



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

FORM 10-K

- ☒ Annual Report Pursuant To Section 13 Or 15(d) Of The Securities Exchange Act Of 1934  
For The Fiscal Year Ended December 31, 2006
- ☐ Transition Report Pursuant To Section 13 Or 15(d) Of The Securities Exchange Act Of 1934

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 Blvd., Suite 300, Houston, TX (Address of principal executive offices)	77056 (Zip Code)

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

SECURITIES REGISTERED PURSUANT TO SECTION 12(b) OF THE ACT:

Common Stock, \$.01 Par Value Series G Preferred Stock Purchase Rights (Title Of Class)	New York Stock Exchange New York Stock Exchange (Name of Exchange on which registered)
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SECURITIES REGISTERED PURSUANT TO SECTION 12(g) OF THE ACT:

None

Indicate by check mark if the Registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act of 1933. Yes ☐ No ☒

Indicate by check mark if the Registrant is not required to file reports pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934. Yes ☐ No ☒

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 if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. Yes ☒ No ☐

Indicate by check mark whether the Registrant is a large accelerated filer, an accelerated filer or a non-accelerated filer as defined in Rule 12b-2 of the Securities Exchange Act of 1934. Large accelerated filer ☐ Accelerated filer ☒ Non-Accelerated filer ☐

Indicate by check mark whether the registrant is a shell company as defined by Rule 12b-2 of the Securities Exchange Act of 1934.  
Yes ☐ No ☒

The aggregate market value of the voting and non-voting common equity held by non-affiliates of the registrant as of June 30, 2006 was approximately \$77.6 million based on the closing price of \$4.59 per share on the New York Stock Exchange.

The number of shares of the registrant's Common Stock, \$.01 par value per share outstanding as of February 28, 2007 was 18,718,490.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the definitive proxy statement to be delivered in connection with the 2007 annual meeting of stockholders are incorporated in Part III of this Report.

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## CAUTIONARY NOTE

This annual report contains forward-looking statements of our management regarding factors that we believe may affect our performance in the future. Such statements typically are identified by terms expressing our future expectations or projections of revenues, earnings, earnings per share, cash flow, market share, capital expenditures, effects of operating and acquisition initiatives, gross profit margin, debt levels, interest costs, tax benefits and other financial items. All forward-looking statements, although made in good faith, are based on assumptions about future events and are therefore inherently uncertain, and actual results may differ materially from those expected or projected. Important factors that may cause our actual results to differ materially from expectations or projections include those described under the heading “Forward-Looking Statements” in Item 7. Forward-looking statements speak only as of the date of this report, and we undertake no obligation to update or revise such statements to reflect new circumstances or unanticipated events as they occur.

## PART I

### ITEM 1. BUSINESS

#### GENERAL

We are a leading provider of death care services and merchandise in the United States. We operate two types of businesses: funeral homes, which currently account for approximately 75% of our total revenue, and cemeteries, which currently account for approximately 25% of our total revenue. As of December 31, 2006, we operated 131 funeral homes in 27 states and 28 cemeteries in 11 states. We primarily serve suburban markets and believe we are a market leader (first or second) in most of those markets. We provide funeral and cemetery services and products on both an “at-need” (time of death) and “preneed” (planned prior to death) basis.

Our operations are divided into two business segments:

- *Funeral Home Operations.* Funeral homes are principally service businesses that provide burial and cremation services and sell related merchandise, such as caskets and urns. Given the high fixed cost structure associated with funeral home operations, we believe the following are key factors affecting our profitability:
  - 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.
- *Cemetery Operations.* Cemeteries are primarily a sales business that provides interment rights (grave sites and mausoleums) and related merchandise, such as markers and memorials. Our cemetery operating results are impacted by the success of our sales organization because approximately 40% of our cemetery revenues during the year ended December 31, 2006 was generated from preneed sales of interment rights. We believe that changes in the level of consumer confidence (a measure of whether consumers will spend money on discretionary items) also impact the amount of such preneed sales. Cemetery revenues generated from at-need service and merchandise sales generally are subject to many of the same key profitability factors as in our funeral home business. Approximately 13% of our cemetery revenues during the year ended December 31, 2006 was attributable to investment earnings on trust funds and finance charges on installment contracts.

Our business strategy is based on strong, local leadership and entrepreneurial principles that we believe drive market share, revenue growth, and profitability in our local markets. Our Standards Operating Model, called “Being the Best,” was implemented at the beginning of 2004. We use the Standards Operating Model to measure the sustainable revenue growth and earning power of our portfolio of deathcare businesses. The standards based model emphasizes growing market share and improving long-term profitability by employing leadership and entrepreneurial principles that fit the nature of our local, personal service, high value business. This model also requires our local and corporate leaders to change our focus from short-term profitability to the drivers of success that create long-term profitability and value for our shareholders. Our operating model emphasizes:

- decentralized management of our local businesses;

- financial and operational standards based upon drivers of success of our best businesses;
- variable compensation that rewards our managers as if they are owners;
- finding, developing and retaining the best people in our industry; and
- information technology designed to support local business and corporate management decisions, measure performance of our businesses against our financial and operational standards, and ensure adherence to established internal control procedures.

Our near-term objectives for 2007 and 2008 include:

- continuing to improve our operating and financial performance by executing our Standards Operating Model;
- upgrading the leadership in our businesses, as necessary;
- executing Strategic Portfolio Optimization Model, a disciplined program that will guide our acquisition and disposition strategies.

Our longer-term objectives over the next five years include:

- continuous improvement and portfolio optimization driven by our Standards Operating Model;
- growing market share, creating new heritage, producing consistent, modest revenue growth and sustainable increasing level of earnings and cash flow
- fully implementing the Strategic Portfolio Optimization Model to change the sustainable earning power profile of our portfolio; and
- raising equity proceeds to enhance our capital structure and support our growth strategy if quality growth opportunities exceed our ability to self finance.

## **HISTORY**

Carriage Services, Inc. was incorporated in Delaware in December of 1993. Prior to 2001, Carriage grew dramatically through acquisitions of funeral homes and cemeteries. A significant amount of debt was incurred in financing these acquisitions. Our business strategy during the four years ended December 31, 2004 focused on increasing operating cash flow and improving our financial condition by reducing debt to lower our interest expense and improve our credit profile. During that same period we initiated a process to identify underperforming businesses and, where appropriate, sold those businesses to reduce our debt. We sold 36 funeral homes and 12 cemeteries along with 20 parcels of excess real estate. We reduced our debt and contingent obligations by approximately \$87 million during the period January 1, 2001 through December 31, 2004. During January 2005, we refinanced our senior debt by issuing \$130 million of Senior Notes due in 2015. This refinancing represented a milestone. The refinancing was the culmination of the effort to reaccess the capital markets and to extend the maturities of our senior debt and to gain the flexibility to reinvest our cash flow in our core business. We plan to use the net cash proceeds from the offering and our cash flow to grow our Company through selective acquisitions. During September 2005, we acquired a funeral business consisting of two chapels in northern Florida, the first acquisition since 2002. See also Note 24 to the Consolidated Financial Statements for acquisitions of businesses subsequent to year end.

## **DEATH CARE INDUSTRY**

Death care companies provide products and services to families in three principal areas: (i) ceremony and tribute, generally in the form of a funeral or memorial service; (ii) disposition of remains, either through burial or cremation; and (iii) memorialization, generally through monuments, markers or inscriptions. The death care industry in the United States is characterized by the following fundamental attributes (the statistics included in this report are based on public reports from financial research firms or public websites):

### ***Death Rates***

Death rates in the United States have been relatively stable on a long-term historical basis. The number of deaths in the United States increased at an annual rate of approximately 1% for the period from 1980 to 2000. From 2001 to 2003, death rates deviated from this long-term trend by declining year-over-year for a three-year period, which is the first time year-over-year declines occurred since the mid-1970s. We understand that the death rate for 2005 increased 0.2 percent compared to 2004 and increased 0.3 percent from 2003 to 2004. The number of deaths per year in the United States is expected to increase from approximately 2.5 million in 2006 to 2.6 million in 2010 according to the United States Bureau of the Census. In addition, the segment of the United States population over 65 years of age is expected to increase by over 10% from approximately 36.7 million in 2005 to 40.2 million in 2010.

### ***Cremation***

In recent years, there has been a steady, gradual increase in the number of families in the United States that have chosen cremation as an alternative to traditional methods of burial. According to industry studies, cremations represented approximately 17% of the U.S. burial market in 1990 and approximately 32% in 2005. Cremation rates can vary significantly based upon geographic, religious and cultural traditions. Historically, direct cremation has been offered as a less costly alternative to a traditional burial. However, cremation is being increasingly accepted as part of a package of funeral services that includes memorials, merchandise and options for the interment of cremated remains.

### ***Highly Fragmented Ownership***

We understand that there are approximately 22,000 funeral homes and 10,000 cemeteries in the United States and that the domestic funeral service industry generates approximately \$15 billion of revenue annually. The three largest public operators, in terms of revenue, of both funeral homes and cemeteries in the United States are Service Corporation International, Stewart Enterprises and Carriage Services. We believe these three companies collectively represent approximately 20% of death care revenues in the United States. Independent businesses represent the remaining amount of industry revenue, accounting for an estimated 80% share. During most of the 1990s, there was a trend toward independent firms consolidating with public operators. However, few acquisitions of independents by the public companies have occurred since 1999 and there have been a number of independent entrants in local markets. As a result, the industry continues to be characterized by a large number of locally-owned, independent businesses. Service Corporation International acquired what was the second largest public company in the industry, Alderwoods Group in 2006, the impact of which to the industry and future acquisition is presently unknown.

### ***Heritage and Tradition***

Death care businesses have traditionally been family-owned businesses that have built a local heritage and tradition through successive generations, providing a foundation for ongoing business opportunities from established client family relationships and related referrals. Given the sensitive nature of our business, we believe that relationships fostered at the local level build trust in the community and are a key driver of market share. While new entrants may enter any given market, the time and resources required to develop local heritage and tradition serve as important barriers to entry.

### ***Deleveraging***

Until 1999, the industry experienced consolidation of independent death care businesses by a few large, primarily publicly owned death care consolidators that sought to benefit from economies of scale, improved managerial control, more effective operating strategies and greater financial resources. In recent years, these consolidators have been divesting selected properties and other assets, and using proceeds from such dispositions, together with cash flow, to accelerate debt reduction and build cash balances. We expect the level of dispositions to substantially decline.

### ***Preneed Marketing***

In addition to at-need sales, we and certain other death care providers sell products and services on a preneed basis. Selling products and services on a preneed basis, if properly executed, provides a backlog of future revenue and enhances the heritage and market share of an established funeral home or cemetery. However, most of our preneed sales lock in the revenue from future services at current prices and result in paying certain costs, such as sales commissions, at the time the preneed contract is originated.

## BUSINESS STRATEGY

Key elements of our overall business strategy include the following:

*Implement Operating Initiatives.* During the last few years, we and the other public consolidators have been restructuring our organizations and improving our financial condition, liquidity and cash flow. On January 1, 2004, we introduced our Standards Operating Model, a more decentralized and entrepreneurial financial operating model for our funeral homes. On January 1, 2006 we implemented a similar model to our cemetery business. These models are based on standards designed to grow market share and increase profitability 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. 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 Standards Operating Model has driven significant changes in our organization, leadership and operating practices. Most importantly, the Standards Operating Model allowed us to measure the sustainable revenue growth and earning power of our portfolio of deathcare businesses, which then led to development of a Strategic Portfolio Optimization Model during 2006 that will guide our acquisition and disposition strategies in the future. Both models, when executed effectively, should drive longer term increases in revenue, earnings and free cash flow.

The standards for our funeral and cemetery businesses are designed to drive longer term performance by growing market share and creating new heritage and producing consistent, modest revenue growth and a sustainable, increasing level of earnings and cash flow. The standards are not designed to produce maximum short term earnings because we do not believe such performance is sustainable without ultimately stressing the business, which often leads to declining market share, revenues and earnings

Our managing partners participate in a variable bonus plan in which they earn a percentage of their business’ earnings based upon the actual standards achieved. We believe our managing partners have the opportunity to be compensated at close to the same level as if they owned the business.

*Presentation and Packaging of Services and Merchandise.* We believe packaging funeral services and merchandise offers both simplicity and convenience for our client families. Well-conceived and thoughtful packages eliminate much of the effort and discomfort experienced by client families concerning matters about which they do not have much knowledge during a very stressful and emotional time. We have entered into updated arrangements with four primary casket suppliers to support our strategy and control wholesale costs. We also anticipate that our packaging strategy will result in increased revenue per cremation service over time as more families select packages that provide services and merchandise. The percentages of funeral services conducted by us in which cremation was chosen as the manner in which to dispose of remains was 33% for the year ended December 31, 2005 and 34% for the year ended December 31, 2006. For the year ended December 31, 2006, approximately 62% of the number of our total cremation services were direct cremations (where no viewing, visitation, or merchandise is involved, although a memorial service may be held) and 13% included additional services and merchandise.

*Preneed Funeral Sales Program.* We operate under a local, decentralized preneed sales strategy whereby each business location customizes its preneed program to its local needs. We emphasize insurance-funded contracts over trusted contracts in most markets, as insurance products allow us to earn commission income to improve our cash flow and offset a significant amount of the up-front costs associated with preneed sales. In addition, the cash flow and earnings from insurance contracts are more stable than traditional trust fund investments. In markets that depend on preneed sales for market share, we supplement the arrangements written by funeral directors with sales sourced by sales counselors and third party sellers.

*Systems and Support Enhancements.* We periodically perform targeted reviews of our systems and support services with the objective of improving effectiveness and streamlining processes. We will continue to review and change corporate processes to improve efficiency and effectiveness.

*Renewed Corporate Development Efforts.* We believe that our capital structure positions us to pursue a strategy of disciplined growth, affording us the flexibility to redeploy our cash and cash flow toward selective acquisitions that meet our criteria. We expect to continue to improve our earning power as we invest in businesses that will contribute incremental revenues, earnings and cash flow. A primary driver of our acquisition strategy will be the execution of our Strategic Portfolio Optimization Model using strategic ranking criteria to assess acquisition candidates as we optimize the sustainable earning power of our deathcare portfolio. As we execute this strategy, we will acquire larger, higher margin strategic businesses and sell smaller, lower margin non-strategic businesses. We believe we can do so without incremental investment in our consolidation platform infrastructure or additional fixed regional and corporate overhead.

Ideal candidates would be those that are demonstrated market leaders, have strong local management, have owners and family members whose objectives are aligned with ours, and have field-level operating margins consistent with our best performing properties. In our quest to find ideal candidates, we have analyzed and projected key statistics in the deathcare industry and believe the following will be true by 2015:

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- The number of national deaths will begin a long-term rise as the death rate among the baby boomer generation accelerates notwithstanding a longer life expectancy.
- The aging baby boomers will possess enormous wealth and the financial flexibility to migrate to attractive retirement and part time second career areas primarily in the southern and western states and other select markets.
- The general population of the United States will continue to grow and migrate to attractive urban and suburban centers in the southern and western states.
- Cremation rates will continue to increase and migrate eastward. The accelerating cremation rate will have a significant impact on the revenue base of more traditional deathcare businesses in the Central and Eastern regions of the United States and a lesser impact on the already high cremation states in the West.

With the above considerations in mind, the Company's vision over the next ten years is to change the profile to be heavily weighted in about 10-15 major markets that have an especially attractive demographic profile and where over time, we could acquire or build up operations in each of these markets by doing one to three thousand calls annually. We believe there are large enough markets for the Company to increase our presence in existing markets by acquisition or enter a new market with a substantial acquisition while leveraging our strong local franchise brands and entrepreneurial leadership. These markets are in geographic areas that complement our existing markets, with a primary focus on suburban markets with growing populations of 100,000 or more, preferably in the Northeast and on the West Coast and firms with at least 300 calls annually (or at least \$1.5 million in annual revenue). We will be applying the Standards Operating Model to qualified acquisition candidates to ensure they can be readily integrated into our portfolio.

## **OUR STRENGTHS**

*Market Leader in Our Suburban and Rural Markets.* Our operations are located in suburban and rural markets, where we primarily compete with smaller, independent operators with significantly less financial and managerial resources. Most of our suburban markets have populations of 100,000 or more. In over 70% of our funeral home markets, we believe that we are either first or second in local market share.

*Partnership Culture.* Our funeral homes and cemeteries are managed by individuals, that we refer to as managing partners, with extensive death care experience, often within their local markets. Our managing partners have responsibility for day-to-day operations but are required to follow operating and financial standards. This strategy allows each local business to maintain its unique identity within its local market and to capitalize on its reputation and heritage while our senior management maintains supervisory controls and provides support services from our corporate headquarters. We believe our culture will be very attractive to owners of premier independent businesses that fit our profile of suitable acquisition candidates.

*Flexible Capital Structure.* In January 2005, we met our goal of reaccessing the capital markets by completing our \$130 million senior debt offering. We used the net proceeds to pay off the existing senior debt that had near term maturities and accrued interest on our TIDES (described below). This transaction eliminated all near-term debt maturity issues. We believe that our capital structure provides us with financial flexibility, which allows us to focus our efforts on improving operations and growing the Company. After completion of the offering, we have four primary components in our capital structure:

- the \$130 million senior notes which have a 2015 maturity;
- a revolving credit facility, described under the heading "Liquidity and Capital Resources" in Item 7;
- our convertible junior subordinated debenture payable to our affiliate trust, which has the ability to defer payments of interest, and a 2029 maturity (our TIDES); and
- our common stock.

*Stable Cash Flow.* Since 2000, we have demonstrated the ability to generate stable cash flow. Prior to 2005, our primary use of cash flow was to repay debt. We have also demonstrated an ability to manage capital expenditures to a consistent level. Free cash flow (cash flow from operations less capital expenditures) for 2006 totaled \$11.8 million. We intend to use cash flow to fund a selective growth strategy. Our growth strategy is the primary way we expect to increase shareholder value, which means that we need to achieve a much higher return on invested capital during this growth cycle compared to the 90's cycle. We will reassess our capital allocation strategy annually, but at this point we believe that our financial goals will best be achieved by continuing to improve the operating and financial performance of our existing portfolio while selectively making new acquisitions.

*Strong Field-Level Operating Margins.* We believe that our field-level operating margins are among the highest reported by the



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public companies in the death care industry and that this performance is a testament to the success of our business strategies. These strong margins and the ability to control costs are important advantages in a business such as ours that is characterized by a high fixed-cost structure. We will continue to seek ways to improve our financial performance, and we believe that our standards-based operating model will continue to yield positive improvement in our financial results.

*Effective Management of Funeral Preneed Sales.* We believe our local, decentralized strategy allows us to adapt our preneed sales selectively to best address the competitive situation in our markets. In highly competitive markets, we execute a more aggressive preneed sales program. In less competitive markets where we have a strong market position, we deploy a more passive preneed sales program. In certain of our markets, we do not deploy a formal preneed program. This approach allows us to target the investment in preneed sales to markets where we have the opportunity to reinforce our market share. Because approximately 80% of our revenues are generated from at-need sales, we retain significant pricing leverage in our funeral business.

