equal to the fair value of the share-based payment issued to employees over the period of vesting. The fair value of stock options and awards containing options is determined using the Black-Scholes valuation model. FAS No. 123R applies to all transactions involving issuance of equity by a company in exchange for goods and services, including employee services.

*Discontinued Operations*

In accordance with the Company's strategic portfolio policy, non-strategic businesses are reviewed to determine whether the businesses should be sold and the proceeds redeployed elsewhere. A marketing plan is then developed for those locations which are identified as held for sale. When the Company receives a letter of intent and financing commitment from the buyer and the sale is expected to occur within one year, the location is no longer reported within the Company's continuing operations. The assets and liabilities associated with the held for sale location are reclassified on the balance sheet and the operating results, as well as impairments, are presented on a comparative basis in the discontinued operations section of the Consolidated Statements of Operations, along with the income tax effect.

**RESULTS OF OPERATIONS**

The following is a discussion of the Company's results of operations for the three and six month periods ended June 30, 2007 and 2008. Funeral homes and cemeteries owned and operated for the entirety of each period being compared are referred to as same-store or existing operations. Funeral homes and cemeteries purchased after January 2005 (date of refinancing our Senior Debt) are referred to as acquired.

Funeral Home Segment. The following table sets forth certain information regarding the revenues and gross profit of the Company from its funeral home operations for the three and six months ended June 30, 2007 compared to the three and six months ended June 30, 2008.

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*Three months ended June 30, 2007 compared to three months ended June 30, 2008 (dollars in thousands):*

|   | Three Months Ended |           | Change     |         |
|---|--------------------|-----------|------------|---------|
|   | 2007               | 2008      | Amount     | %       |
| Total same-store revenue                  | \$ 27,362          | \$ 26,725 | \$ (637)   | (2.3%)  |
| Acquired                                  | 2,087              | 4,751     | 2,664      | *       |
| Preneed insurance commissions revenue     | 625                | 675       | 50         | 8.0%    |
| Revenues from continuing operations       | \$ 30,074          | \$ 32,151 | \$ 2,077   | 6.9%    |
| Revenues from discontinued operations     | \$ 413             | \$ 241    | \$ (172)   | *       |
| Total same-store gross profit             | \$ 7,916           | \$ 6,750  | \$ (1,166) | (14.7%) |
| Acquired                                  | 579                | 1,221     | 642        | *       |
| Preneed insurance gross profit            | 149                | 299       | 150        | *       |
| Gross profit from continuing operations   | \$ 8,644           | \$ 8,270  | \$ (374)   | (4.3%)  |
| Gross profit from discontinued operations | \$ 31              | \$ 88     | \$ 57      | *       |

\* not meaningful

Funeral same-store revenues for the three months ended June 30, 2008 decreased \$0.6 million, or 2.3%, when compared to the three months ended June 30, 2007 as we experienced a 0.2% increase in the number of contracts and a decrease of 2.5% to \$5,255 in the average revenue per contract for those existing operations. The decline in the average revenue per contract was heavily influenced by a 380 basis point increase in the cremation rate to 37.2%. The average per contract for at need burial services declined slightly, an indication that the economy may be affecting the consumer. Performance was weakest in the Central Region, where the number of contracts decreased 5.8% and the contract average decreased 0.6%.

Total same-store gross profit for the three months ended June 30, 2008 decreased \$1.2 million, or 14.7% from the comparable three months of 2007, and as a percentage of funeral same-store revenue, decreased from 28.9% to 25.3% as we experienced higher salaries and benefits costs and increased costs of maintaining our facilities in combination with lower level of revenue. Salaries and benefits at our same-store funeral businesses increased \$0.7 million or 9.4%, year over year, while facilities costs increased \$0.2 million, or 17.2%.

As previously discussed, we completed seven acquisitions in 2007 involving twelve new funeral homes. Acquired revenue and gross profit is related primarily to the businesses acquired during 2007. The cremation rate for the acquired businesses was 51.2% for the second quarter of 2008 as these businesses are located in higher cremation areas compared to the existing locations. The average revenue per contract for the second quarter of 2008 was \$4,013, a slight decline compared to the prior year quarter.

Gross profit for acquired businesses as a percentage of revenue from acquired businesses was 25.7% for the second quarter of 2008 compared to 27.7% for the second quarter of 2007. As a percentage of revenues, salaries and benefits increased year over year from 28.4% to 32.7%.