*Integrated Information Systems.* We have implemented information systems to support local business decisions and to monitor performance of our businesses compared to financial and performance standards. All of our funeral homes and cemeteries are connected to our corporate headquarters, which allows us to monitor and assess critical operating and financial data in order to analyze the performance of individual locations on a timely basis. Furthermore, our information system infrastructure provides senior management with a critical tool for monitoring and adhering to our established internal controls, which is critical given our decentralized model and the sensitive nature of our business operations.

*Proven Management Team.* Our management team, headed by Company founder Mel Payne, is characterized by a dynamic culture that reacts quickly and proactively to address changing market conditions and emerging trends. We believe this culture has been critical to our successful recent efforts and will provide an important advantage as the death care industry evolves. We are committed to continue operating an efficient corporate organization and strengthening our corporate and local business leadership. We believe that our Being the Best operating model will ensure this commitment at all levels of the organization. At mid-year 2006 we reorganized our funeral and cemetery divisions into three Regions, each headed by a Regional Partner. This change should engender more cooperation and synergy between our funeral and cemetery operations and support the goal of market-share and volume growth in our most significant markets. The three Regional Partners report to Mel Payne in the role of Chief Operating Officer.

## **OPERATIONS**

We conduct our funeral and cemetery operations only in the United States. Our operations are divided into two segments: funeral operations and cemetery operations. Information for each of our segments is presented below and in our financial statements set forth herein.

### ***Funeral Home Operations***

At December 31, 2006, we operated 131 funeral homes in 27 states. Funeral home revenues currently account for approximately 75% of our total revenues. The funeral home operations are managed by a team of experienced death care industry professionals and selected region-level individuals with substantial management experience in our industry. See Note 20 to the Consolidated Financial Statements for the year ended December 31, 2006, for segment data related to funeral home operations.

Our funeral homes offer a complete range of services to meet a family's funeral needs, including consultation, the removal and preparation of remains, the sale of caskets and related funeral merchandise, the use of funeral home facilities for visitation and worship, and transportation services. Most of our funeral homes have a non-denominational chapel on the premises, which permits family visitation and religious services to take place at one location and thereby reduces our transportation costs and inconvenience to the family.

Funeral homes are principally a service business that provides burial and cremation services and sells related merchandise, such as caskets and urns. Given the high fixed cost structure associated with funeral home operations, we believe the following are key factors affecting our profitability:

- favorable demographic trends in terms of population growth and average age, which impact death rates and number of deaths;
- 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.

## ***Cemetery Operations***

As of December 31, 2006, we operated 28 cemeteries in 11 states. The cemetery operations are managed by a team of experienced death care industry and sales professionals. Cemetery revenues currently account for approximately 25% of our total revenues. See Note 20 to the Consolidated Financial Statements for the year ended December 31, 2006, for segment data related to cemetery operations.

Our cemetery products and services include interment services, the rights to interment in cemetery sites (including grave sites, mausoleum crypts and niches) and related cemetery merchandise such as memorials and vaults. Cemetery operations generate revenues through sales of interment rights and memorials, installation fees, fees for interment and cremation services, finance charges from installment sales contracts and investment income from preneed cemetery merchandise and perpetual care trusts.

Our cemetery operating results are impacted by the success of our sales organization because approximately 40% of our cemetery revenues was generated from preneed sales of interment rights during the year ended December 31, 2006. An additional 20% of our 2006 cemetery revenues was from deliveries of merchandise and services previously sold on preneed contracts. We believe that changes in the level of consumer confidence (a measure of whether consumers will spend money on discretionary items) also impact the amount of cemetery revenues. Cemetery revenues generated from at-need services and merchandise sales generally are subject to many of the same key profitability factors as in our funeral home business. Approximately 13% of our cemetery revenues was attributable to investment earnings on trust funds and finance charges on installment contracts during the year ended December 31, 2006. Changes in the capital markets and interest rates affect this component of our cemetery revenues.

## ***Preneed Programs***

In addition to sales of funeral merchandise and services, cemetery interment rights and cemetery merchandise and services at the time of need, we also market funeral and cemetery services and products on a preneed basis. Preneed funeral or cemetery contracts enable families to establish, in advance, the type of service to be performed, the products to be used and the cost of such products and services. Preneed contracts permit families to eliminate issues of making death care plans at the time of need and allow input from other family members before the death occurs.

Preneed funeral contracts are usually paid on an installment basis. The performance of preneed funeral contracts is usually secured by placing the funds collected in trust for the benefit of the customer or by the purchase of a life insurance policy, the proceeds of which will pay for such services at the time of need. Insurance policies, intended to fund preneed funeral contracts, cover the original contract price and generally include an element of growth (earnings) designed to offset future inflationary cost increases. Revenue from preneed funeral contracts, along with accumulated earnings, are not recognized until the time the funeral service is performed. The commission income is recognized as revenue when the period of refund expires (generally one year), which helps us defray the costs we incur to originate the preneed contract (primarily commissions we pay to our sales counselors). Additionally, we generally earn a commission from the insurance company from the sale of insurance-funded policies. Prior to 2005, the direct marketing commissions and costs incurred from the sale of preneed funeral contracts were deferred and amortized on an actuarial method to match the expected maturity of the preneed contracts. Effective January 1, 2005, the Company changed its method for accounting for deferred obtaining costs and began expensing all costs as incurred. See Note 3 to the Consolidated Financial Statements for the year ended December 31, 2006, for more detailed discussion of the Company's accounting change.

In addition to preneed funeral contracts, we also offer "preplanned" funeral arrangements whereby a client determines in advance substantially all of the details of a funeral service without any financial commitment or other obligation on the part of the client until the actual time of need. Preplanned funeral arrangements permit a family to avoid issues of making death care plans at the time of need and enable a funeral home to establish relationships with a client that may eventually lead to an at-need sale.

Preneed sales of cemetery interment rights are usually financed through interest-bearing installment sales contracts, generally with terms of up to five years. In substantially all cases, we receive an initial down payment at the time the contract is signed. The interest rates generally range between 12% and 14%. Preneed sales of cemetery interment rights are generally recorded as revenue when 10% of the contract amount related to the interment right has been collected. Merchandise and services may similarly be sold on an installment basis, but revenue is recorded when delivery has occurred. Allowances for customer cancellations and refunds are recorded at the date that the contract is executed and periodically evaluated thereafter based upon historical experience.

Carriage sold 4,877 and 4,998 preneed funeral contracts during the years ended December 31, 2005 and 2006, respectively. At December 31, 2006, we had a backlog of 56,719 preneed funeral contracts to be delivered in the future. Approximately 20% of the funeral revenues recognized during each of the last three years and during the twelve months ended December 31, 2006 originated through preneed contracts. Cemetery revenues that originated from preneed contracts represented approximately 55% and 52% of Carriage's net cemetery revenues for both 2005 and 2006, respectively.

As of December 31, 2006, we employed a staff of 192 advance-planning and family service representatives for the sale of preneed products and services.

## **TRUST FUNDS AND INSURANCE CONTRACTS**

The Company has established a variety of trusts in connection with funeral home and cemetery operations as required under applicable state law. Such trusts include (i) preneed funeral trusts; (ii) preneed cemetery merchandise and service trusts; and (iii) perpetual care trusts. These trusts are typically administered by independent financial institutions selected by the Company. Independent financial advisors are also used for investment management and advisory services.

Preneed funeral sales generally require deposits to a trust or purchase of a third-party insurance product. Trust fund income earned and the receipt and recognition of any insurance benefits are deferred until the service is performed, while trust fund holdings and deferred revenue are reflected currently on the Company's balance sheet. In most states, the Company is not permitted to withdraw principal or investment income from such trusts until the funeral service is performed. Some states, however, allow for the retention of a percentage (generally 10%) of the receipts to offset any administrative and selling expenses. The aggregate balance of our preneed funeral contracts held in trust, insurance contracts and receivables from customers was approximately \$215 million as of December 31, 2006.

The Company is generally required under applicable state laws to deposit a specified amount (which varies from state to state, generally 50% to 100% of selling price) into a merchandise and service trust fund for cemetery merchandise and services preneed sales. The related trust fund income earned is recognized when the related merchandise and services are delivered. The Company is generally permitted to withdraw the trust principal and accrued income when the merchandise is actually purchased, when the service is provided or when the contract is cancelled. Cemetery merchandise and service trust fund balances, in the aggregate, totaled approximately \$55.5 million as of December 31, 2006.

In most states, regulations require a portion (generally 10%) of the sale amount of cemetery property and memorials to be placed in a perpetual care trust. The income from these perpetual care trusts provides a portion of the funds necessary to maintain cemetery property and memorials in perpetuity. This trust fund income is recognized, as earned, in cemetery revenues. While the Company is entitled to withdraw the income from perpetual care trusts to provide for maintenance of cemetery property and memorials, the Company is restricted from withdrawing any of the principal balances of the trust fund. Perpetual care trust balances totaled approximately \$32.5 million at December 31, 2006.

For additional information with respect to our trusts, see Notes 7, 8, 9 and 10 to the Consolidated Financial Statements for the year ended December 31, 2006.

## **COMPETITION**

The operating environment in the death care industry has been highly competitive. Publicly traded companies operating in the United States are Service Corporation International, Stewart Enterprises, Inc, Keystone North America, Inc., StoneMor Partners L.P. and Alderwoods Group until acquired by Service Corporation International in late 2006. In addition, a number of smaller, non-public companies have been active in acquiring and operating funeral homes and cemeteries.

Our funeral home and cemetery operations usually face competition in the markets that they serve. Our primary competition in most of our markets is from local independent operators. We have observed an increase in new start-up competition in certain areas of the country, which in any one market may have impacted our profitability because of the high fixed cost nature of funeral homes. Market share for funeral homes and cemeteries is largely a function of reputation and heritage, although competitive pricing, professional service and attractive, well-maintained and conveniently located facilities are also important. Because of the importance of reputation and heritage, market share increases are usually gained over a long period of time. The sale of preneed funeral services and cemetery property has increasingly been used by many companies as a marketing tool to build market share.

There has been increasing competition from providers specializing in specific services, such as cremations, who offer minimal service and low-end pricing. We also face competition from companies that market products and related information over the Internet and non-traditional casket stores in certain markets. These competitors have been successful in capturing a portion of the low-end market and product sales.

## **REGULATION**

Our operations are subject to regulations, supervision and licensing under numerous foreign, federal, state and local laws, ordinances and regulations, including extensive regulations concerning trust funds, preneed sales of funeral and cemetery products and services and various other aspects of our business. We believe that we comply in all material respects with the provisions of these laws, ordinances and regulations. We operate in the United States under the Federal Trade Commission (FTC) comprehensive trade

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regulation rule for the funeral industry. The rule contains requirements for funeral industry practices, including extensive price and other affirmative disclosures and imposes mandatory itemization of funeral goods and services.

We are subject to the requirements of the federal Occupational Safety and Health Act (“OSHA”) and comparable state statutes. The OSHA hazard communication standard, the United States Environmental Protection Agency community right-to-know regulations under Title III of the federal Superfund Amendment and Reauthorization Act and similar state statutes require us to organize information about hazardous materials used or produced in our operations. Certain of this information must be provided to employees, state and local governmental authorities and local citizens.

Our operations, including our preneed sales activities and the management and administration of preneed trust funds, are also subject to regulation, supervision and licensing under state laws and regulations. We believe that we are in substantial compliance with all such laws and regulations.

In accordance with the rules of the New York Stock Exchange, Inc., we submitted a Section 12(a) CEO Certification in 2006, which was not qualified in any manner. In addition, in accordance with the rules, attached as Exhibits 31.1 and 31.2 are our CEO and CFO certifications as required by Section 302 of the Sarbanes-Oxley Act of 2002.

## **EMPLOYEES**

As of December 31, 2006, we and our subsidiaries employed 1,526 employees, of whom 714 were full-time and 812 part-time. All of our funeral directors and embalmers possess licenses required by applicable regulatory agencies. We believe that our relationship with our employees is good. Approximately ten of our employees in Nevada have elected to have the local teamsters union represent them in contract negotiations with the Company. To date, the Company has not entered into any contracts with the union.

## **AVAILABLE INFORMATION**

Our website address is [www.carriageservices.com](http://www.carriageservices.com). Available on this website under “Investor Relations-Investor Relations Menu — SEC Filings,” free of charge, are Carriage’s annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, insider reports on Forms 3, 4 and 5 filed on behalf of directors and officers and amendments to those reports as soon as reasonably practicable after such materials are electronically filed with or furnished to the United States Securities and Exchange Commission (“SEC”).

Also posted on our website, and available in print upon request, are charters for the Company’s Audit Committee, Compensation Committee and Corporate Governance Committee. Copies of the Code of Business Conduct and Ethics and the Corporate Governance Guidelines are also posted on the Company’s website under the “Corporate Governance” section. Within the time period required by the SEC and the New York Stock Exchange, Inc., the Company will post on its website any modifications to the Codes and any waivers applicable to senior officers as defined in the applicable Code, as required by the Sarbanes-Oxley Act of 2002.

## **ITEM 1A. RISK FACTORS**

### **RISKS RELATED TO OUR BUSINESS**

#### **Marketing and sales activities by existing and new competitors could cause us to lose market share and lead to lower revenues and margins.**

We face competition in all of our markets. Most of our competitors are independently owned, and some are relatively recent market entrants. Certain of the recent entrants are individuals who were formerly employed by us or by our competitors and have relationships and name recognition within our markets. As a group, independent competitors tend to be aggressive in distinguishing themselves by their independent ownership, and they promote their independence through advertising, direct mailings and personal contact. Increasing pressures from new market entrants and continued advertising and marketing by competitors in local markets could cause us to lose market share and revenues. In addition, competitors may change the types or mix of products or services offered. These changes may attract customers, causing us to lose market share and revenue as well as to incur costs in response to competition to vary the types or mix of products or services offered by us.

#### **Our ability to generate preneed sales depends on a number of factors, including sales incentives and local and general economic conditions.**

Declines in preneed sales would reduce our backlog and revenue and could reduce our future market share. On the other hand, a significant increase in preneed sales can have a negative impact on cash flow as a result of commissions and other costs incurred without corresponding revenues.

As we have localized our preneed sales strategies, we are continuing to refine the mix of service and product offerings in both our funeral and cemetery segments, including changes in our sales commission and incentive structure. These changes could cause us to experience declines in preneed sales in the short-run. In addition, economic conditions at the local or national level could cause declines in preneed sales either as a result of less discretionary income or lower consumer confidence. Declines in preneed cemetery property sales would reduce current revenue, and declines in other preneed sales would reduce our backlog and future revenue and could reduce future market share.

Preneed sales of cemetery property and funeral and cemetery merchandise and services are generally cash flow negative initially, primarily due to the commissions paid on the sale, the portion of the sales proceeds required to be placed into trust or escrow and the terms of the particular contract such as the size of the down payment required and the length of the contract. As a result, preneed sales reduce cash flow available for other activities, and, to the extent preneed activities are increased, cash flow will be further reduced.

**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.**

We have historically experienced price competition primarily from independent funeral home and cemetery operators, and from monument dealers, casket retailers, low-cost funeral providers and other non-traditional providers of services or products. New market entrants tend to attempt to build market share by offering lower cost alternatives. In the past, this price competition has resulted in our losing market share in some markets. In other markets, we have had to reduce prices thereby reducing profit margins in order to retain or recapture market share. Increased price competition in the future could further reduce revenues, profit margins and our backlog.

**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.**

There has been little acquisition activity by us from 2001 through 2006, and there is no assurance that we will be able to identify candidates that meet our criteria or that we will be able to reach terms with identified candidates for transactions that are acceptable to us. We intend to apply standards established under our Strategic Portfolio Optimization Model in qualifying acquisition candidates, and there is no assurance that we will be successful in doing so or that we will find attractive candidates that satisfy these standards.

**Increased or unanticipated costs, such as insurance, taxes and new computer systems implementations, may have a negative impact on our earnings and cash flows.**

We have experienced material increases in certain costs during the previous years, such as implementing computer systems. We will incur large systems maintenance and upgrade costs annually, which costs can only be estimated. These types of cost increases may impair our ability to achieve revenue growth that exceeds our cost increases. Our 2007 plan assumes that we will be successful in increasing revenues at a rate that is greater than the growth in the cost of sales. We can give no assurance that we will be successful in achieving such increases.

**Improved performance in our funeral and cemetery segments is highly dependent upon successful execution of our standards-based Being the Best operating model.**

We have implemented our standards-based operating model to improve and better measure performance in our funeral and cemetery operations. We developed standards according to criteria, each with a different weighting, designed around market share, people, and operational and financial metrics. We also incentivise our location managing partners by giving them the opportunity to earn a fixed percentage of the field-level earnings before interest, taxes, depreciation and amortization based upon the number and weighting of the standards achieved. Our expectation is that, over time, the Standards Operating Model will result in our maintaining or improving field-level margins, market share, customer satisfaction and overall financial performance, but there is no assurance that these goals will be met. We have learned that success using the model is highly dependent on having the right leader in the business.

**Smaller businesses are typically dependent upon one or a few key employees for success.**

Death care businesses have built local heritage and tradition through successive generations, providing a foundation for ongoing business opportunities from established client family relationships and related referrals. We believe these relationships build trust in the community and are a key driver to market share. Our smaller businesses, which tend to be located in smaller communities, usually have one or a few key employees that drive this relationship to the community. We can give no assurance that we can retain these employees or that these relationships will drive market share.

**Earnings from and principal of trust funds and insurance contracts could be reduced by changes in financial markets and the mix of securities owned.**

Earnings and investment gains and losses on trust funds and insurance contracts are affected by financial market conditions and the mix of fixed-income and equity securities that we choose to maintain in the funds. During 2004 and 2005, we revised the mix of investments within the cemetery trusts according to our new asset allocation model in an effort to increase earnings and lower volatility. We made similar changes in some of the funeral trusts in 2006. We may not choose the optimal mix for any particular market condition. Declines in earnings from perpetual care trust funds would cause a decline in current revenues, while declines in earnings from other trust funds could cause a decline in future cash flows and revenues.

**Covenant restrictions under our debt instruments may limit our flexibility in operating our business.**

The terms of our credit facility and the indenture governing the Senior Notes may limit our ability and the ability of our subsidiaries to, among other things:

- incur additional debt;
- pay dividends or make distributions or redeem or repurchase stock;
- make investments;
- grant liens;
- make capital expenditures;
- enter into transactions with affiliates;
- enter into sale-leaseback transactions;
- sell assets; and
- acquire the assets of, or merge or consolidate with, other companies.

Our credit facility also requires us to maintain certain financial ratios. Complying with these restrictive covenants and financial ratios, as well as those that may be contained in any future debt agreements, may impair our ability to finance our future operations or capital needs or to take advantage of other favorable business opportunities. Our ability to comply with these restrictive covenants and financial ratios will depend on our future performance, which may be affected by events beyond our control. Our failure to comply with any of these covenants or restrictions when they apply will result in a default under the particular debt instrument, which could permit acceleration of the debt under that instrument and, in some cases, the acceleration of debt under other instruments that contain cross-default or cross-acceleration provisions. In the case of an event of default, or in the event of a cross-default or cross-acceleration, we may not have sufficient funds available to make the required payments under our debt instruments. If we are unable to repay amounts owed under the terms of our amended senior secured credit facility, the lenders thereunder may be entitled to sell certain of our funeral assets to satisfy our obligations under the agreement.

## **RISKS RELATED TO THE DEATH CARE INDUSTRY**

**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.**

Declines in the number of deaths could cause at-need sales of funeral and cemetery services, property and merchandise to decline, which could decrease revenues. Although the United States Bureau of the Census estimates that the number of deaths in the United States will increase through 2010, longer life spans could reduce the rate of deaths. In addition, changes in the number of deaths can vary among local markets and from quarter to quarter, and variations in the number of deaths in our markets or from quarter to quarter are not predictable. These variations may cause our revenues to fluctuate and our results of operations to lack predictability.

**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.**

Our traditional cemetery and funeral service operations face competition from the increasing number of cremations in the United States. Industry studies indicate that the percentage of cremations has steadily increased and that cremations will represent approximately 35% of the U.S. burial market by the year 2010, compared to approximately 32% in 2005. The trend toward cremation could cause cemeteries and traditional funeral homes to lose market share and revenues to firms specializing in cremations. In addition, direct cremations (with no funeral service, casket, urn, mausoleum niche, columbarium niche or burial) produce no revenues for cemetery operations and lower revenues than traditional funerals and, when delivered at a traditional funeral home, produce lower profit margins as well.

**If we are not able to respond effectively to changing consumer preferences, our market share, revenues and profitability could decrease.**

Future market share, revenues and profits will depend in part on our ability to anticipate, identify and respond to changing consumer preferences. In past years, we have implemented new product and service strategies based on results of customer surveys that we conduct on a continuous basis. However, we may not correctly anticipate or identify trends in consumer preferences, or we may identify them later than our competitors do. In addition, any strategies we may implement to address these trends may prove incorrect or ineffective.

**Because the funeral and cemetery businesses are high fixed-cost businesses, changes in revenue can have a disproportionately large effect on cash flow and profits.**

Companies in the funeral home and cemetery business must incur many of the costs of operating and maintaining facilities, land and equipment regardless of the level of sales in any given period. For example, we must pay salaries, utilities, property taxes and maintenance costs on funeral homes and maintain the grounds of cemeteries regardless of the number of funeral services or interments performed. Because we cannot decrease these costs significantly or rapidly when we experience declines in sales, declines in sales can cause margins, profits and cash flow to decline at a greater rate than the decline in revenues.

**Changes or increases in, or failure to comply with, regulations applicable to our business could increase costs or decrease cash flows.**

The death care industry is subject to extensive regulation and licensing requirements under federal, state and local laws. For example, the funeral home industry is regulated by the Federal Trade Commission, which requires funeral homes to take actions designed to protect consumers. State laws impose licensing requirements and regulate preneed sales. Embalming and cremation facilities are subject to stringent environmental and health regulations. Compliance with these regulations is burdensome, and we are always at risk of not complying with the regulations or facing costly and burdensome investigations from regulatory authorities.

In addition, from time to time, governments and agencies propose to amend or add regulations, which could increase costs or decrease cash flows. For example, federal, state, local and other regulatory agencies have considered and may enact additional legislation or regulations that could affect the death care industry. Several states and regulatory agencies have considered or are considering regulations that could require more liberal refund and cancellation policies for preneed sales of products and services, limit or eliminate our ability to use surety bonding, increase trust requirements and prohibit the common ownership of funeral homes and cemeteries in the same market. If adopted by the regulatory authorities of the jurisdictions in which we operate, these and other possible proposals could have a material adverse effect on us, our financial condition, our results of operations and our future prospects. For additional information regarding the regulation of the death care industry, see “Business — Regulation”.

## ITEM 1B. UNRESOLVED STAFF COMMENTS

None.

## ITEM 2. PROPERTIES

At December 31, 2006, we operated 131 funeral homes in 27 states and 28 cemeteries in 11 states. Carriage owns the real estate and buildings for 80% of our funeral homes and leases facilities for the remaining 20%. Carriage owns 23 cemeteries and operates five cemeteries under long-term contracts with municipalities and non-profit organizations at December 31, 2006. Ten funeral homes are operated in combination with cemeteries as these locations are physically located on the same property or very close proximity and under same management. The 28 cemeteries operated by Carriage have an inventory of unsold developed lots totaling approximately 106,000 and 114,000 at December 31, 2005 and 2006, respectively. In addition, approximately 495 acres are available for future development. We anticipate having a sufficient inventory of lots to maintain our property sales for the foreseeable future. The specialized nature of our business requires that our facilities be well-maintained. Management believes this standard is met.

The following table sets forth certain information as of December 31, 2006, regarding Carriage's properties used by the funeral homes segment and by the cemeteries segment identified by state:

State	Number of Funeral Homes		Number of Cemeteries	
	Owned	Leased(1)	Owned	Managed
California	16	2	3	0
Connecticut	6	2	0	0
Florida	6	3	6	3
Georgia	3	0	0	0
Idaho	4	1	1	0
Illinois	1	4	1	0
Iowa	2	0	0	0
Kansas	7	0	0	0
Kentucky	10	3	1	0
Maryland	1	0	0	0
Massachusetts	6	0	0	0
Michigan	4	0	0	0
Missouri	0	1	0	0
Montana	1	0	0	0
Nevada	2	0	2	1
New Jersey	4	1	0	0
New Mexico	1	0	0	0
New York	1	1	0	0
North Carolina	1	2	1	0
Ohio	4	3	0	1
Oklahoma	1	0	1	0
Rhode Island	4	0	0	0
Tennessee	3	0	0	0
Texas	11	1	6	0
Virginia	3	1	1	0
Washington	1	1	0	0
West Virginia	1	1	0	0
Total	104	27	23	5

- (1) The leases, with respect to these funeral homes, have remaining terms ranging from one to seven years, and, generally, we have the right to renew past the initial terms and a right of first refusal on any proposed sale of the property where these funeral homes are located.

Carriage's corporate headquarters occupy approximately 37,000 square feet of leased office space in Houston, Texas. At December 31, 2006, we operated 559 vehicles, of which 557 are owned and 2 are leased.



**ITEM 3. LEGAL PROCEEDINGS**

Carriage 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.

We self-insure against certain risks and carry insurance with coverage and coverage limits for risks 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 the reserves and our insurance provides reasonable coverage for known asserted or unasserted claims. In the event the Company sustained a loss from a claim and the insurance carrier disputed coverage or coverage limits, the Company may record a charge in a different period than the recovery, if any, from the insurance carrier.

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

No matters were submitted to a vote of the Company's stockholders during the fourth quarter of 2006.

**PART II****ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES**

Carriage's Common Stock is traded on the New York Stock Exchange under the symbol "CSV". The following table presents the quarterly high and low sale prices as reported by the New York Stock Exchange:

<u>2006</u>	<u>High</u>	<u>Low</u>
First Quarter	\$5.25	\$4.60
Second Quarter	\$5.16	\$4.40
Third Quarter	\$4.94	\$4.12
Fourth Quarter	\$5.19	\$4.61
<u>2005</u>		
First Quarter	\$5.71	\$4.77
Second Quarter	\$6.30	\$5.20
Third Quarter	\$6.75	\$6.00
Fourth Quarter	\$6.41	\$4.76

As of February 28, 2007, there were 18,718,490 shares of Carriage's Common Stock outstanding and the closing price as reported by the New York Stock Exchange was \$7.01 per share. The Common Stock shares outstanding are held by approximately 300 stockholders of record. Each share is entitled to one vote on matters requiring the vote of stockholders. We believe there are approximately 5,000 beneficial owners of the Common Stock.

We have never paid a cash dividend on our Common Stock. Carriage currently intends to retain earnings to fund the growth and development of our business. Any future change in our policy will be made at the discretion of our Board of Directors in light of the financial condition, capital requirements, earnings prospects of Carriage and any limitations imposed by lenders or investors, as well as other factors the Board of Directors may deem relevant.

We have a compensation policy for fees paid to its directors under which our directors may choose to receive director compensation fees either in the form of cash compensation or equity compensation based on the fair market value of our common stock based on the closing price published by the New York Stock Exchange on the date the fees are earned. Prior to May 2006, the shares issued to directors in lieu of payment in cash were unregistered. In connection with our Annual Meeting of Stockholders in May 2006, the stockholders approved our 2006 Long Term Incentive Plan and the Company registered the shares available for future issue for this compensation policy and other corporate purposes. The Company issued 13,709 and 3,003 unregistered shares of common stock to directors in lieu of payment in cash for their fees for the years ended December 31, 2005 and 2006, respectively, the value of which was charged to operations. No underwriter was used in connection with these issuances. Carriage relied on the Section 4(2) exemption from the registration requirements of the Securities Act of 1933, as amended.

We did not repurchase any of our equity securities during the fourth quarter of the year ended December 31, 2006.

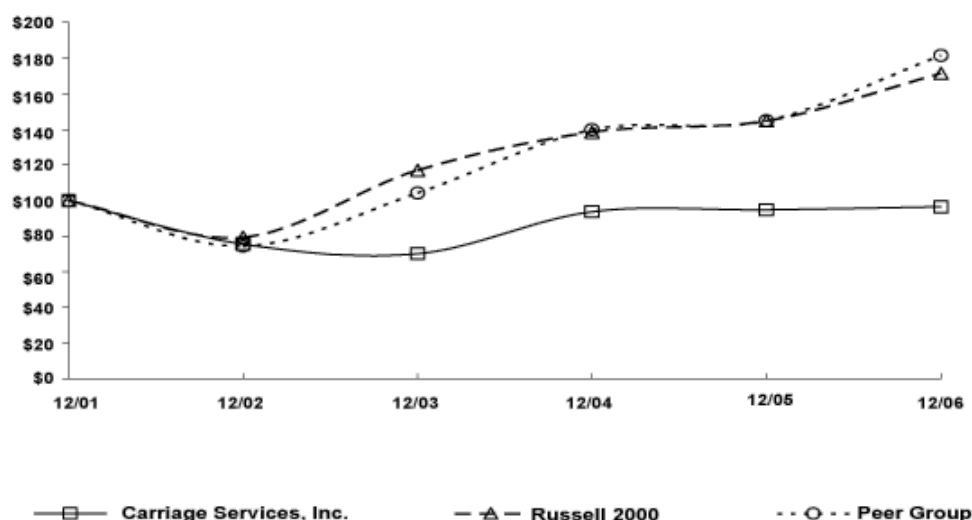
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The following graph compares the cumulative 5-year total return provided shareholders on Carriage Services, Inc.'s common stock relative to the cumulative total returns of the Russell 2000 index, and a customized peer group of three companies that includes: Service Corp. International, Stewart Enterprises Income and Stonemor Partners Limited Partnership. An investment of \$100 (with reinvestment of all dividends) is assumed to have been made in our common stock, in the peer group, and the index on December 31, 2001 and its relative performance is tracked through December 31, 2006.

*The performance graph shall not be deemed incorporated by reference by any general statement incorporating by reference this annual report into any filing under the Securities Act of 1933, except to the extent we specifically incorporate this information by reference, and shall not otherwise be deemed filed under such acts.*

### COMPARISON OF 5 YEAR CUMULATIVE TOTAL RETURN\*

Among Carriage Services, Inc., The Russell 2000 Index  
And A Peer Group



\* \$100 invested on 12/31/01 in stock or index-including reinvestment of dividends. Fiscal year ending December 31.

	12/01	12/02	12/03	12/04	12/05	12/06
Carriage Services, Inc.	100.00	75.52	70.21	93.74	94.88	96.58
Russell 2000	100.00	79.52	117.09	138.55	144.86	171.47
Peer Group	100.00	74.50	104.20	139.79	144.81	181.46

*The stock price performance included in this graph is not necessarily indicative of future stock price performance.*

### PEER GROUP

Service Corp. International  
Stewart Enterprises Income  
Stonemor Partners Limited Partnership

## ITEM 6. SELECTED FINANCIAL DATA

The following table sets forth selected consolidated financial information for Carriage that has been derived from the audited Consolidated Financial Statements of Carriage as of and for each of the years ended December 31, 2002, 2003, 2004, 2005, and 2006. These historical results are neither indicative of our future performance, nor necessarily comparable as a result of a change in accounting methods discussed below.

We adopted FASB Interpretation No. 46, as revised (“FIN 46R”), *Consolidation of Variable Interest Entities, an Interpretation of Accounting Research Bulletin (ARB) No. 51*, as of March 31, 2004. The adoption of FIN 46R resulted in the consolidation of funeral and cemetery merchandise and service, and perpetual care trusts in our consolidated balance sheet at fair value. We do not consolidate certain funeral trusts for which we do not absorb a majority of their expected losses and, therefore, are not considered a primary beneficiary of these funeral trusts under FIN 46R. The adoption of FIN 46R also resulted in the deconsolidation of Carriage Services Capital Trust, the issuer of TIDES preferred securities. Instead, we now report as a liability the junior subordinated debenture payable to the Trust. Amounts and balances prior to March 31, 2004 have not been restated to reflect the adoption of FIN 46R.

The Company changed its method of accounting for preneed selling costs, which are direct costs incurred for the origination of prearranged funeral and cemetery service and merchandise sales contracts, effective January 1, 2005. The change affects the comparability of the operating results in the following table. Prior to this change, commissions and other direct selling costs related to originating preneed funeral and cemetery service and merchandise sales contracts were deferred and amortized with the objective of recognizing the selling costs in the same period that the related revenue is recognized. Under the new accounting method, the commissions and other direct selling costs, which are current obligations are paid and use operating cash flow, are expensed as incurred. The Company’s results of operations for the years ended December 31, 2005 and 2006 are reported on the basis of our changed method, but the periods prior to 2005 are reported using the prior accounting method. See Note 3 of Notes to Consolidated Financial Statements for the year ended December 31, 2006.

Effective January 1, 2006, the Company adopted Statement of Financial Accounting Standards No. 123 (Revised), Share-Based Payment (“SFAS 123R”), which requires, among other things, entities to recognize in the income statement the grant-date fair value of stock options and other stock-based awards over the service periods the awards are expected to vest. Pursuant to the provisions of SFAS 123R, the Company applied the modified-prospective transition method. Under this method, the fair value provision of SFAS 123R is applied to new employee stock-based awards granted after December 31, 2005. Measurement and recognition of compensation cost for unvested awards at December 31, 2005, granted prior to the adoption of SFAS 123R, are recognized under the provisions of SFAS No 123, Accounting for Stock-Based Compensation (“SFAS 123”), after adjustments for estimated forfeiture. SFAS 123R no longer permits pro-forma disclosure for income statement periods after December 31, 2005 and compensation expense is recognized for all stock-based awards based on grant-date fair value. The Company’s results of operations for the year ended December 31, 2006 is reported on the basis of our changed method, but the periods prior to 2006 are reported using the prior accounting method. See Note 1 of Notes to Consolidated Financial Statements for the year ended December 31, 2006.

You should read this historical financial data together with “Management’s Discussion and Analysis of Financial Condition and Results of Operations” included in this report and Carriage’s Consolidated Financial Statements and notes thereto included elsewhere in this report.

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	2002	Year ended December 31,			2006
		2003	2004	2005	
		(in thousands, except per share and operating data)			
INCOME STATEMENT DATA:					
Revenues:					
Funeral	\$ 110,453	\$ 107,850	\$ 108,478	\$ 111,643	\$ 114,927
Cemetery	32,925	33,059	36,115	37,555	36,159
Total revenues	143,378	140,909	144,593	149,198	151,086
Gross profit:					
Funeral	32,126	28,037	28,584	29,192	30,109
Cemetery	7,690	8,128	8,578	6,525	3,943
Total gross profit	39,816	36,165	37,162	35,717	34,052
General and administrative expenses	10,557	10,492	10,665	12,383	11,258
Other charges (income)	871	432	495	(822)	—
Operating income	28,388	25,241	26,002	24,156	22,794
Interest expense	(19,543)	(17,773)	(16,908)	(18,599)	(18,514)
Additional interest and other costs of senior debt refinancing	—	—	—	(6,933)	—
Other income (expense)	865	657	940	(73)	1,921
Income (loss) before income taxes	9,710	8,125	10,034	(1,449)	6,201
(Provision) benefit for income taxes	7,172	(3,047)	(81)	456	(2,375)
Net income (loss) from continuing operations	16,882	5,078	9,953	(993)	3,826
Income (loss) from discontinued operations	3,396	1,547	(719)	1,884	(5,242)
Cumulative effect of the change in accounting, net of taxes	—	—	—	(22,756)	—
Net income (loss)	\$ 20,278	\$ 6,625	\$ 9,234	\$ (21,865)	\$ (1,416)
Earnings (loss) per share					
Basic:					
Continuing operations	\$ 1.00	\$ 0.29	\$ 0.56	\$ (0.05)	\$ 0.21
Discontinued operations	0.20	0.09	(0.04)	0.10	(0.29)
Cumulative effect of the change in accounting principle	—	—	—	(1.24)	—
Basic earnings (loss) per share	\$ 1.20	\$ 0.38	\$ 0.52	\$ (1.19)	\$ (0.08)
Diluted:					
Continuing operations	\$ .96	\$ 0.29	\$ 0.55	\$ (0.05)	\$ 0.20
Discontinued operations	0.20	0.08	(0.04)	0.10	(0.28)
Cumulative effect of the change in accounting principle	—	—	—	(1.24)	—
Diluted earnings (loss) per share	\$ 1.16	\$ 0.37	\$ 0.51	\$ (1.19)	\$ (0.08)
Weighted average number of common and common equivalent shares outstanding:					
Basic	16,973	17,444	17,786	18,334	18,545
Diluted	17,433	17,808	18,260	18,334	18,912
OPERATING AND FINANCIAL DATA:					
Funeral homes at end of period	144	139	135	133	131
Cemeteries at end of period	30	30	30	29	28
Funeral services performed	23,990	23,323	22,673	22,792	22,468
Preneed funeral contracts sold	5,456	5,174	4,936	4,877	4,998
Backlog of preneed funeral contracts	59,412	59,696	60,309	58,531	56,719
Depreciation and amortization	\$ 9,526	\$ 9,934	\$ 10,647	\$ 9,336	\$ 8,688
BALANCE SHEET DATA:					
Total assets	\$ 549,948	\$ 538,917	\$ 565,156	\$ 570,640	\$ 564,996
Working capital (deficit)	(1,598)	(14,285)	4,933	26,915	35,755
Long-term debt, net of current maturities	141,207	105,355	102,714	134,572	133,841
Convertible junior subordinated debenture (1)	—	—	93,750	93,750	93,750
Redeemable convertible preferred stock (TIDES) (1)	90,193	90,327	—	—	—
Stockholders' equity	\$ 98,091	\$ 105,930	\$ 116,438	\$ 96,374	\$ 96,373

- (1) When the TIDES were issued in 1999, we reported the securities as a component of temporary equity because they have predominantly equity-like characteristics which are not normally found in debt securities (including traditional subordinated debt). In 2004, we changed that classification to report the securities as subordinated debt in order to comply with a new accounting standard.