*Six months ended June 30, 2007 compared to six months ended June 30, 2008 (dollars in thousands):*

|  | Six Months Ended |      | Change |   |
|--|------------------|------|--------|---|
|  | 2007             | 2008 | Amount | % |

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|   |           |           |          |        |
|---|-----------|-----------|----------|--------|
| Total same-store revenue                  | \$ 57,182 | \$ 58,028 | \$ 846   | 1.5%   |
| Acquired                                  | 3,713     | 9,712     | 5,999    | *      |
| Preneed insurance commissions revenue     | 1,253     | 1,428     | 175      | 13.9%  |
| Revenues from continuing operations       | \$ 62,148 | \$ 69,168 | \$ 7,020 | 11.3%  |
| Revenues from discontinued operations     | \$ 1,042  | \$ 477    | \$ (565) | *      |
| Total same-store gross profit             | \$ 17,772 | \$ 17,133 | \$ (639) | (3.6%) |
| Acquired                                  | 1,126     | 2,759     | 1,633    | *      |
| Preneed insurance gross profit            | 321       | 680       | 359      | *      |
| Gross profit from continuing operations   | \$ 19,219 | \$ 20,572 | \$ 1,353 | 7.0%   |
| Gross profit from discontinued operations | \$ 163    | \$ 144    | \$ (19)  | *      |

\* not meaningful

Funeral same-store revenue for the six months ended June 30, 2008 increased \$0.8 million, or 1.5%, when compared to the six months ended June 30, 2007 as we experienced a 2.3% increase in the number of contracts and a 0.8% decline in the average revenue per contract to \$5,335.

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The number of burial contracts declined 3.3% while the average revenue for burial contracts increased 2.7%. The number of cremation contracts increased 12.2% and the average revenue per cremation contract increased 1.0%. The increase in volumes was influenced primarily due to a more significant flu season during the first quarter of 2008 compared to the prior year.

Funeral same-store gross profit for the six months ended June 30, 2008 declined \$0.6 million, or 3.6%, when compared to the six months ended June 30, 2007, due to higher costs. Our largest area of costs in the funeral homes is salaries and benefits for the location personnel. Year to date, those costs have risen \$0.7 million to 26.7% of same-store funeral revenues. The next largest area of cost increase is the cost of maintaining the funeral home facilities, which increased \$0.4 million to 4.3% of same-store revenues.

Acquired funeral homes generated \$9.7 million in revenue, equal to 14.3% of our funeral home revenue, and \$2.8 million in gross profit, equal to 13.9% of our funeral home gross profit. Year to date, the average revenue per contract is \$3,990, and the cremation rate is 51.8%.

**Cemetery Segment.** The following table sets forth certain information regarding the revenues and gross profit of the Company from its cemetery operations for the three and six months ended June 30, 2007 compared to the three and six months ended June 30, 2008.

*Three months ended June 30, 2007 compared to three months ended June 30, 2008 (dollars in thousands):*

|   | <b>Three Months Ended</b> |                 | <b>Change</b> |          |
|---|---------------------------|-----------------|---------------|----------|
|   | <b>June 30,</b>           | <b>June 30,</b> | <b>Amount</b> | <b>%</b> |
|   | <b>2007</b>               | <b>2008</b>     |               |          |
| Total same-store revenue                  | \$ 10,141                 | \$ 9,144        | \$ (997)      | (9.8%)   |
| Acquired                                  | 1,101                     | 1,404           | 303           | *        |
| Revenues from continuing operations       | \$ 11,242                 | \$ 10,548       | \$ (694)      | (6.2%)   |
| Revenues from discontinued operations     | \$                        | \$              | \$            | *        |
| Total same-store gross profit             | \$ 2,262                  | \$ 1,213        | \$ (1,049)    | (46.4%)  |
| Acquired                                  | 208                       | 267             | 59            | *        |
| Gross profit from continuing operations   | \$ 2,470                  | \$ 1,480        | \$ (990)      | (40.1%)  |
| Gross profit from discontinued operations | \$                        | \$              | \$            | *        |

\* not meaningful

Cemetery same-store revenues for the three months ended June 30, 2008 decreased \$1.0 million, or 9.8% compared to the three months ended June 30, 2007. The Company's largest business, Rolling Hills Memorial Park, experienced a year over year decline of \$0.7 million in revenues primarily due to a \$0.6 million decrease in preneed property sales. Company-wide, same-store revenue from preneed property sales decreased \$0.8 million.