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

### OVERVIEW

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 a service business 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 memorials. As of December 31, 2006, we operated 131 funeral homes in 27 states and 28 cemeteries in 11 states within the United States. Substantially all administrative activities are conducted in our home office in Houston, Texas.

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 37% 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.

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. 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. We have also determined that this model is most effective in larger businesses. Being the best is not something that occurs easily and quickly, but we believe execution of the model should result in improving performance in 2007 and beyond.

The cemetery operating results are affected by the size and success of our sales organization because approximately 59% of our cemetery revenues for the year ended December 31, 2006 relate to sales of grave sites and mausoleums and related merchandise and services before the time of need. 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 13% of our cemetery revenues for the year ended December 31, 2006 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.

### 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, because 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. Our significant accounting policies are summarized in Note 1 to the Consolidated Financial Statements. 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 from the delivery of merchandise and performance of services related to contracts that were acquired in acquisitions are typically lower than those originated by the Company.

Allowances for bad debts and customer cancellations refunds and bad debts are provided at the date that sale is recognized as revenue. In addition, we monitor changes in delinquency rates and provide additional bad debt and cancellation reserves when warranted. 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 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 and other direct related costs of originating preneed sales contracts. Prior to 2005, these costs were deferred and amortized into funeral and cemetery costs and expenses over the period we expect to perform the services or deliver the merchandise covered by the preneed contracts. The periods over which the costs were recognized were based on actuarial statistics for the actual contracts we hold, provided by a third-party administrator. Beginning in 2005, we changed our method of accounting for preneed selling costs. Preneed selling costs are now expensed as incurred. The cumulative impact of the change was a charge in the amount of \$22.8 million, net of tax, equal to \$1.24 per diluted share. See the following section, Accounting Method Change, and Note 3 to the Consolidated Financial Statements.

### *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, 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 FAS 109, "Accounting for Income Taxes." 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, stock option and employee stock purchase plans. Beginning January 1, 2006, 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 share based payment 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. The Company adopted FAS No. 123R in the first quarter of 2006, using the modified prospective application method, which results in no restatement of the Company's previously issued annual consolidated financial statements. See Note 1 to the consolidated financial statements.

Prior to 2006, the Company accounted for stock based compensation under APB No. 25 and provided the disclosures required under FAS No. 123, "Accounting for Stock-Based Compensation", as amended by FAS No. 148, "Accounting for Stock-Based

Compensation — Transition and Disclosure.” Had the Company accounted for stock options and shares pursuant to its employee stock benefit plans under FAS No. 123R for the years ended December 31, 2004 and 2005, diluted earnings per share for those periods would have been lower by approximately \$0.02 and \$0.01, respectively, for each year.

We have granted restricted stock to certain officers and key employees of the Company, which vest over a period of four years. These shares are valued at the dates granted and the value is charged to operations as the shares vest.

#### *Preneed Funeral and Cemetery Trust Funds*

The FASB issued FASB Interpretation No. 46, as revised, (“FIN 46R”), “*Consolidation of Variable Interest Entities, an Interpretation of Accounting Research Bulletin (ARB) No. 51.*” This interpretation clarifies the circumstances in which certain entities that do not have equity investors with a controlling financial interest must be consolidated by its sponsor. The Company implemented FIN 46R as of March 31, 2004, which resulted, for financial reporting purposes, in the consolidation of the Company’s preneed and perpetual care trust funds. The investments of such trust funds have been reported at market value and the Company’s future obligations to deliver merchandise and services have been reported at estimated settlement amounts. The Company has also recognized the non-controlling financial interests of third parties in the trust funds. There was no cumulative effect of an accounting change recognized by the Company as a result of the implementation of FIN 46R. The implementation of FIN 46R affected certain accounts on the Company’s balance sheet beginning March 31, 2004 as described below; however, it did not affect cash flow, net income or the manner in which we recognize and report revenues.

Although FIN 46R requires consolidation of preneed and perpetual care trusts, it did not change the legal relationships among the trusts, the Company and its customers. In the case of preneed trusts, the customers are the principal beneficiaries. In the case of perpetual care trusts, the Company does not have a right to access the corpus in the perpetual care trusts. For these reasons, the Company has recognized non-controlling interests in our financial statements to reflect third party interests in these consolidated trust funds.

Both the preneed trusts and the cemetery perpetual care trusts hold investments in marketable securities which have been classified as available-for-sale. The investments are reported at fair value, with unrealized gains and losses allocated to Non-controlling interests in trust investment in the Company’s consolidated balance sheet. Unrealized gains and losses attributable to the Company, but that have not been earned through the performance of services or delivery of merchandise, are allocated to deferred revenues.

Also, in connection with the implementation of FIN 46R, the Company began recognizing the income, gains and losses of the preneed trusts and the unrealized income, gains and losses of the cemetery perpetual care trusts. The Company recognizes a corresponding expense equal to the recognized earnings of these trusts attributable to the non-controlling interest holders. When such earnings attributable to the Company have not been earned through the performance of services or delivery of merchandise, the Company will record such earnings as deferred revenue.

For preneed trusts, the Company recognizes as revenues amounts attributed to the non-controlling interest holders and the Company, including accumulated earnings, when the contracted services have been performed and merchandise delivered. For cemetery perpetual care trusts, the Company recognizes investment earnings in cemetery revenues when such earnings are realized and distributable. Such earnings are intended to defray cemetery maintenance costs incurred by the Company.

#### *Discontinued Operations*

In accordance with the Company’s strategic portfolio policy, smaller, lower margin, 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.



## ACCOUNTING METHOD CHANGES

### *Accounting Changes and Error Corrections*

The FASB issued FAS No. 154, “Accounting Changes and Error Corrections” (“FAS No. 154”). This statement is a replacement of Accounting Principles Board Opinion No. 20 and FAS No. 3. FAS No. 154 changes the requirements for the accounting for and reporting of a change in accounting principle and error corrections. It establishes, unless impracticable and in the absence of explicit transition requirements, retrospective application as the required method of a change in accounting principle to the newly adopted accounting principle. Also, it establishes guidance for reporting corrections of errors as reporting errors involves adjustments to previously issued financial statements similar to those generally applicable to reporting accounting changes retrospectively. FAS No. 154 also provides guidance for determining and reporting a change when retrospective application is impracticable. FAS No. 154 is effective for accounting changes and corrections of errors made in the fiscal years beginning after December 15, 2005. The Company adopted the requirements beginning January 1, 2006, which had no effect on the Company’s presentation and disclosure.

### *Income Taxes*

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 years after December 15, 2006 and will be adopted by the company in the first quarter of 2007. The company has reviewed its income tax positions and identified certain tax deductions related to business acquisitions that are not certain. The cumulative effect of adopting FIN 48 will be recorded in retained earnings and other balance sheet accounts, as applicable. The Company has not determined the effect that the adoption of FIN 48 will have on our financial position and results of operations. Should penalties and interest be recorded in connection with the Company’s tax position, they will be recognized as income tax expense. Because the Company presently has net operating losses available to offset taxable income, no penalties or interest are recorded in connection with the adoption of FIN 48.

### *Fair Value Measurements*

In September 2006, the FASB issued SFAS No. 157, “Fair Value Measurements” (“SFAS No. 157”), which establishes a framework for measuring fair value in accordance with Generally Accepted Accounting Principles (“GAAP”) and expands disclosures about fair value measurements. This statement is effective as of the beginning of the entity’s first fiscal year that begins after November 15, 2007. The Company is currently evaluating the impact, if any, the adoption of SFAS No. 157 will have on its consolidated financial statements.

### *Consideration of Misstatements*

In September 2006, the SEC released Staff Accounting Bulletin No. 108, “Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements” (SAB 108), which provides interpretive guidance on how the effects of the carryover or reversal of prior year misstatements should be considered in quantifying a current year misstatement. The SEC staff believes that registrants should quantify errors using both a balance sheet and an income statement approach and evaluate whether either approach results in quantifying a misstatement that, when all relevant quantitative and qualitative factors are considered, is material. The provisions of SAB 108 is effective for financial statements as of the beginning of the first fiscal year ending after November 15, 2006. The Company adopted the requirements at November 15, 2006. The impact of SAB 108 in the future will depend on the nature and extent of any prior year misstatements, but we do not anticipate SAB 108 will have any impact to our consolidated financial statements.



## SELECTED INCOME AND OPERATIONAL DATA

The following table sets forth certain income statement data for Carriage expressed as a percentage of net revenues for the periods presented:

	Year Ended December 31,		
	2004	2005	2006
Total revenues	100.0%	100.0%	100.0%
Total gross profit	25.7	23.9	22.5
General and administrative expenses	7.4	8.3	7.5
Operating income	18.0	16.2	15.1
Interest expense	11.7	12.5	12.3

The following table sets forth the number of funeral homes and cemeteries owned and operated by Carriage for the periods presented:

	Year Ended December 31,		
	2004	2005	2006
Funeral homes at beginning of period	139	135	133
Acquisitions	—	2	1
Divestitures, mergers or closures of existing funeral homes	4	4	3
Funeral homes at end of period	<u>135</u>	<u>133</u>	<u>131</u>
Cemeteries at beginning of period	30	30	29
Acquisitions	—	—	—
Divestitures	—	1	1
Cemeteries at end of period	<u>30</u>	<u>29</u>	<u>28</u>

The following is a discussion of Carriage's results of operations for 2004, 2005, and 2006. The term "same-store" or "existing operations" refers to funeral homes and cemeteries owned and operated for the entirety of each period being compared.

## YEAR ENDED DECEMBER 31, 2006 COMPARED TO YEAR ENDED DECEMBER 31, 2005

The following is a discussion of the Company's results of operations for the years ended December 31, 2005 and 2006.

Net income from continuing operations for the year ended December 31, 2006 totaled \$3.8 million, equal to \$0.20 per diluted share as compared to a net (loss) from continuing operations of \$(1.0) million for the year ended December 31, 2005, or \$(0.05) per diluted share. The variance between the two periods was primarily due to a \$6.0 million make-whole payment during the first quarter of 2005 to the former debtholders in connection with the repayment of previously outstanding senior debt along with a charge in the amount of \$0.9 million to write off the related unamortized loan costs, in total equal to \$0.24 per diluted share. We repaid this senior debt and paid the make-whole payment with proceeds from our \$130 million senior note offering, which closed in January 2005. During 2006 the Company recorded charges of approximately \$0.8 million for environmental remediation, equal to \$0.03 per diluted share. Excluding the effect of these items, diluted earnings per share from continuing operations for the year ended December 31, 2005 equaled \$0.20 compared to \$0.23 for the year ended December 31, 2006.

There are two major operational areas that management is focusing its efforts to improve results: (1) The Central Region funeral operations, which suffered a year over year decline in pretax profitability of \$0.7 million, and (2) a cemetery in California, whose pretax profits declined by \$2.6 million compared to 2005. The decline in profitability in these two areas is equivalent to \$(0.12) per diluted share for the year. We recently made changes in leadership over each of these areas to focus on the issues affecting profits, such as local sales management, receivable collections, expense management, pricing and marketshare losses.

(Loss) from discontinued operations for the year ended December 31, 2006 totaled \$(5.2) million, equal to \$(0.28) per diluted share. During 2006, the Company sold a funeral home business and a combination funeral home and cemetery business for approximately \$6.5 million and ceased operations at a funeral home business. We recorded impairment charges of \$6.3 million, a substantial portion of which related to specifically identified goodwill, and recognized \$0.2 million of net losses. We recorded additional impairment charges totaling \$2.1 million, which is related to specifically identified goodwill, for three funeral home businesses to be sold in 2007. The sales of two of these businesses were completed in January and February of 2007. Income from discontinued operations for the year ended December 31, 2005 totaled \$1.9 million, equal to \$0.10 per diluted share, and consisted primarily of a gain on the sale of a funeral home business during the first quarter of 2005.

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**Funeral Home Segment.** The following table sets forth certain information regarding the revenues and gross profit of the Company from the funeral home operations for the year ended December 31, 2005 compared to the year ended December 31, 2006. For purposes of our discussion, the revenue and gross profit of our businesses identified to be sold are included in the same-store classification up to the quarter prior to their sale.

	Year Ended December 31,		Change	
	2005	2006	Amount	Percent
	(dollars in thousands)			
Total same-store revenue	\$ 111,606	\$ 114,497	\$ 2,891	2.6%
Less: businesses held for sale	(2,258)	(1,837)	421	*
Preneed insurance commissions revenue	2,295	2,267	(28)	(1.2)%
Revenues from continuing operations	\$ 111,643	\$ 114,927	\$ 3,284	2.9%
Revenues from discontinued operations	\$ 4,707	\$ 3,007	\$ (1,700)	*
Total same-store gross profit	\$ 27,548	\$ 28,159	\$ 611	2.2%
Less: businesses held for sale	(651)	(317)	334	*
Preneed insurance commissions revenue	2,295	2,267	(28)	(1.2)%
Gross profit from continuing operations	\$ 29,192	\$ 30,109	\$ 917	3.1%
Gross profit from discontinued operations	\$ 1,167	\$ 551	\$ (616)	*

\* not meaningful

Funeral same-store revenues for the year ended December 31, 2006 increased \$2.9 million, or 2.6%, when compared to the year ended December 31, 2005, as we experienced an increase of 3.1% to \$5,149 in the average revenue per service for those existing operations and the number of services declined by 107, or 0.5%. Performance was strong in the Eastern Region, where the number of contracts increased 2.9% and the contract average increased 3.7%. The Western Region number of contracts remained constant, while the contract average increased 5.2%. The Central Region suffered a decline of 5.5% in the number of contracts and an increase of 1.1% in the contract average. Cremation services represented 34.3% of the number of funeral services during 2006, compared to 32.8% for 2005. The average revenue for burial contracts increased 4.6% to \$7,076, and the average revenue for cremation contracts increased 8.4% to \$2,636. The Company has addressed the growing demand for cremation by training the funeral directors to present multiple merchandise and service options to families, resulting in choices that produce higher revenues.

Total funeral same-store gross profit for the year ended December 31, 2006 increased \$0.6 million, or 2.2% from 2005, yet as a percentage of revenue, remained constant year over year. We experienced a 2.4% increase in funeral operating expenses yet lower pretax earnings in our Central Region of \$0.7 million, equal to \$0.02 per diluted share.

**Cemetery Segment.** The following table sets forth certain information regarding the revenues and gross profit of the Company from the cemetery operations for the year ended December 31, 2006 compared to the year ended December 31, 2005:

	Year Ended December 31,		Change	
	2005	2006	Amount	Percent
	(dollars in thousands)			
Revenues from continuing operations	\$ 37,555	\$ 36,159	\$ (1,396)	(3.7)%
Revenues from discontinued operations	\$ 1,851	\$ 778	\$ (1,073)	*
Gross profit from continuing operations	\$ 6,525	\$ 3,943	\$ (2,582)	(39.6)%
Gross profit from discontinued operations	\$ 371	\$ 121	\$ (250)	*

\* not meaningful

Cemetery same-store revenues for the year ended December 31, 2006 decreased \$1.4 million, or (3.7)%, over the year ended December 31, 2005, and cemetery same store gross profit decreased \$2.6 million, or (39.6)%, over 2005. Revenues from preneed interment sales decreased \$1.7 million. Though the number of interments sold on a preneed basis declined 0.6 million, or 8.5%, over 2005, the average price per space increased 8.6%. Continuing gross margin decreased from 17.4% for the year ended December 31, 2005 to 10.9% for the year ended December 31, 2006. The decline in revenues and gross profit from continuing operations relates to a particular California cemetery that experienced a decline

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of \$2.1 million in preneed property sales, an increase in bad debts of \$0.2 million and a decline of \$0.2 million in atneed revenues. Financial revenues (trust earnings and finance charges on installment contracts) increased \$0.2 million on the strength of higher trust earnings.

*Other.* General and administrative expenses decreased \$1.1 million for the year ended December 31, 2006 primarily because 2005 included higher professional fees related to our compliance with the internal control requirements of Sarbanes-Oxley and the development of a new cemetery system. 2006 is the first period in which the Company recognized compensation expense related to its stock options and employee stock purchase plan under a new accounting standard. See Note 1 to the Consolidated Financial Statement. Stock-based compensation totaling \$236,000 is included in general and administrative expenses for the year ended December 31, 2006.

Other income for the year ended December 31, 2006 includes a gain on the sale of excess real estate and interest income on the short-term investments.

Interest expense for the year ended December 31, 2006 was consistent to the year ended December 31, 2005.

*Income taxes.* See Note 15 to the Consolidated Financial Statements for a discussion of the income taxes for 2005 and 2006.

### **YEAR ENDED DECEMBER 31, 2005 COMPARED TO YEAR ENDED DECEMBER 31, 2004**

The following is a discussion of the Company's results of operations for the years ended December 31, 2004 and 2005.

Net income (loss), which includes the effect of discontinued operations, totaled \$(1.19) per diluted share compared to \$0.51 per share for 2004. The decrease is primarily attributable to additional interest of \$6.9 million, or \$0.24 per diluted share, specifically related to the senior debt refinancing and the change in accounting method of \$22.8 million, net, equal to \$1.24 per diluted share in 2005. Additionally, 2004 benefited from a \$4.1 million income tax benefit related to the change in the deferred tax valuation allowance. This added \$0.22 per diluted share to 2004's earnings.

*Funeral Home Segment.* The following table sets forth certain information regarding the net revenues and gross profit of the Company from the funeral home operations for the year ended December 31, 2005 compared to the year ended December 31, 2004.

	Year Ended December 31,		Change	
	2004	2005	Amount	Percent
	(dollars in thousands)			
Total same-store revenue	\$ 110,903	\$ 113,342	\$ 2,439	2.2%
Acquired and closed	282	435	153	54.3%
Preneed insurance commissions revenue	1,319	2,295	976	74.0%
Revenues from continuing operations	\$ 112,504	\$ 116,072	\$ 3,568	3.2%
Revenues from discontinued operations	\$ 1,972	\$ 279	\$ (1,693)	(85.9)%
Total same-store gross profit	\$ 28,213	\$ 28,190	\$ (23)	(0.1)%
Acquired and closed	(80)	(75)	5	6.3%
Preneed insurance commissions revenue	1,319	2,295	976	74.0%
Gross profit from continuing operations	\$ 29,452	\$ 30,410	\$ 958	3.3%
Gross profit from discontinued operations	\$ 208	\$ (29)	\$ (237)	(113.9)%

Funeral same-store revenues for the year ended December 31, 2005 increased \$2.4 million, or 2.2%, when compared to the year ended December 31, 2004, as we experienced an increase of 1.9% to \$4,993 in the average revenue per service and an increase of 58 additional contracts, or 0.3%, for those existing operations. Cremation services represented 32.8% of the number of funeral services during 2005 compared to 31.3% for 2004, and our average revenue per cremation service increased 2.2 percent to \$2,434.

Total funeral same-store gross profit for the year ended December 31, 2005 was essentially flat compared to 2004 and gross profit from continuing operations increased \$1.0 million, equal to the \$1.0 million increase in preneed insurance commission revenue. Gross profit for the year ended December 31, 2005 was minimally affected by the change in accounting method for preneed selling costs. See Note 3 to the Consolidated Financial Statements for a discussion of the change in accounting method. Funeral costs and expenses

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increased approximately \$2.6 million or 3.1% from 2004. The most significant variance year over year was a noncash charge of \$0.8 million in 2005 to modify the employee vacation plan.

*Cemetery Segment.* The following table sets forth certain information regarding the net revenues and gross profit of the Company from the cemetery operations for the year ended December 31, 2004 compared to the year ended December 31, 2003:

	Year Ended December 31,		Change	
	2004	2005	Amount	Percent
	(dollars in thousands)			
Revenues from continuing operations	\$ 37,390	\$ 38,962	\$ 1,572	4.2%
Revenues from discontinued operations	\$ 640	\$ 443	\$ (197)	(30.8)%
Gross profit from continuing operations	\$ 8,874	\$ 6,855	\$ (2,019)	(22.8)%
Gross profit from discontinued operations	\$ 149	\$ 133	\$ (16)	(10.7)%

No cemetery businesses were acquired during the two years; one cemetery, which is included in discontinued operations, was sold during 2005.

Cemetery revenues from continuing operations for the year ended December 31, 2005 increased \$1.6 million, or 4.2%, over the year ended December 31, 2004 as investment income and gains from the perpetual care trust funds contributed \$1.1 million to the year over year improvement. Cemetery gross profit from continuing operations decreased \$2.0 million, or 22.8%, compared to 2004, substantially due to higher preneed selling costs as a result of the change in accounting method. Gross profit for the year ended December 31, 2005 was reduced by approximately \$1.5 million for the change in accounting method for preneed selling costs. See Note 3 to the Consolidated Financial Statements for a discussion of the change in accounting method. Excluding the affect of the change in accounting method for preneed selling costs, gross margin from continuing operations decreased from 18.1% for the year ended December 31, 2004 to 17.6% for the year ended December 31, 2005 due to higher costs of maintaining the facilities and grounds.

*Other.* General and administrative expenses increased \$1.7 million for the year ended December 31, 2005 primarily because of higher professional and consulting fees related to compliance with the Sarbanes-Oxley Act of 2002 and implementing a new cemetery system.

Interest expense for the year ended December 31, 2005 increased \$1.7 million, or 10.0%, compared to the year ended December 31, 2004. Although debt outstanding has increased by approximately \$31 million, or 28.2%, during 2005, we are not reporting a proportional increase in interest expense because the 2004 expense was negatively impacted by higher loan fees and compound interest on the deferred interest on the convertible subordinated debentures.

*Income Taxes.* See Note 15 to the Consolidated Financial Statements for a discussion of the income taxes for the three year period.

## LIQUIDITY AND CAPITAL RESOURCES

Cash and corporate investments at December 31, 2006 totaled \$41.0 million and consisted of \$22.8 million in cash, \$10.3 million in short-term corporate investments, \$2.9 million in restricted cash and \$5.0 million in Federal agency bonds. Cash and short-term investments totaled \$33.1 million at December 31, 2006, representing an increase of \$8.3 million from December 31, 2005. For the year ended December 31, 2006, cash provided by operating activities was \$18.2 million as compared to \$1.7 million for the year ended December 31, 2005. The \$16.5 million improvement occurred primarily because the 2005 period included the \$6.0 million make-whole payment and the payment of the previously deferred interest on the convertible junior subordinated debenture in the amount of \$10.3 million. Additionally, capital expenditures totaled \$6.4 million compared to \$8.1 million in the prior year. For the year 2007, capital expenditures are expected to total approximately \$6.5 million.

In accordance with the terms of our credit facility, a portion of the cash proceeds from the sale of funeral home and cemetery businesses are pledged to the benefit of the lenders and are restricted for use only for acquisitions of similar businesses, capital expenditures, or paydowns of debt. During 2006, approximately \$5.5 million of such proceeds were so pledged, with \$2.6 million subsequently released from the pledge and \$2.9 million remaining pledged as of December 31, 2006.

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The outstanding principal of senior debt at December 31, 2006 totaled \$140.2 million and consisted of \$130.0 million in Senior Notes, described below, and \$10.2 million in acquisition indebtedness and capital lease obligations. Additionally, \$0.4 million in letters of credit were issued under the credit facility and were outstanding at December 31, 2006.

In January 2005, we issued \$130 million of 7.875% Senior Notes due in 2015. The proceeds from these notes were used to refinance the Series 1999 Senior Notes (including payments for accrued interest and make-whole payments), to bring current the deferred distributions on the convertible junior subordinated debentures and the TIDES, and for general corporate purposes. In connection with the early retirement of the senior debt, we made a required “make whole” payment of \$6.0 million (recorded as additional interest) and recorded a charge to write off \$0.7 million of unamortized loan costs. These charges equal \$4.2 million after tax, or \$0.23 per diluted share, and were reported in the first quarter of 2005. The refinancing improved our liquidity by replacing debt totaling approximately \$96 million due in 2006 and 2008 with debt maturing in 2015.

In April 2005, we entered into 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 new credit facility bear interest at either prime or LIBOR options. At December 31, 2006, the LIBOR option was set at LIBOR plus 300 basis points. The facility is currently undrawn, except for the letters of credit referred to above, and no borrowings are anticipated during 2007.

A total of \$93.8 million was outstanding on December 31, 2006 on the convertible junior subordinated debenture. Amounts outstanding under the debenture are payable to our affiliate trust, Carriage Services Capital Trust, bear interest at 7.0% and mature in 2029. Substantially all the assets of the Trust consist of the convertible junior subordinated debentures. In 1999, the Trust issued 1.875 million shares of term income deferrable equity securities (“TIDES”). The rights of the debentures 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 at our discretion. During the period in which distribution payments are deferred, distributions will continue to accumulate at the 7% annual rate. Also, the deferred distributions themselves accumulate distributions at the annual rate of 7% and are recorded as a liability. During the deferral period, we are prohibited from paying dividends on common stock or repurchasing common stock, subject to limited exceptions. We deferred distributions on the TIDES from September 2003 through December 2004. In March 2005, we paid the \$10.3 million for the cumulative deferred distributions on the TIDES and are current with respect to quarterly interest and distributions.

We intend to use its cash and short-term investments, cash flow provided by operations and proceeds from the sale of businesses, to acquire funeral home and cemetery businesses. We also have the ability to draw on our revolving credit facility, subject to customary terms and conditions of the credit agreement, to finance acquisitions.

### *Contractual Obligations*

The following table summarizes our balance sheet liabilities to make future payments as of December 31, 2006. Where appropriate we have indicated the footnote to our annual Consolidated Financial Statements where additional information is available.

	Note Reference	Total	Payments By Period (in millions)					After 5 Years
			2007	2008	2009	2010	2011	
Long-term debt	12	\$135.5	1.6	2.1	0.5	0.2	0.3	130.8
Capital lease obligations	14	15.1	0.6	0.6	0.7	0.7	0.7	11.8
Convertible junior subordinated debenture (a)	13	93.8	—	—	—	—	—	93.8
Total contractual obligations		\$244.4	2.2	2.7	1.2	0.9	1.0	236.4

(a) Matures in 2029

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### *Off-Balance Sheet Arrangements*

The following table summarizes our off-balance sheet arrangements as of December 31, 2006. Where appropriate we have indicated the footnote to our annual Consolidated Financial Statements where additional information is available.

	Note Reference	Total	Payments By Period (in millions)					After 5 Years
			2007	2008	2009	2010	2011	
Operating leases	14	\$ 10.2	2.1	1.9	1.3	0.9	0.8	3.2
Interest payments on long-term debt	12	240.8	17.6	17.5	17.4	17.4	17.1	153.8
Noncompete agreements	14	5.0	1.2	1.0	0.7	0.6	0.4	1.1
Consulting agreements	14	1.0	0.4	0.3	0.2	0.1	—	—
Executive Management agreements	14	1.6	0.9	0.3	0.2	0.2	—	—
Total contractual cash obligations		\$258.6	22.2	21.0	19.8	19.2	18.3	158.1

The obligations related to our off-balance sheet arrangements are significant to our future liquidity; however, although we can provide no assurances, we anticipate that these obligations will be funded from cash provided from our operating activities. If we are not able to meet these obligations with cash provided for by our operating activities, we may be required to access the capital markets or draw down on our credit facilities.

Additionally, we are party to a variety of contractual agreements under which we may be obligated to indemnify the other party for certain matters. These contracts primarily relate to the purchase or sale of business assets, commercial contracts and operating leases and arose through representations and warranties (e.g., ownership of assets or environmental matters). The terms of these indemnifications range in duration and may not be explicitly defined.

### 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 death 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 Carriage's operations.

### FORWARD-LOOKING STATEMENTS

In addition to historical information, this Annual Report contains forward-looking statements within the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. These statements include any projections of earnings, revenues, asset sales, cash flow, debt levels or other financial items; any statements of the plans, strategies and objectives of management for future operation; 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.

### ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

In the ordinary course of business, the Company is typically exposed to a variety of market risks. Currently, these are primarily related to changes in interest rates related to outstanding debts, decreases in interest rates related to the Company's short-term investments and changes in the values of securities associated with the preneed and perpetual care trusts. Management is actively involved in monitoring exposure to market risk and developing and utilizing appropriate risk management techniques when appropriate and when available for a reasonable price. The Company is not exposed to any other significant market risks including commodity price risk, nor foreign currency exchange risk.

The Company monitors current and forecasted interest rate risk in the ordinary course of business and seeks to maintain optimal financial flexibility, quality and solvency. As of December 31, 2006, the Company's debt is comprised of fixed rate obligations.

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The Company does not currently have any floating rate long-term borrowings outstanding under its \$35 million floating rate line of credit. If the Company borrows against the line of credit, any change in the floating rate would cause a change in interest expense.

The 7.875% Senior Notes were issued to the public at par and are carried at a cost of \$130 million. At December 31, 2006, these securities were typically trading at prices ranging from 96.875 to 97.875.

The convertible junior subordinated debenture payable to Carriage Services Capital Trust pay interest at the fixed rate of 7% and are carried on the Company's balance sheet at a cost of approximately \$93.8 million. The estimated fair value of these securities is estimated to be \$79 million and \$80 million at December 31, 2005 and 2006, respectively, based on available broker quotes of the corresponding preferred securities issued by the Trust.

Increases in market interest rates may cause the value of these instruments to decrease but such changes will not affect the Company's interest costs. The remainder of the Company's long-term debt and leases consist of non-interest bearing notes and fixed rate instruments that do not trade in a market, nor otherwise have a quoted market value. Any increase in market interest rates causes the fair value of those liabilities to decrease.

Securities subject to market risk consist of investments held by the Company's preneed funeral, cemetery merchandise and services and perpetual care trust funds. See Notes 7, 8 and 10 to our Consolidated Financial Statements for the estimated fair values of those securities.

**ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA**

**CARRIAGE SERVICES, INC.  
INDEX TO CONSOLIDATED FINANCIAL STATEMENTS**

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## **MANAGEMENT'S REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING**

Management of the Company is responsible for establishing and maintaining adequate internal control over financial reporting as such term is defined under Rule 13a-15(f) promulgated under the Securities Exchange Act of 1934, as amended.

Internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of the Company's Consolidated Financial Statements for external purposes in accordance with generally accepted accounting principles.

Internal control over financial reporting includes those policies and procedures that (i) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the Company; (ii) provide reasonable assurance that transactions are recorded as necessary to permit the preparation of the Consolidated Financial Statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the Company are being made only in accordance with appropriate authorizations of management and directors of the Company; and (iii) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the Company's assets that could have a material effect on the Consolidated Financial Statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

Management conducted an assessment of the Company's internal control over financial reporting as of December 31, 2006 using the framework specified in *Internal Control — Integrated Framework*, published by the Committee of Sponsoring Organizations of the Treadway Commission. Based on such assessment, management has concluded that the Company's internal control over financial reporting was effective as of December 31, 2006.

Management's assessment of the effectiveness of the Company's internal control over financial reporting as of December 31, 2006 has been audited by KPMG LLP, an independent registered public accounting firm, which also audited the financial statements of the Company for the year ended December 31, 2006, as stated in their report which is presented in this Annual Report.

/s/ Melvin C. Payne

\_\_\_\_\_  
Melvin C. Payne

Chairman of the Board, President and Chief Executive Officer

/s/ Joseph Saporito

\_\_\_\_\_  
Joseph Saporito

Executive Vice President and Chief Financial Officer

March 9, 2007

**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

The Board of Directors and Stockholders  
Carriage Services, Inc.:

We have audited management's assessment, included in the accompanying *Management's Report on Internal Control Over Financial Reporting*, that Carriage Service, Inc. maintained effective internal control over financial reporting as of December 31, 2006, based on criteria established in *Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)*. Carriage Service, Inc. management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on management's assessment and an opinion on the effectiveness of Carriage Service, Inc.'s internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, management's assessment that Carriage Services, Inc. maintained effective internal control over financial reporting as of December 31, 2006, is fairly stated, in all material respects, based on criteria established in *Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)*. Also, in our opinion, Carriage Services, Inc. maintained, in all material respects, effective internal control over financial reporting as of December 31, 2006, based on criteria established in *Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)*.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets of Carriage Services, Inc. and subsidiaries as of December 31, 2006 and 2005, and the related consolidated statements of operations and comprehensive income, changes in stockholders' equity, and cash flows for each of the years in the three-year period ended December 31, 2006, and our report dated March 9, 2007 expressed an unqualified opinion on those consolidated financial statements.

/s/ KPMG LLP  
Houston, Texas  
March 9, 2007

**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

The Board of Directors and Stockholders  
Carriage Services, Inc.:

We have audited the accompanying consolidated balance sheets of Carriage Services, Inc. and subsidiaries as of December 31, 2006 and 2005, and the related consolidated statements of operations, changes in stockholders' equity, and cash flows for each of the years in the three-year period ended December 31, 2006. These consolidated financial statements are the responsibility of Carriage Services, Inc.'s management. Our responsibility is to express an opinion on these consolidated financial statements and financial statement schedules based on our audits.

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

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Carriage Services, Inc. and subsidiaries as of December 31, 2006 and 2005, and the results of their operations and their cash flows for each of the years in the three-year period ended December 31, 2006, in conformity with U.S. generally accepted accounting principles.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of Carriage Services, Inc.'s internal control over financial reporting as of December 31, 2006, based on criteria established in *Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)*, and our report dated March 9, 2007 expressed an unqualified opinion on management's assessment of, and the effective operation of, internal control over financial reporting.

As discussed in Note 3 to the consolidated financial statements, the Company changed its method of accounting for preneed selling costs in 2005, and as discussed in Note 1 to the consolidated financial statements, effective January 1, 2006, the Company adopted the provisions of Statement of Financial Accounting Standards No. 123R, Share-Based Payment.

/s/ KPMG LLP

Houston, Texas  
March 9, 2007

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

	<b>December 31,</b>	
	<b>2005</b>	<b>2006</b>
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 7,949	\$ 22,820
Short term investments	16,908	10,303
Accounts receivable-trade, net of allowance for bad debts of \$937 in 2005 and \$925 in 2006	13,412	13,822
Assets held for sale	—	2,634
Inventories and other current assets	12,883	11,883
Total current assets	<u>51,152</u>	<u>61,462</u>
Restricted cash	—	2,888
Preneed cemetery trust investments	54,768	55,483
Preneed funeral trust investments	47,678	44,851
Preneed receivables, net of allowance for bad debts of \$478 in 2005 and \$492 in 2006	17,151	15,127
Receivables from preneed funeral trusts	16,229	15,649
Property, plant and equipment, net of accumulated depreciation of \$45,694 in 2005 and \$47,250 in 2006	105,435	99,894
Cemetery property	62,905	57,798
Goodwill	157,358	148,845
Deferred charges and other non-current assets	25,608	30,459
Cemetery perpetual care trust investments	32,356	32,540
Total assets	<u>\$ 570,640</u>	<u>\$ 564,996</u>
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
Current liabilities:		
Current portion of long-term debt and obligations under capital leases	\$ 2,074	\$ 1,610
Accounts payable	6,183	7,148
Accrued liabilities	15,980	15,888
Liabilities associated with assets held for sale	—	1,061
Total current liabilities	<u>24,237</u>	<u>25,707</u>
Senior long-term debt, net of current portion	134,572	133,841
Convertible junior subordinated debenture due in 2029 to an affiliated trust	93,750	93,750
Obligations under capital leases, net of current portion	4,775	4,728
Deferred preneed cemetery revenue	51,928	50,785
Deferred preneed funeral revenue	29,446	28,289
Non-controlling interests in funeral trust investments	47,678	44,851
Non-controlling interests in cemetery trust investments	54,768	55,483
Total liabilities	<u>441,154</u>	<u>437,434</u>
Commitments and contingencies		
Non-controlling interests in perpetual care trust investments	33,112	31,189
Stockholders' equity:		
Common Stock, \$.01 par value; 80,000,000 shares authorized; 18,458,000 and 18,608,000 issued and outstanding in 2005 and 2006, respectively	185	186
Additional paid-in capital	189,110	190,524
Accumulated deficit	(92,921)	(94,337)
Total stockholders' equity	<u>96,374</u>	<u>96,373</u>
Total liabilities and stockholders' equity	<u>\$ 570,640</u>	<u>\$ 564,996</u>

The accompanying notes are an integral part of these Consolidated Financial Statements.

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

	For the years ended December 31,		
	2004	2005	2006
Revenues:			
Funeral	\$ 108,478	\$ 111,643	\$ 114,927
Cemetery	36,115	37,555	36,159
	144,593	149,198	151,086
Costs and expenses:			
Funeral	79,894	82,451	84,818
Cemetery	27,537	31,030	32,216
	107,431	113,481	117,034
Gross profit	37,162	35,717	34,052
General and administrative expenses	10,665	12,383	11,258
Other charges (income)	495	(822)	—
Operating income	26,002	24,156	22,794
Interest expense	(16,908)	(18,599)	(18,514)
Additional interest and other costs of senior debt refinancing	—	(6,933)	—
Interest income and other, net	940	(73)	1,921
Total interest expense and other	(15,968)	(25,605)	(16,593)
Income (loss) from continuing operations before income taxes	10,034	(1,449)	6,201
(Provision) benefit for income taxes	(81)	456	(2,375)
Net income (loss) from continuing operations	9,953	(993)	3,826
Discontinued operations:			
Income (loss) from discontinued operations before income taxes	(1,228)	2,839	(7,943)
Income tax (provision) benefit	509	(955)	2,701
Income (loss) from discontinued operations	(719)	1,884	(5,242)
Cumulative effect of change in accounting method, net of tax benefit	—	(22,756)	—
Net income (loss)	\$ 9,234	\$ (21,865)	\$ (1,416)
Basic earnings (loss) per share:			
Continuing operations	\$ 0.56	\$ (0.05)	\$ 0.21
Discontinued operations	(0.04)	0.10	(0.29)
Cumulative effect of change in accounting method	—	(1.24)	—
Net income (loss)	\$ 0.52	\$ (1.19)	\$ (0.08)
Diluted earnings (loss) per share:			
Continuing operations	\$ 0.55	\$ (0.05)	\$ 0.20
Discontinued operations	(0.04)	0.10	(0.28)
Cumulative effect of change in accounting method	—	(1.24)	—
Net income (loss)	\$ 0.51	\$ (1.19)	\$ (0.08)
Weighted average number of common and common equivalent shares outstanding:			
Basic	17,786	18,334	18,545
Diluted	18,260	18,334	18,912

The accompanying notes are an integral part of these Consolidated Financial Statements.