Cemetery same-store gross profit for the three months ended June 30, 2008 decreased \$1.0 million, or 46.4%. As a percentage of revenues, cemetery same store gross profit decreased from 22.3% to 13.3%. The primary reasons for the decline were the lower revenues on what is a relatively fixed cost business, along with an increase in grounds maintenance costs.

Acquired revenue and gross profit for the three months ended June 30, 2007 represents the results of Seaside Memorial Park in Corpus Christi, Texas which was acquired in January 2007. The three months ended June 30, 2008 also includes Conejo Mountain Memorial Park in Camarillo, California, which was acquired in April 2007 and Cloverdale Park, Inc. which was acquired in June 2007.

Financial revenues (trust earnings and finance charges on installment contracts) are included in revenues and increased \$0.2 million to \$1.0 million on the strength of higher perpetual care trust earnings. Earnings from perpetual care trust funds are included in financial revenues and totaled \$0.4 million for the three months ended June 30, 2008 compared to \$0.2 million for the three months ended June 30, 2007.

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Six months ended June 30, 2007 compared to six months ended June 30, 2008 (dollars in thousands):

|   | Six Months Ended |                  | Change     |         |
|---|------------------|------------------|------------|---------|
|   | June 30,<br>2007 | June 30,<br>2008 | Amount     | %       |
| Total same-store revenue                  | \$ 19,838        | \$ 17,427        | \$ (2,411) | (12.2%) |
| Acquired                                  | 1,490            | 3,021            | 1,531      | *       |
| Revenues from continuing operations       | \$ 21,328        | \$ 20,448        | \$ (880)   | (4.1%)  |
| Revenues from discontinued operations     | \$               | \$               | \$         | *       |
| Total same-store gross profit             | \$ 4,420         | \$ 2,351         | \$ (2,069) | (46.8%) |
| Acquired                                  | 253              | 794              | 541        | *       |
| Gross profit from continuing operations   | \$ 4,673         | \$ 3,145         | \$ (1,528) | (32.7%) |
| Gross profit from discontinued operations | \$               | \$               | \$         | *       |

\* not meaningful

Cemetery same-store revenues for the six months ended June 30, 2008 decreased \$2.4 million, or 12.2%, compared to the six months ended June 30, 2007. Preneed property revenue at existing cemeteries declined \$2.0 million, or 25.3%, to \$6.0 million as the number interments sold on a preneed basis declined 20.4% and the percentage of those we were able to recognize as revenue because we received at least 10% of the sales price from the customer declined from 82.4% to 79.6%. Atneed revenues from property, merchandise and services declined \$0.5 million, or 6.5%, to \$6.7 million as the average sale per atneed contract and the number of interments both declined. The revenue decline was primarily at Rolling Hills Memorial Park where revenues from atneed and preneed operations were down \$1.8 million, or 35%, year over year. Turnover in key sales positions has been the primary cause of the weaker results at Rolling Hills.

Cemetery same-store gross profit for the six months ended June 30, 2008 decreased \$2.1 million, or 46.8%, compared to the six months ended June 30, 2007. Cost inflation was evident in most categories of costs and expenses, but the majority of the decline in gross profit was due to lower revenues.

The three cemeteries acquired in 2007 produced \$0.8 million in gross profit equal to 26.3% of the revenue from the acquired businesses.

Financial revenues increased \$0.4 million to \$2.1 million primarily because perpetual care trust fund earnings improved by \$0.3 million year over year.

**Corporate General, Administrative and Other.** Corporate general, administrative and other expenses totaled \$4.8 million for the three months ended June 30, 2008, an increase of \$1.3 million compared to the three months ended June 30, 2007. Approximately one-half of the increase was related to severance and benefits for the former Chief Financial Officer, who left the Company effective April 30, 2008. The remainder of the year over year increase was due to higher legal and professional fees related primarily due to the litigation described in Note 14 and higher salaries and benefits.

Corporate general, administrative and other expenses totaled \$8.4 million for the six months ended June 30, 2008, an increase of \$1.4 million compared to the six months ended June 30, 2007. The increase in costs and expenses occurred in the second quarter as discussed in the preceding paragraph.

**Income Taxes.** The Company recorded income taxes on earnings from continuing operations at the effective rate of 39.5% during 2008. For Federal income tax reporting purposes, Carriage has net operating loss carryforwards totaling



\$4.9 million net of unrecognized tax benefits available at June 30, 2008 to offset future Federal taxable income, which expire between 2023 and 2025, if not utilized. Carriage also has approximately \$66.0 million of state net operating loss carryforwards that will expire between 2009 and 2029, if not utilized. Based on management's assessment of the various state net operating losses, it was determined that it is more likely than not that the Company will not be able to realize tax benefits on a substantial amount of the state losses. Accordingly, the Company established a valuation allowance against a substantial portion of the deferred tax asset related to the state operating losses.