**CARRIAGE SERVICES, INC.**  
**CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY**  
(in thousands)

	Shares	Common Stock	Additional Paid-in Capital	Accumulated Deficit	Total
<b>Balance — December 31, 2003</b>	<u>17,545</u>	<u>\$ 175</u>	<u>\$ 186,045</u>	<u>\$ (80,290)</u>	<u>\$ 105,930</u>
Net income - 2004	—	—	—	9,234	9,234
Issuance of common stock	130	2	577	—	579
Exercise of stock options	135	1	308	—	309
Issuance of restricted common stock	100	1	(1)	—	—
Amortization of restricted common stock	—	—	386	—	386
<b>Balance — December 31, 2004</b>	<u>17,910</u>	<u>179</u>	<u>187,315</u>	<u>(71,056)</u>	<u>116,438</u>
Net loss - 2005	—	—	—	(21,865)	(21,865)
Issuance of common stock	118	1	685	—	686
Exercise of stock options	177	2	528	—	530
Issuance of restricted common stock	268	3	(3)	—	—
Cancellation and retirement of restricted common stock	(15)	—	—	—	—
Amortization of restricted common stock	—	—	585	—	585
<b>Balance — December 31, 2005</b>	<u>18,458</u>	<u>185</u>	<u>189,110</u>	<u>(92,921)</u>	<u>96,374</u>
Net loss - 2006	—	—	—	(1,416)	(1,416)
Issuance of common stock	93	1	386	—	387
Exercise of stock options	87	1	319	—	320
Issuance of restricted common stock	35	—	—	—	—
Cancellation and retirement of restricted common stock	(65)	(1)	1	—	—
Amortization of restricted common stock	—	—	472	—	472
Stock-based compensation expense	—	—	236	—	236
<b>Balance — December 31, 2006</b>	<u>18,608</u>	<u>\$ 186</u>	<u>\$ 190,524</u>	<u>\$ (94,337)</u>	<u>\$ 96,373</u>

The accompanying notes are an integral part of these Consolidated Financial Statements.

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

	For the years ended December 31,		
	2004	2005	2006
Cash flows from operating activities:			
Net income (loss)	\$ 9,234	\$ (21,865)	\$ (1,416)
Adjustments to reconcile net income (loss) to net cash provided by operating activities:			
(Income) loss from discontinued operations	719	(1,884)	5,242
Cumulative effect of change in accounting method	—	22,756	—
Depreciation and amortization	10,647	9,336	8,688
Loan cost amortization	924	754	714
Provision for bad debts	2,185	2,648	3,880
(Gain) loss on sale or disposition of assets	885	738	(513)
Stock-based compensation expense	464	675	784
Deferred income taxes (benefit)	(81)	(456)	2,375
Other	480	21	120
Changes in operating assets and liabilities that provided (required) cash, net of effects from acquisitions and dispositions			
Accounts receivable	(999)	(3,686)	(2,113)
Inventories and other current assets	(940)	(1,032)	335
Deferred charges and other	(4,906)	(818)	11
Preneed funeral and cemetery trust investments	(6,122)	(7,477)	(13,888)
Accounts payable and accrued liabilities	(1,146)	(1,383)	588
Deferred preneed funeral and cemetery revenue	3,195	10,893	10,095
Non-controlling interests in preneed funeral and cemetery trusts investments	2,664	1,825	2,526
Deferred interest on convertible junior subordinated debenture	7,015	(10,345)	—
Net cash provided by operating activities of continuing operations	24,380	700	17,428
Net cash provided by (used in) operating activities of discontinued operations	(2)	1,039	755
Net cash provided by operating activities	24,378	1,739	18,183
Cash flows of investing activities:			
Acquisitions	—	(1,285)	(1,072)
Proceeds from sales of businesses and other assets	1,215	586	670
Purchase of corporate investments	—	(32,724)	(50,927)
Maturities of corporate investments	—	15,816	52,533
Sales proceeds deposited into restricted accounts, net of withdrawals	—	—	(2,888)
Capital expenditures	(5,766)	(8,125)	(6,387)
Net cash used in investing activities of continuing operations	(4,551)	(25,732)	(8,071)
Net cash provided by investing activities of discontinued operations	3,075	1,530	6,332
Net cash used in investing activities	(1,476)	(24,202)	(1,737)
Cash flows of financing activities:			
Proceeds (payments) under bank line of credit	4,500	(25,600)	—
Payments on senior long-term debt and obligations under capital leases	(28,024)	(72,558)	(2,138)
Proceeds from the issuance of senior notes	—	130,000	—
Payment of financing costs	—	(4,175)	—
Proceeds from the exercise of stock options and employee stock purchase plan	686	936	567
Tax benefit from stock-based compensation	—	—	63
Net cash provided by (used in) financing activities of continuing operations	(22,838)	28,603	(1,508)
Net cash used in financing activities of discontinued operations	(140)	(139)	(67)
Net cash provided by (used in) financing activities	(22,978)	28,464	(1,575)
Net increase (decrease) in cash and cash equivalents	(76)	6,001	14,871
Cash and cash equivalents at beginning of year	2,024	1,948	7,949
Cash and cash equivalents at end of year	\$ 1,948	\$ 7,949	\$ 22,820

The accompanying notes are an integral part of these Consolidated Financial Statements.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

#### *Business*

Carriage Services, Inc. (“Carriage” or the “Company”) was founded in 1991 and incorporated under the laws of the State of Delaware in 1993. The Company owns and operates 131 funeral homes in 27 states and 28 cemeteries in 11 states at December 31, 2006. Carriage provides a complete range of preneed and atneed services and products related to funerals, burials and cremations.

#### *Principles of Consolidation and Basis of Presentation*

The financial statements include the Consolidated Financial Statements of Carriage Services, Inc. and its subsidiaries, after eliminating all significant intercompany balances and transactions. Certain prior year amounts in the Consolidated Financial Statements have been reclassified to conform to current year presentation.

The accounting policies and procedures reflected herein have been consistently followed during the periods presented, except for the changes in accounting methods discussed in Note 1 related to stock-based employee compensation and Note 3 related to expensing preneed selling costs.

#### *Funeral and Cemetery Operations*

We record the revenue from sales of funeral and cemetery merchandise and services when the merchandise is delivered or the 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 (SFAS) No. 66 “Accounting for Sales of Real Estate.” This method 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 from the delivery of merchandise and performance of services related to contracts that were acquired in acquisitions are typically lower than those originated by the Company.

Allowances for bad debts and customer cancellations are provided at the date that the sale is recognized as revenue based on our historical experience. In addition, we monitor changes in delinquency rates and provide additional bad debt and cancellation reserves when warranted. 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 are recognized as revenues at the point at which the commission is no longer subject to refund, which is typically one year after the policy is issued.

Trade accounts receivable consists of approximately \$8.4 million and \$8.3 million of funeral receivables and approximately \$7.5 million and \$6.6 million of current cemetery receivables at December 31, 2005 and 2006, respectively. Non-current preneed receivables at December 31, 2005 and 2006, represent the payments expected to be received beyond one year from the balance sheet date.

#### *Preneed Contracts*

Interment rights, merchandise and services are also sold on a preneed basis and in many instances the customer pays the contract over a period of time. Cash proceeds from preneed sales less amounts that the Company may retain under state regulations are deposited to a trust or used to purchase a third-party insurance policy. The principal and accumulated earnings of the trusts may generally be withdrawn at maturity (death) or cancellation. The trust income earned and the increases in insurance benefits on the insurance products are deferred until the service is performed. The customer receivables and amounts deposited in trusts that Carriage controls are included in the non-current asset section of the balance sheet. The preneed contracts secured by third party insurance policies are not recorded as assets or liabilities of the Company (Notes 7 and 8).



## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

### 1. BASIS OF PRESENTATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

In the opinion of management, the proceeds from the trust funds and the insurance policies at the times the preneed contracts mature will exceed the estimated future costs to perform services and provide products under such arrangements. The types of instruments in which the trusts may invest are regulated by state agencies.

#### *Cemetery Perpetual Care Trust Investments*

In accordance with respective state laws, the Company is required to deposit a specified amount into perpetual and memorial care trust funds for each interment/entombment right and memorial sold. Income from the trust funds is distributed to Carriage and used to provide care and maintenance for the cemeteries and mausoleums. Such trust fund income is recognized as revenue when realized by the trust and distributable to the Company. The Company is restricted from withdrawing any of the principal balances of these funds.

#### *Cash and Cash Equivalents*

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

#### *Goodwill*

The excess of the purchase price over the fair value of net identifiable assets of funeral homes 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 in connection with the acquisitions of cemetery businesses. In accordance with SFAS No. 142, 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.

#### *Inventory*

Inventory consists primarily of caskets, outer burial containers and cemetery monuments and markers, and is recorded at the lower of its cost basis (determined by the specific identification method) or net realizable value.

#### *Property, Plant and Equipment*

Property, plant and equipment are stated at cost. The costs of ordinary maintenance and repairs are charged to operations as incurred, while renewals and betterments are capitalized. Capitalized interest totaled approximately \$46,000 and \$50,000 in 2005 and 2006, respectively. Depreciation of property, plant and equipment is computed based on the straight-line method over the following estimated useful lives of the assets:

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

### 1. BASIS OF PRESENTATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

	<u>Years</u>
Buildings and improvements	15 to 40
Furniture and fixtures	7 to 10
Machinery and equipment	5 to 10
Automobiles	5 to 7

Property, plant and equipment was comprised of the following at December 31, 2005 and 2006:

	<u>2005</u>	<u>2006</u>
	<u>(in thousands)</u>	
Land	\$ 26,311	\$ 26,589
Buildings and improvements	82,329	81,567
Furniture, equipment and automobiles	42,489	41,076
	<u>151,129</u>	<u>149,232</u>
Less: accumulated depreciation	(45,694)	(47,932)
	<u>\$ 105,435</u>	<u>\$ 101,300</u>
Less: Property, plant and equipment included in assets held for sale	—	(1,406)
	<u>\$ 105,435</u>	<u>\$ 99,894</u>

During 2004, 2005 and 2006, the Company recorded \$6,973,000, \$6,922,000 and \$6,897,000 respectively, in depreciation expense in income from continuing operations.

Long-lived assets, such as property, plant and equipment, and purchased intangibles subject to amortization, are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to estimated undiscounted future cash flows expected to be generated by the asset. If the carrying amount of an asset exceeds its estimated future cash flows, an impairment charge is recognized by the amount by which the carrying amount of the asset exceeds the fair value of the asset. The long-lived assets to be held and used are reported at the lower of carrying amount or fair value. Assets to be disposed of and assets not expected to provide any future service potential to the Company are recorded at the lower of carrying amount or fair value less estimated cost to sell.

#### *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 No. 109, "Accounting for Income Taxes", (Note 15). 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.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

### 1. BASIS OF PRESENTATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

#### *Stock Compensation Plans*

The Company has stock-based employee compensation plans in the form of restricted stock, stock option and employee stock purchase plans. The Company accounts for stock-based compensation under SFAS 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 awards issued to employees over the period of vesting. The fair value of awards for options or 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. The Company adopted FAS No. 123R in the first quarter of 2006, using the modified prospective application method, which results in no restatement of the Company's previously issued annual consolidated financial statements.

Prior to 2006, the Company accounted for stock based compensation under APB No. 25 and provided the disclosures required under SFAS No. 123, "Accounting for Stock-Based Compensation", as amended by SFAS No. 148, "Accounting for Stock-Based Compensation – Transition and Disclosure."

Pursuant to the provisions of SFAS 123R, the Company applied the modified-prospective transition method. Under this method, the fair value provision of SFAS 123R is applied to new employee stock-based awards granted after December 31, 2005. Measurement and recognition of compensation cost for unvested awards at December 31, 2005, granted prior to the adoption of SFAS 123R, are recognized under the provisions of SFAS No 123, Accounting for Stock-Based Compensation ("SFAS 123"), after adjustments for estimated forfeitures. SFAS 123R no longer permits pro-forma disclosure for income statement periods after December 31, 2005 and compensation expense will be recognized for all stock-based awards based on grant-date fair value.

Carriage has three types of stock-based compensation plans for which the accounting is changed: stock options, restricted stock and an employee stock purchase plan ("ESPP"). Options to purchase Carriage common stock have been granted with an exercise price equal to the fair market value at the date of grant with vesting generally occurring annually over four years. The value of the options at the date of grant is amortized to compensation expense over the vesting period on a straight line basis. Twenty-five percent of the restricted shares vest annually on each of the next four anniversary dates of the grants. The value of the restricted stock at the date of grant is amortized to compensation expense over the vesting period on a straight line basis. The ESPP allows employees, through payroll deductions, to purchase Carriage common stock at 85% of the value of the common stock on the quarterly purchase dates or the annual grant date, whichever is lower.

The fair value of the stock option awards and the ESPP awards are determined using the Black-Scholes valuation model, which is consistent with the valuation methods previously utilized for the awards in the proforma footnote disclosures required under SFAS 123, as amended by SFAS No. 148, Accounting for Stock-Based Compensation – Transition and Disclosure. The Company recorded pretax stock-based compensation expense for the stock options and the ESPP totaling \$236,000 for the year ended December 31, 2006. Had SFAS 123R been effective for 2005 and 2004, the Company would have recorded additional pretax stock-based compensation totaling \$312,000 and \$702,000, respectively, as disclosed in the following tables (in thousands).

	Year ended December 31, 2005		
	As Reported	Effect of Change	Proforma
Loss from continuing operations before income taxes	\$ (1,449)	\$ (312)	\$ (1,761)
Net loss available to common stockholders	(21,865)	(195)	(22,060)
Net loss per share available to common stockholders:			
Basic	\$ (1.19)	\$(0.01)	\$ (1.20)
Diluted	\$ (1.19)	(0.01)	(1.20)

	Year ended December 31, 2004		
	As Reported	Effect of Change	Proforma
Income from continuing operations before income taxes	\$10,034	\$ (702)	\$9,332
Income available to common stockholders	9,234	(440)	8,794
Net income per share available to common stockholders:			
Basic	\$ 0.52	\$(0.02)	\$ 0.50
Diluted	0.51	(0.02)	0.49

See Note 16 to the consolidated financial statements for additional information on the Company's stock-based compensation plans.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

### 1. BASIS OF PRESENTATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

#### *Computation of Earnings Per Common Share*

Basic earnings per share are computed using the weighted average number of common shares outstanding during the period. Diluted earnings per share are computed using the weighted average number of common and dilutive common equivalent shares outstanding during the period. Dilutive common equivalent shares consist of stock options.

#### *Fair Value of Financial Instruments*

Carriage believes that the carrying value approximates fair value for cash and cash equivalents and trade receivables and payables. Additionally, our floating rate credit facility, when drawn, approximates its fair value. Management also believes that the carrying value of senior long-term debt approximates fair value. Management estimates that the fair value of the Convertible junior subordinated debenture at December 31, 2006 was approximately \$80 million, based on available broker quotes of the corresponding convertible preferred securities at Carriage Services Capital Trust.

#### *Discontinued Operations*

In accordance with the Company's strategic portfolio policy, smaller, lower, margin 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 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.

#### *Consolidation of Variable Interest Entities*

The FASB issued FASB Interpretation No. 46, as revised, ("FIN 46R"), "*Consolidation of Variable Interest Entities, an Interpretation of Accounting Research Bulletin (ARB) No. 51.*" This interpretation clarifies the circumstances in which certain entities that do not have equity investors with a controlling financial interest must be consolidated by its sponsor. The Company implemented FIN 46R as of March 31, 2004, which resulted, for financial reporting purposes, in the consolidation of the Company's preneed and perpetual care trust funds. The investments of such trust funds have been reported at market value and the Company's future obligations to deliver merchandise and services have been reported at estimated settlement amounts. The Company has also recognized the non-controlling financial interests of third parties in the trust funds. There was no cumulative effect of an accounting change recognized by the Company as a result of the implementation of FIN 46R. The implementation of FIN 46R affected certain accounts on the Company's balance sheet beginning March 31, 2004 as described below; however, it did not affect cash flow, net income or the manner in which we recognize and report revenues.

Although FIN 46R requires consolidation of preneed and perpetual care trusts, it did not change the legal relationships among the trusts, the Company and its customers. In the case of preneed trusts, the customers are the legal beneficiaries. In the case of perpetual care trusts, the Company does not have a right to access the corpus in the perpetual care trusts. For these reasons, the Company has recognized non-controlling interests in our financial statements to reflect third party interests in these consolidated trust funds.

Both the preneed trusts and the cemetery perpetual care trusts hold investments in marketable securities which have been classified as available-for-sale. The investments are reported at fair value, with unrealized gains and losses allocated to *Non-controlling interests in trust investments* in the Company's consolidated balance sheet. Unrealized gains and losses attributable to the Company, but that have not been earned through the performance of services or delivery of merchandise are allocated to *deferred revenues*.

Also in connection with the implementation of FIN 46R, the Company began recognizing the income, gains and losses of the preneed trusts and the unrealized income, gains and losses of the cemetery perpetual care trusts. The Company recognizes a corresponding expense equal to the recognized earnings of these trusts attributable to the non-controlling interest holders. When such earnings attributable to the Company have not been earned through the performance of services or delivery of merchandise, the Company will record such earnings as deferred revenue.

For preneed trusts, the Company recognizes as revenues amounts attributed to the non-controlling interest holders and the Company, including accumulated realized earnings, when the contracted services have been performed and merchandise delivered.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

### 1. BASIS OF PRESENTATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

For cemetery perpetual care trusts, the Company recognizes investment earnings in cemetery revenues when such earnings are realized and distributable. Such earnings are intended to defray cemetery maintenance costs incurred by the Company.

Also, the Company was required to deconsolidate Carriage Services Capital Trust (the “Trust”), a trust established in 1999 to issue redeemable convertible preferred securities. The Company’s obligation to the Trust consists of convertible junior subordinated debentures. The preferred securities of the Trust were previously classified as temporary equity in the consolidated balance sheet. As a result of deconsolidating the Trust, the Company now reports its obligation to the Trust, the convertible junior subordinated debentures, as a long-term liability.