**LIQUIDITY AND CAPITAL RESOURCES**

Cash and cash equivalents at June 30, 2008 totaled \$8.8 million compared to \$3.4 million at December 31, 2007, an increase of \$5.4 million since year end 2007. For the six months ended June 30, 2008, cash provided by operating activities of continuing operations was \$11.9 million as compared to \$10.1 million for the three months ended June 30, 2007. Additionally, capital expenditures totaled \$7.3 million for the six months ended June 30, 2008 compared to \$5.6 million in the six months ended June 30, 2007. Capital expenditures during 2008 include \$2.4 million for the purchase of a tract of land to construct a new funeral home and approximately \$1.1 million for cemetery inventory development projects.

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The Company's senior debt at June 30, 2008 totaled \$138.2 million and consisted of \$130.0 million in Senior Notes and \$8.2 million in acquisition indebtedness and capital lease obligations.

The Company has a \$35 million senior secured revolving credit facility that matures in 2010 and is collateralized by all personal property and funeral home real property in certain states. Borrowings under the revolving credit facility will bear interest at prime or LIBOR options with the current LIBOR option set at LIBOR plus 275 basis points. The revolving credit facility is currently undrawn except for \$0.4 million in letters of credit that are outstanding under the credit facility at June 30, 2008.

The outstanding principal amount of the Company's convertible junior subordinated debenture is \$93.75 million, is payable to the Company's unconsolidated affiliate, Carriage Services Capital Trust (the "Trust"), bears interest at 7% and matures in 2029. Substantially all the assets of the Trust consist of the convertible junior subordinated debenture of the Company. The Trust, in turn, issued 1.875 million shares of convertible preferred term income deferrable equity securities (TIDES) in the public markets. The rights of the debenture are functionally equivalent to those of the TIDES.

The convertible junior subordinated debenture payable to the affiliated trust and the TIDES each contain a provision for the deferral of interest payments and distributions for up to 20 consecutive quarters. During any period in which distribution payments are deferred, distributions continue to accumulate at the 7% annual rate. Also, the deferred distributions themselves accumulate distributions at the annual rate of 7%. During any deferral period, Carriage is prohibited from paying dividends on the common stock or repurchasing its common stock, subject to limited exceptions. The Company currently expects to continue paying the distributions as due.

The Company intends to use its cash, cash flow and proceeds from the sale of businesses, to acquire funeral home and cemetery businesses and for internal growth projects, such as cemetery inventory development. As discussed in Note 14 to the consolidated financial statements we have a share repurchase program, whereby the Company may purchase up to \$5.0 million of its common stock. The Company also has the ability to draw on its revolving credit facility, subject to customary terms and conditions of the credit agreement, to finance acquisitions.

**SEASONALITY**

The Company's business can be affected by seasonal fluctuations in the death rate. Generally, the rate is higher during the winter months because the incidences of deaths from influenza and pneumonia are higher during this period than other periods of the year.

**INFLATION**

Inflation has not had a significant impact on the results of operations of the Company.

**Item 3. Quantitative and Qualitative Disclosures about Market Risk**

Carriage is currently exposed to market risk primarily related to changes in interest rates related to the Company's debt, decreases in interest rates related to the Company's short-term investments and changes in the values of securities associated with its preneed and perpetual care trusts. For information regarding the Company's exposure to certain market risks, see Item 7A, "Quantitative and Qualitative Market Risk Disclosure" in the Company's Annual Report filed on Form 10-K for the year ended December 31, 2007. There have been no significant changes in the Company's market risk from that disclosed in the Form 10-K for the year ended December 31, 2007.

**Item 4. Controls and Procedures**

In accordance with the Securities Exchange Act of 1934 Rules 13a-15 and 15d-15, we carried out an evaluation under the supervision and with the participation of management, including our Chief Executive Officer and Chief Financial Officer, of the effectiveness of our disclosure controls and procedures as of the end of the period covered by this report. Based on that evaluation, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures were effective as of June 30, 2008 to provide reasonable assurance that information required to be disclosed in our reports filed or submitted under the Exchange Act is recorded, processed, summarized, and reported within the time periods specified in the Securities and Exchange Commission's rules and forms. Our disclosure controls and procedures include controls and procedures designed to ensure that information required to be disclosed in reports filed or submitted under the Exchange Act is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure.