#### *Use of Estimates*

The preparation of the Consolidated Financial Statements requires us to make estimates and judgments that effect 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.

#### *Accounting Changes and Error Corrections*

The FASB issued SFAS No. 154, “Accounting Changes and Error Corrections” (“FAS No. 154”). This statement is a replacement of Accounting Principles Board Opinion No. 20 and FAS No. 3. FAS No. 154 changes the requirements for the accounting for and reporting of a change in accounting principle and error corrections. It establishes, unless impracticable and absence of explicit transition requirements, retrospective application as the required method of a change in accounting principle to the newly adopted accounting principle. Also, it establishes guidance for reporting corrections of errors as reporting errors involves adjustments to previously issued financial statements similar to those generally applicable to reporting accounting changes retrospectively. FAS No. 154 also provides guidance for determining and reporting a change when retrospective application is impracticable. FAS No. 154 is effective for accounting changes and corrections of errors made in the fiscal years beginning after December 15, 2005. The Company adopted the requirements beginning January 1, 2006, which had no effect on the Company’s presentation and disclosure.

#### *Impairment of Investments*

In March 2004, the FASB reached consensus on the guidance provided by Emerging Issues Task Force Issue 03-1 (EITF 03-1), “*The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments*.” The guidance is applicable to debt and equity securities that are within the scope of FASB Statement of Financial Accounting Standard (SFAS) No. 115, “*Accounting for Certain Investments in Debt and Equity Securities*.” EITF 03-1 specifies that an impairment would be considered other-than-temporary unless (a) the investor has the ability and intent to hold an investment for a reasonable period of time sufficient for the recovery of the fair value up to (or beyond) the cost of the investment and (b) evidence indicating the cost of the investment is recoverable within a reasonable period of time outweighs evidence of the contrary. EITF 03-1 is effective for reporting periods ending after June 15, 2004 except for the measurement and recognition provisions relating to debt and equity securities which had been deferred. The disclosure requirements continue to be effective in annual financial statements for fiscal years ending after June 15, 2004. We adopted the disclosure provisions during the period ended June 30, 2004. The guidance for measurement and recognition provisions has subsequently been replaced by SFAS No. 115-1 and SFAS No. 124-1 “*The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments*” which is effective for reporting periods beginning after December 15, 2005. The Company adopted the requirements beginning January 1, 2006 which had no effect on the Consolidated Financial Statements, result of operations or liquidity of the Company.

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)****2. RECENTLY ISSUED ACCOUNTING STANDARDS***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 years after December 15, 2006 and will be adopted by the Company in the first quarter of 2007. The Company has reviewed its income tax positions and identified certain tax deductions related to business acquisitions that are not certain. The cumulative effect of adopting FIN 48 will be recorded in retained earnings and other balance sheet accounts, as applicable. The Company has not determined the effect that the adoption of FIN 48 will have on our financial position and results of operations. Should penalties and interest be recorded in connection with the Company’s tax position, they will be recognized as income tax expense. Because the Company presently has net operating losses available to offset taxable income, no penalties or interest are recorded in connection with the adoption of FIN 48.

*Fair Value Measurements*

In September 2006, the FASB issued SFAS No. 157, “Fair Value Measurements” (“SFAS No. 157”), which establishes a framework for measuring fair value in accordance with Generally Accepted Accounting Principles (“GAAP”) and expands disclosures about fair value measurements. This statement is effective as of the beginning of the entity’s first fiscal year that begins after November 15, 2007. The Company is currently evaluating the impact, if any, the adoption of SFAS No. 157 will have on its consolidated financial statements.

*Consideration of Misstatements*

In September 2006, the SEC released Staff Accounting Bulletin No. 108, “Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements” (SAB 108), which provides interpretive guidance on how the effects of the carryover or reversal of prior year misstatements should be considered in quantifying a current year misstatement. The SEC staff believes that registrants should quantify errors using both a balance sheet and an income statement approach and evaluate whether either approach results in quantifying a misstatement that, when all relevant quantitative and qualitative factors are considered, is material. The provisions of SAB 108 is effective for financial statements as of the beginning of the first fiscal year ending after November 15, 2006. The Company adopted the requirements at November 15, 2006. The impact of SAB 108 in the future will depend on the nature and extent of any prior year misstatements, but we do not anticipate SAB 108 will have any impact to our consolidated financial statements.

**3. CHANGE IN ACCOUNTING METHOD FOR PRENEED SELLING COSTS**

On June 30, 2005, the Company changed its method of accounting for preneed selling costs, incurred for the origination of prearranged funeral and cemetery service and merchandise sales contracts. The Company has applied this change in accounting method effective January 1, 2005. Therefore, the Company’s results of operations for the year ended December 31, 2005 and 2006 are reported on the basis of the changed method. Prior to this change, commissions and other costs that were related to the origination of prearranged funeral and cemetery service and merchandise sales were deferred and amortized with the objective of recognizing the selling costs in the same period that the related revenue is recognized. Under the prior accounting method, the commissions and other direct selling costs, which are current obligations that are paid and use operating cash flow, are not recognized currently in the income statement.

As of January 1, 2005, the Company recorded the cumulative effect of the change in accounting method in the amount of \$35.8 million pretax or \$22.8 million after tax (net of income tax benefit of \$13.0 million), or \$1.24 per diluted share, which represents the cumulative balance of deferred preneed selling costs in the Company’s consolidated balance sheet at that date.

The tables below presents the pro forma amounts for the year ended December 31, 2004 as if the accounting change had been in effect during 2004 (in thousands, except per share amounts).

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

### 3. CHANGE IN ACCOUNTING METHOD FOR PRENEED SELLING COSTS (continued)

		Year Ended December 31, 2004	
	As Reported	Effect of Change	Proforma
Income from continuing operations	\$10,034	\$(1,865)	\$8,169
Net income	9,234	(1,686)	7,548
Diluted earnings per common share from continuing operations	0.55	(0.10)	0.45
Diluted earnings per common share	0.51	(0.10)	0.41

### 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 assess disposition candidates. The execution of this strategy entails selling generally smaller, lower margin non-strategic businesses.

During 2006, the Company sold a funeral home business and a combination funeral home and cemetery business for approximately \$6.5 million and ceased operations at a funeral home business. The Company recorded impairment charges of \$6.3 million, a substantial portion of which related to specifically identified goodwill, and recognized \$0.2 million of net losses.

The Company recorded additional impairment charges totaling \$2.1 million, which is related to specifically identified goodwill, for three funeral home businesses to be sold in 2007. The sales of two of these businesses were completed in January and February of 2007 (Note 24).

During 2005, the Company sold a funeral home business and a cemetery business for cash proceeds totaling \$1.6 million and ceased operations at a funeral home business. The transactions generated gains of approximately \$1.3 million.

The Company sold three funeral homes businesses during 2004. The sales were preceded by the recording of approximately \$3.7 million of impairment charges. Those sales generated net cash proceeds totaling \$3.3 million and a gain of approximately \$1.1 million.

No businesses were held for sale at December 31, 2005. At December 31, 2006, assets and liabilities associated with the three funeral home businesses held for sale in the accompanying balance sheet consisted of the following (in thousands).

	December 31, 2006
<b>Assets:</b>	
Current assets	\$ 124
Property, plant and equipment, net	1,406
Preneed receivables and trust investments	634
Goodwill	324
Deferred charges and other assets	146
<b>Total</b>	<b>\$ 2,634</b>
<b>Liabilities:</b>	
Current liabilities	\$ 229
Deferred preneed funeral contracts revenue	78
Senior long-term debt, net of current portion	54
Non-controlling interests in funeral and cemetery trust investments	700
<b>Total</b>	<b>\$ 1,061</b>

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

### 4. DISCONTINUED OPERATIONS (continued)

The operating results of businesses discontinued during the periods presented, as well as impairments and gains or losses on the disposal, are presented in the discontinued operations section of the consolidated statements of operations, along with the income tax effect. Likewise, the operating results, impairment charges and gains or losses from those businesses have been similarly reported for comparability. The results for the businesses presented in the discontinued operations section are as follows (in thousands):

	For the years ended December 31,		
	2004	2005	2006
Revenues	\$ 7,913	\$ 6,558	\$ 3,785
Operating income	1,402	1,538	672
Gain (losses) on sale and (impairments)	(2,630)	1,301	(8,615)
(Provision) benefit for income taxes	509	(955)	2,701
Income (loss) from discontinued operations	<u>\$ (719)</u>	<u>\$ 1,884</u>	<u>\$ (5,242)</u>

### 5. SHORT TERM INVESTMENTS

Short term investments are investments purchased with an original maturity of greater than three months but less than a year at the time of purchase. Short term investments at December 31, 2006 consisted of commercial paper with maturity dates that range from January 2007 to February 2007 at rates ranging from 5.17 % to 5.19 % per annum. Market value approximates cost.

### 6. GOODWILL

Many of the acquired funeral homes and former owners have provided high quality service to families for generations. The resulting loyalty often represents a substantial portion of the value of a funeral business. 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.

The following table presents changes in goodwill for the year ended December 31, 2005 and 2006 (in thousands):

	December 31, 2005	December 31, 2006
Goodwill at beginning of year	\$ 156,983	\$ 157,358
Impairments	—	(8,392)
Divestitures	—	(121)
Acquisitions	375	—
Goodwill at end of year	<u>\$ 157,358</u>	<u>\$ 148,845</u>



## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

### 7. PRENEED TRUST INVESTMENTS

#### *Cemetery preneed trust investments*

Cemetery preneed 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 cemetery preneed trust assets at December 31, 2006 are detailed below (in thousands). The Company believes the unrealized losses related to trust investments are temporary in nature.

	Cost	Unrealized Gains	Unrealized Losses	Market
Cash, money market and short-term investments	\$ 4,559	—	—	\$ 4,559
Fixed income securities:				
U.S. Agency obligations	13,544	3	(89)	13,458
State obligations	5,811	66	(155)	5,722
Corporate	2,426	17	(19)	2,424
Other	6	—	—	6
Common Stock	10,074	1,582	(60)	11,596
Mutual funds:				
Equity	11,192	1,305	(155)	12,342
Fixed income	5,061	83	(16)	5,128
Other investments	—	—	—	—
Trust investments	<u>\$ 52,673</u>	<u>\$ 3,056</u>	<u>\$ (494)</u>	<u>\$ 55,235</u>
Accrued investment income	<u>\$ 248</u>			<u>\$ 248</u>
Trust assets				<u>\$ 55,483</u>
Market value as a percentage of cost				<u>105.3%</u>

The estimated maturities of the fixed income securities included above are as follows:

Due in one year or less	\$ 2,532
Due in one to five years	14,882
Due in five to ten years	3,888
Thereafter	308
	<u>\$ 21,610</u>

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

### 7. PRENEED TRUST INVESTMENTS (continued)

The cost and market values associated with cemetery preneed trust assets at December 31, 2005 are detailed below (in thousands).

	Cost	Unrealized Gains	Unrealized Losses	Market
Cash, money market and other short-term investments	\$ 6,291	\$ —	\$ —	\$ 6,291
Fixed income securities:				
U.S. Agency obligations	5,502	2	(81)	5,423
State obligations	11,507	177	(223)	11,461
Corporate	3,745	48	(36)	3,757
Other	7	—	—	7
Common Stock	12,830	1,413	(230)	14,013
Mutual funds:				
Equity	5,195	306	(52)	5,449
Fixed income	6,676	49	(43)	6,682
Other investments	1,349	90	(4)	1,435
Trust investments	<u>\$ 53,102</u>	<u>\$ 2,085</u>	<u>\$ (669)</u>	<u>\$ 54,518</u>
Accrued investment income	<u>\$ 250</u>			<u>\$ 250</u>
Trust assets				<u>\$ 54,768</u>
Market value as a percentage of cost				<u>103.1%</u>

#### *Preneed Funeral Trust Investments*

Funeral preneed trust investments represent trust fund assets that the Company expects to withdraw when the services and merchandise are provided.

The cost and market values associated with funeral preneed trust assets at December 31, 2006 are detailed below (in thousands). The Company believes the unrealized losses related to trust investments are temporary in nature.

	Cost	Unrealized Gains	Unrealized Losses	Market
Cash, money market and other short-term investments	\$ 15,865	\$ —	\$ —	\$ 15,865
Fixed income securities:				
U.S. Treasury	7,811	25	(7)	7,829
State obligations	1,678	53	—	1,731
Corporate	2,186	31	(16)	2,201
Obligations and guarantees of U.S. government agencies	1,075	3	(16)	1,062
Common Stock	2,301	590	—	2,891
Mutual funds:				
Equity	8,598	1,169	(25)	9,742
Fixed income	3,278	263	(11)	3,530
Trust investments	<u>\$ 42,792</u>	<u>\$ 2,134</u>	<u>\$ (75)</u>	<u>\$ 44,851</u>
Market value as a percentage of cost				<u>104.8%</u>

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

## 7. PRENEED TRUST INVESTMENTS (continued)

The estimated maturities of the fixed income securities included above are as follows:

Due in one year or less	\$ 1,824
Due in one to five years	9,233
Due in five to ten years	1,636
Thereafter	130
	<u>\$ 12,823</u>

The cost and market values associated with funeral preneed trust assets at December 31, 2005 are detailed below (in thousands).

	Cost	Unrealized Gains	Unrealized Losses	Market
Cash, money market and other short-term investments	\$ 19,216	\$ —	\$ —	\$ 19,216
Fixed income securities:				
U.S. Treasury	434	—	(12)	422
State obligations	1,819	63	(1)	1,881
Corporate	1,289	16	(14)	1,291
Obligations and guarantees of U.S. government agencies	1,067	2	(25)	1,044
Common Stock	2,592	364	(48)	2,908
Mutual funds:				
Equity	5,412	758	—	6,171
Fixed income	15,032	58	(344)	14,745
Trust investments	<u>\$ 46,861</u>	<u>\$ 1,261</u>	<u>\$ (444)</u>	<u>\$ 47,678</u>

Market value as a percentage of cost 101.7%

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 in the Consolidated Financial Statements.

### Trust Investment Security Transactions

Cemetery and funeral trust investment security transactions recorded in Other income in the Consolidated Statements of Operations for the years ended December 31, 2005 and 2006 are as follows (in thousands):

	December 31, 2005	December 31, 2006
Investment income	\$ 4,165	\$ 2,913
Realized gains	3,938	3,433
Realized losses	(305)	(1,273)
Expenses	(1,185)	(1,126)
Increase in non-controlling interests in trust investments	(6,614)	(3,947)
	<u>\$ —</u>	<u>\$ —</u>

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

### 8. RECEIVABLES FROM PRENEED FUNERAL TRUSTS

The receivables from funeral trusts at December 31, 2005 and 2006 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.

The components of the receivables from funeral trusts in the consolidated balance sheet at December 31, 2005 and 2006 are as follows (in thousands):

	December 31, 2005	December 31, 2006
Amount due from preneed funeral trust funds	\$ 18,071	\$ 17,427
Less: allowance for cancellation	(1,842)	(1,778)
	<u>\$ 16,229</u>	<u>\$ 15,649</u>

The following summary reflects the composition of the assets held in trust and controlled by third parties to satisfy Carriage's future obligations under preneed funeral arrangements related to the preceding contracts at December 31, 2006 and 2005. The cost basis includes reinvested interest and dividends that have been earned on the trust assets. Fair value includes unrealized gains and losses on trust assets.

	Historical Cost Basis (in thousands)	Fair Value
As of December 31, 2006:		
Cash and cash equivalents	\$ 2,658	\$ 2,658
Fixed income investments	11,607	11,079
Mutual funds and common stocks	109	108
Annuities	3,053	3,296
Total	<u>\$ 17,427</u>	<u>\$ 17,141</u>
	Historical Cost Basis (in thousands)	Fair Value
As of December 31, 2005:		
Cash and cash equivalents	\$ 3,183	\$ 3,183
Fixed income investments	11,897	11,335
Mutual funds and common stocks	210	210
Annuities	2,781	3,034
Total	<u>\$ 18,071</u>	<u>\$ 17,762</u>

### 9. CONTRACTS SECURED BY INSURANCE

Certain preneed funeral contracts are secured by life insurance policies. 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 \$166.9 and \$161.1 million at December 31, 2005 and 2006, respectively and are not recorded on the Company's balance sheet.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

### 10. 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. As a result of the implementation of FIN 46R, the Company has consolidated the perpetual care trust funds with a corresponding amount as Non-controlling interests in perpetual care trusts. Realized and distributable earnings from these perpetual care trust investments are recognized in current cemetery revenues and are used to defray cemetery maintenance costs which are expensed as incurred.

The cost and market values associated with the trust investments held in perpetual care trust funds at December 31, 2006 are detailed below (in thousands). The Company believes the unrealized losses related to the trust investments are temporary in nature.

	Cost	Unrealized Gains	Unrealized Losses	Market
Cash, money market and other short-term investments	\$ 1,542	\$ —	\$ —	\$ 1,542
Fixed income securities:				
U.S. Treasury	499	4	(3)	500
U.S. Agency obligation	6,444	3	(61)	6,386
State obligations	609	15	—	624
Corporate	1,049	22	(2)	1,069
Other	363	—	(10)	353
Common Stock	9,104	1,678	(63)	10,719
Mutual funds:				
Equity	5,660	858	(132)	6,386
Fixed income	4,737	110	(6)	4,841
Other assets	—	—	—	—
Trust investments	<u>\$ 30,007</u>	<u>\$ 2,690</u>	<u>\$ (277)</u>	<u>\$ 32,420</u>
Accrued investment income	<u>\$ 120</u>			<u>\$ 120</u>
Trust assets				<u>\$ 32,540</u>
Market value as a percentage of cost				<u>108.4%</u>

The estimated maturities of the fixed income securities included above are as follows:

Due in one year or less	\$ 1,294
Due in one to five years	5,691
Due in five to ten years	1,479
Thereafter	468
	<u>\$ 8,932</u>

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

### 10. CEMETERY PERPETUAL CARE TRUST INVESTMENTS (continued)

The cost and market values associated with the trust investments held in perpetual care trust funds at December 31, 2005 are detailed below (in thousands). The Company believes the unrealized losses related to the trust investments are temporary in nature. Net unrealized and realized gains totaled \$1.2 million for the year ended December 31, 2005.