There has been no change in our internal control over financial reporting that occurred during the six months ended June 30, 2008 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

**PART II OTHER INFORMATION**

**Item 1. Legal Proceedings**

We and our subsidiaries are parties to a number of legal proceedings that arise from time to time in the ordinary course of business. While the outcome of these proceedings cannot be predicted with certainty, we do not expect these matters to have a material adverse effect on the financial statements. Information regarding litigation is set forth in Part I, Item 1. Financial Statements, Note 13 of this Form 10-Q.

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We self-insure against certain risks and carry insurance with coverage and coverage limits for risk in excess of the coverage amounts consistent with our assessment of risks in our business and of an acceptable level of financial exposure. Although there can be no assurance that self-insurance reserves and insurance will be sufficient to mitigate all damages, claims or contingencies,

We believe that our reserves and insurance provide reasonable coverage for known asserted or unasserted claims. In the event the Company sustains a loss from a claim and the insurance carrier disputes coverage or coverage limits, the Company may record a charge in a different period than the recovery, if any, from the insurance carrier.

**Item 1A. Risk Factors**

There have been no material changes in our risk factors from those disclosed in Item 1A of our Annual Report on Form 10-K for the year ended December 31, 2007.

**Item 2. Unregistered Sales of Equity Securities and Use of Proceeds**

Information required by Item 701 of Regulation S-K for unregistered sales of equity securities was previously provided in a Current Report on Form 8-K/A filed on April 22, 2008.

As discussed in Note 15 to the consolidated financial statements, the Company initiated a share repurchase program under which the Company may purchase up to an aggregate of \$5 million of its common stock. Pursuant to the program, we repurchased the following shares during the second quarter of 2008:

| Period        |                | Total<br>Number of<br>Shares<br>Purchased | Average<br>Price Paid<br>Per<br>Share | Total Number of<br>Shares<br>Purchased as<br>Part of Publicly<br>Announced<br>Program | Dollar Value<br>of Shares That<br>May Yet Be<br>Purchased<br>Under<br>the Program |
|---------------|----------------|---|---------------------------------------|---|---|
| April 1, 2008 | April 30, 2008 |   |                                       |   |   |
| May 1, 2008   | May 31, 2008   |   |                                       |   |   |
| June 1, 2008  | June 30, 2008  | 17,900                                    | \$6.80                                | 17,900  | \$4,878,234   |
| Total         |                | 17,900                                    |                                       | 17,900  |   |

**Item 3. Defaults Upon Senior Securities**

None

**Item 4. Submission of Matters to a Vote of Security Holders**

The Company's 2008 annual meeting was held on May 20, 2008. The director nominee was elected. The voting tabulation was as follows:

| Name of Nominee/Plan | Number of<br>Votes<br>For | Number of<br>Votes<br>Against | Number of<br>Votes<br>Withheld |
|----------------------|---------------------------|-------------------------------|--------------------------------|
| Ronald A. Erickson   | 16,357,891                |                               | 304,013                        |

The terms of the following directors continue after the meeting as follows:

| Director          | Expiration of Term at<br>Annual Shareholder's<br>Meeting |
|-------------------|--|
| Melvin C. Payne   | 2009   |
| Joe R. Davis      | 2009   |
| Gary L. Forbes    | 2010   |
| Vincent D. Foster | 2010   |

**Item 5. Other Information**

The Company reported on Form 8-K during the quarter covered by this report all information required to be reported on such form.

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**Item 6. Exhibits**

11.1 Computation of Per Share Earnings

31.1 Certification of Periodic Financial Reports by Melvin C. Payne in satisfaction of Section 302 of the Sarbanes-Oxley Act of 2002

31.2 Certification of Periodic Financial Reports by Billy D. Dixon in satisfaction of Section 302 of the Sarbanes-Oxley Act of 2002

32 Certification of Periodic Financial Reports by Melvin C. Payne and Billy D. Dixon in satisfaction of Section 906 of the Sarbanes-Oxley Act of 2002 and 18 U.S.C. Section 1350

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**SIGNATURE**

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

CARRIAGE SERVICES, INC.

August 8, 2008

/s/ Terry E. Sanford

Date

Terry E. Sanford  
Senior Vice President, Chief Accounting  
Officer and Treasurer

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