	Cost	Unrealized Gains	Unrealized Losses	Market
Cash, money market and other short-term investments	\$ 2,767	\$ —	\$ —	\$ 2,767
Fixed income securities:				
U.S. Treasury	596	7	(8)	595
U.S. Agency obligation	6,610	8	(85)	6,533
State obligations	58	—	—	58
Corporate	2,589	63	(23)	2,629
Other	1,509	3	(13)	1,499
Common Stock	9,970	1,222	(195)	10,997
Mutual funds:				
Equity	2,926	140	(32)	3,034
Fixed income	3,146	99	(21)	3,242
Other assets	886	63	(98)	851
Trust investments	<u>\$ 31,075</u>	<u>\$ 1,605</u>	<u>\$ (475)</u>	<u>\$ 32,205</u>
Accrued investment income	<u>\$ 151</u>			151
Trust assets				<u>\$ 32,356</u>

Market value as a percentage of cost 104.1%

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, 2005 and 2006 are as follows:

	December 31, 2005	December 31, 2006
Trust assets, at market value	\$ 32,356	\$ 32,540
Pending withdrawals of income	(719)	(1,080)
Debt due to a perpetual care trust	1,092	—
Pending deposits	383	(271)
Non-controlling interests	<u>\$ 33,112</u>	<u>\$ 31,189</u>

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

### 10. CEMETERY PERPETUAL CARE TRUST INVESTMENTS (continued)

#### *Trust Investment Security Transactions*

Perpetual care trust investment security transactions recorded in Other income in the Consolidated Statements of Operations for the year ended December 31, 2005 and 2006 are as follows (in thousands):

	December 31, 2005	December 31, 2006
Investment income	\$ 2,480	\$ 1,217
Realized gains	1,688	2,033
Realized losses	(140)	(501)
Expenses	(591)	(507)
Increase in non-controlling interests in perpetual care trust investments	(3,437)	(2,242)
	<u>\$ —</u>	<u>\$ —</u>

### 11. DEFERRED CHARGES AND OTHER NON-CURRENT ASSETS

Deferred charges and other non-current assets at December 31, 2005 and 2006 were as follows:

	2005 (in thousands)	2006
Agreements not to complete, net of accumulated amortization of \$3,944 and \$4,092, respectively	\$ 831	\$ 511
Deferred loan costs, net of accumulated amortization of \$3,009 and \$1,083, respectively	4,592	4,012
Deferred tax asset	15,894	16,540
Federal agency bond (cost approximates market)	—	5,000
Other	4,291	4,396
	<u>\$ 25,608</u>	<u>\$ 30,459</u>

The cost of agreements not to compete with former owners of businesses acquired is amortized over the term of the respective agreements, ranging from four to ten years. Deferred loan costs are being amortized over the term of the related debt.

### 12. LONG-TERM DEBT

#### *Long-Term Debt*

The Company's long-term debt consisted of the following at December 31:

	2005 (in thousands)	2006
Credit Facility, secured floating rate \$35 million line at December 31, 2005 and 2006. Interest is due on a quarterly basis and on the maturity date at prime or LIBOR options, matures in April, 2010	\$ —	\$ —
7.875% Senior Notes due 2015	130,000	130,000
Acquisition debt	4,305	2,669
Other	2,293	2,731
Less: current portion	(2,026)	(1,559)
	<u>\$ 134,572</u>	<u>\$ 133,841</u>

In January 2005, the Company issued \$130 million of 7.875% Senior Notes at par, due in 2015. The proceeds from these notes were used to refinance the Series 1999 Senior Notes, bring current the cumulative deferred distributions on the convertible junior subordinated debenture and the TIDES, and for general corporate purposes. In March 2005, the Company paid the cumulative deferred distributions on the TIDES totaling \$10.9 million. During April 2005, the Company entered into a \$35 million senior secured revolving credit facility that matures in five years to replace the existing unsecured credit facility. Borrowings under the new

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)****12. LONG-TERM DEBT (continued)**

credit facility bear interest at prime or LIBOR options with the current LIBOR option set at LIBOR plus 300 basis points. The credit facility is collateralized by all personal property and funeral home real property in certain states. The facility is currently undrawn.

In accordance with the terms of the Company's credit facility, a portion of the cash proceeds from the sale of funeral home and cemetery businesses are pledged to the benefit of the lenders and are restricted for use only for acquisitions of similar businesses, capital expenditures, or paydowns of debt. During 2006, approximately \$5.5 million of such proceeds were so pledged, with \$2.6 million subsequently released from the pledge and \$2.9 million remaining pledged as of December 31, 2006.

Carriage, the parent entity, has no independent assets or operations. 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 our debentures issued in connection with our TIDES) have fully and unconditionally guaranteed our obligations under the 7.875% Senior Notes. Additionally, we do not currently have any significant restrictions on our ability to receive dividends or loans from any subsidiary guarantor under the new Senior Notes.

In connection with the 2005 senior note refinancing, the Company made a required "make whole" payment of \$6.0 million (recorded as additional interest) and recorded a charge to write off \$0.7 million of unamortized loan costs (in aggregate \$4.2 million after tax, or \$0.23 per diluted share) during the first quarter of 2005. In connection with the new senior secured revolving credit facility, the Company recorded a charge to write off \$0.2 million or \$0.01 per diluted share of unamortized loan costs during the second quarter.

The Company was in compliance with the covenants contained in the credit facility and the Senior Notes as of and for the years ended December 31, 2005 and 2006.

Acquisition debt consists of deferred purchase prices payable to sellers. The deferred purchase price notes bear interest at 0%, discounted at imputed interest rates ranging from 6% to 8%, with original maturities from three to 15 years.

The aggregate maturities of long-term debt for the next five years as of December 31, 2006 are approximately \$1,613,000, \$2,122,000, \$511,000, \$229,000 and \$238,000, respectively and \$130,818,000 thereafter.

**13. CONVERTIBLE JUNIOR SUBORDINATED DEBENTURE PAYABLE TO AFFILIATE AND COMPANY OBLIGATED MANDATORILY REDEEMABLE CONVERTIBLE PREFERRED SECURITIES OF CARRIAGE SERVICES CAPITAL TRUST**

During June 1999, Carriage's wholly-owned subsidiary, Carriage Services Capital Trust, issued 1,875,000 units of 7% convertible preferred securities (TIDES), resulting in approximately \$90 million in net proceeds, and the Company issued a 7% convertible junior subordinated debenture to the Trust in the amount of \$93.75 million. The convertible preferred securities have a liquidation amount of \$50 per unit, and are convertible into Carriage's Common Stock at the equivalent conversion price of \$20.4375 per share of Common Stock. The subordinated debentures and the TIDES mature in 2029 and the TIDES are guaranteed on a subordinated basis by the Company. Both the subordinated debentures and the TIDES contain a provision for the deferral of distributions for up to 20 consecutive quarters. During the period in which distribution payments are deferred, distributions will continue to accumulate at the 7 percent annual rate. Also, the deferred distributions will themselves accumulate distributions at the annual rate of 7 percent. During the period in which distributions are deferred, Carriage is prohibited from paying dividends on its common stock or repurchasing its common stock, with limited exceptions. The Company deferred the distributions during the period September 2003 to January 2005. The Company brought the deferred distributions current during January 2005. There are no deferred distributions at December 31, 2006.



## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

### 14. COMMITMENTS AND CONTINGENCIES

#### *Leases*

Carriage leases certain office facilities, vehicles and equipment under operating leases for terms ranging from one to 15 years. Certain of these leases provide for an annual adjustment and contain options for renewal. Rent expense totaled \$3,625,000, \$3,805,000 and \$3,735,000 for 2004, 2005 and 2006, respectively. Assets acquired under capital leases are included in property, plant and equipment in the accompanying consolidated balance sheets in the amount of \$1,676,000 in 2005 and \$1,387,000 in 2006, net of accumulated depreciation. Capital lease obligations are included in current and long-term debt as indicated below.

At December 31, 2006, future minimum lease payments under noncancellable lease agreements were as follows:

	Future Minimum Lease Payments	
	Operating Leases	Capital Leases
	(in thousands)	
Years ending December 31, 2007	\$ 2,109	\$ 613
2008	1,894	638
2009	1,314	664
2010	920	691
2011	777	713
Thereafter	3,200	11,782
Total future minimum lease payments	<u>\$ 10,214</u>	<u>\$ 15,101</u>
Less: amount representing interest (rates ranging from 7% to 11.5%)		(10,322)
Less: current portion of obligations under capital leases		(51)
Long-term obligations under capital leases		<u>\$ 4,728</u>

#### *Agreements and Employee Benefits*

Carriage obtained various agreements not to compete from former owners of businesses acquired. Payments for such agreements are generally not made in advance. These agreements are generally for one to 10 years and provide for future payments annually, quarterly or monthly. The aggregate payments due under these agreements for the next five years total \$1,214,000, \$1,045,000, \$686,000, \$602,000 and \$411,000, respectively and \$1,115,000 thereafter.

The Company has entered into various consulting agreements with former owners of businesses acquired. Payments for such agreements are generally not made in advance. These agreements are generally for one to 10 years and provide for future payments monthly or bi-weekly. The aggregate payments for the next five years total \$399,000, \$331,000, \$160,000, \$50,000 and \$18,000, respectively and \$43,000 thereafter.

The Company has entered into employment agreements with the executive officers. These agreements are generally for two to five years and provide for future payments bi-weekly plus discretionary bonus payments. These payments due under these agreements for the next four years total \$895,000, \$270,000, \$270,000, and \$202,500, respectively. New employment agreements for certain executive officers are expected to be completed in 2007.

Carriage sponsors a defined contribution plan (401k) for the benefit of its employees. The Company's matching contributions and plan administrative expenses totaled \$365,000, \$268,000 and \$217,000 for 2004, 2005 and 2006, respectively. The Company does not offer any post-retirement or post-employment benefits.

#### *Other Commitments*

In 2005, the Company entered into an agreement to outsource the processing of transactions for the cemetery business. The Company and the contractor may terminate the contract for various reasons upon written notification and set terms. Payments vary based on the level of resources provided. The Company paid \$1.2 and \$2.2 million to the contractor for services in 2005 and 2006, respectively.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

### 14. COMMITMENTS AND CONTINGENCIES (continued)

#### *Litigation*

Carriage and its 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, management does not expect these matters to have a material adverse effect on the financial statements.

The Company self-insures against certain insurable risks and carries insurance with coverage and coverage limits for risks in excess of the self-insured amounts consistent with management's assessment of risks in the 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, management believes that the reserves and insurance provides reasonable coverage for known asserted or unasserted claims. In the event the Company sustained a loss from a claim and the insurance carrier disputed coverage or coverage limits, the Company may record a charge in a different period than the recovery, if any, from the insurance carrier.

### 15. INCOME TAXES

The provision (benefit) for income taxes from continuing operations for 2004, 2005 and 2006 consisted of:

	<u>2004</u>	<u>2005</u> (in thousands)	<u>2006</u>
<b>Current:</b>			
U. S. Federal	\$ —	\$ —	\$ 227
State	141	241	491
Total current provision	<u>141</u>	<u>241</u>	<u>718</u>
<b>Deferred:</b>			
U. S. Federal	(156)	(302)	2,032
State	96	(395)	(375)
Total deferred provision (benefit)	<u>(60)</u>	<u>(697)</u>	<u>1,657</u>
Total income tax provision (benefit)	<u>\$ 81</u>	<u>\$ (456)</u>	<u>\$ 2,375</u>

A reconciliation of taxes to the U.S. federal statutory rate to those reflected in the consolidated statements of operations for 2004, 2005 and 2006 is as follows:

	<u>2004</u>		<u>2005</u>		<u>2006</u>	
	<u>Amount</u>	<u>Percent</u>	<u>Amount</u>	<u>Percent</u>	<u>Amount</u>	<u>Percent</u>
Federal statutory rate	\$ 3,748	34.0%	\$ (493)	34.0%	\$ 2,108	34.0%
Effect of state income taxes, net of federal benefit	276	2.5	(36)	2.5	475	7.7
Effect of non-deductible expenses and other, net	120	1.1	214	(14.7)	101	1.6
Change in valuation allowance	(4,063)	(36.9)	(141)	9.7	(309)	(5.0)
	<u>\$ 81</u>	<u>0.7%</u>	<u>\$ (456)</u>	<u>31.5%</u>	<u>\$ 2,375</u>	<u>38.3%</u>

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

### 15. INCOME TAXES (continued)

The tax effects of temporary differences that give rise to significant deferred tax assets and liabilities at December 31, 2005 and 2006 were as follows:

	2005	2006
	(in thousands)	
Deferred tax assets (liabilities):		
Net operating loss carryforwards	\$ 7,501	\$ 5,927
Accrued liabilities and other	1,525	1,672
Amortization of non-compete agreements	1,579	1,813
Amortization and depreciation	(12,729)	(13,697)
Preneed revenue and costs, net	20,618	23,320
	18,494	19,035
Valuation allowance	(1,075)	(823)
Total net deferred tax assets	<u>\$ 17,419</u>	<u>\$ 18,212</u>
Current deferred tax asset	\$ 1,525	\$ 1,672
Non-current deferred tax asset	15,894	16,540
Total net deferred tax assets	<u>\$ 17,419</u>	<u>\$ 18,212</u>

The current deferred tax asset is included in Inventories and other current assets at December 31, 2005 and 2006. The non-current deferred tax asset is included in Deferred charges and other non-current assets at December 31, 2005 and 2006.

Carriage 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. The Company reduced its valuation allowance and recorded deferred tax benefits in the amounts of \$0.3 million (equal to \$0.01 per diluted share) during 2006.

For federal income tax reporting purposes, Carriage has net operating loss carryforwards totaling \$9.7 million available at December 31, 2006 to offset future Federal taxable income, which expire between 2021 and 2025 if not utilized. Carriage also has approximately \$79.5 million of state net operating loss carryforwards that will expire between 2007 and 2026, 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. The valuation allowance at December 31, 2006 is attributable to the deferred tax asset related to the state operating losses.

### 16. STOCKHOLDERS' EQUITY

#### *Stock Based Compensation Plans*

During the period 2004 through 2006 Carriage had five stock benefit plans in effect under which stock option grants or restricted stock have been issued or remain outstanding: the 1995 Stock Incentive Plan (the "1995 Plan"), the 1996 Stock Option Plan (the "1996 Plan"), the 1996 Directors' Stock Option Plan (the "Directors' Plan"), the 1998 Stock Option Plan for Consultants (the "Consultants' Plan") and the 2006 Long Term Incentive Plan (the "2006 Plan"). Substantially all of the options granted under the plans have ten-year terms. The 1995 Plan expired in 2005 and the 1996 Plan, the Director's Plan and the Consultants Plan were terminated during 2006 prior to the approval of the 2006 Plan at the annual shareholders meeting. The expiration and termination of these plans does not affect the options previously issued and outstanding.

All stock-based plans are administered by the Compensation Committee appointed by the Board of Directors. The 2006 Plan provides for grants of options as non-qualified options or incentive stock options, restricted stock, stock appreciation rights and performance awards. Options are granted with an exercise price equal to or greater than the then fair market value of Carriage's Common Stock as determined by the closing price on the date of the option grant. Because of changes in the Company's compensation philosophy, options have not been awarded to officers since 2003 and only a small percentage of the outstanding options are currently unvested.

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

## 16. STOCKHOLDERS' EQUITY (continued)

The status of each of the plans at December 31, 2006 are as follows (in thousands):

	Shares Reserved	Shares Available to Issue	Options Outstanding
1995 Plan	—	—	358
1996 Plan	—	—	642
Consultants' Plan	—	—	8
Directors' Plan	—	—	235
2006 Plan	1,350	1,309	—
Total	1,350	1,309	1,243

A summary of the stock options at December 31, 2004, 2005 and 2006 and changes during the three years ended is presented in the table and narrative below:

	Year ended December 31,					
	2004		2005		2006	
	Shares (000)	Wtd. Avg. Ex Price	Shares (000)	Wtd. Avg. Ex Price	Shares (000)	Wtd. Avg. Ex Price
Outstanding at beginning of period	1,679	\$ 3.57	1,616	\$ 3.64	1,365	\$ 3.39
Granted	110	4.74	24	6.02	24	4.81
Exercised	(134)	2.46	(178)	2.99	(87)	3.01
Canceled or expired	(39)	8.27	(97)	8.93	(59)	6.06
Outstanding at end of year	1,616	3.64	1,365	3.39	1,243	3.32
Exercisable at end of year	1,385	3.51	1,253	3.30	1,202	3.28
Weighted average fair value of options granted		\$ 2.21		\$ 3.22		\$ 2.44

The aggregate intrinsic value of the outstanding and exercisable stock options at December 31, 2006 totaled \$2,795,000 and \$2,768,000 respectively.

The total intrinsic value of options exercised during 2004, 2005 and 2006 totaled \$354,000, \$357,000 and \$155,000, respectively. As of December 31, 2006, there was \$77,000 of unrecognized compensation cost, net of estimated forfeitures, related to nonvested stock options, which is expected to be recognized over a weighted average period of approximately one year. Pursuant to the Company's adoption of FAS 123R on January 1, 2006, the Company recorded compensation expense totaling \$117,000 in 2006 related to the vesting of stock options.

The following table further describes the Company's outstanding stock options at December 31, 2006 (shares in thousands):

Actual Range of Exercise Prices 150% increment	Options Outstanding			Options Exercisable	
	Number Outstanding at 12/31/06	Weighted-Average Remaining Contractual Life	Weighted-Average Exercise Price	Number Exercisable at 12/31/06	Weighted-Average Exercise Price
\$1.19- 1.56	632	4.0	\$ 1.49	632	\$ 1.49
\$2.06- 3.09	152	3.5	\$ 2.89	151	\$ 2.89
\$3.12- 4.66	139	6.3	\$ 4.21	102	\$ 4.15
\$4.77- 6.19	268	5.8	\$ 5.06	266	\$ 5.05
\$7.56- 11.00	1	2.8	\$ 8.06	1	\$ 8.06
\$13.25- 19.88	45	1.8	\$ 15.09	45	\$ 15.09
\$21.00- 27.50	6	0.3	\$ 21.19	5	\$ 21.19
\$1.19- 27.50	1,243	4.5	\$ 3.32	1,202	\$ 3.28

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

### 16. STOCKHOLDERS' EQUITY (continued)

#### *Employee Stock Purchase Plan*

Carriage provides all employees the opportunity to purchase Common Stock through payroll deductions. Purchases are made quarterly; the price being 85% of the lower of the price on the grant date or the purchase date. In 2004, employees purchased a total of 120,195 shares at a weighted average price of \$3.51 per share. In 2005, employees purchased a total of 86,354 shares at a weighted average price of \$4.20 per share. During 2006, employees purchased a total of 74,536 shares at a weighted average price of \$4.03 per share. Pursuant to the Company's adoption of FAS 123R on January 1, 2006, compensation cost totaling approximately \$119,000 was expensed in 2006.

The fair values of stock options granted during the three years and grants at the beginning of each of the years pursuant to the Company's employee stock purchase plan ("ESPP") were estimated using the following weighted average assumptions:

	<u>Stock Options</u>	<u>ESPP</u>
<b>2006 Assumptions:</b>		
Expected dividend yield	0%	0%
Expected volatility	58%	58%
Risk-free interest rate	4.25%	4.25%
Expected life (years)	5	.25,.50,.75,1
	<u>Stock Options</u>	<u>ESPP</u>
<b>2005 Assumptions:</b>		
Expected dividend yield	0%	0%
Expected volatility	50%	50%
Risk-free interest rate	4.04%	4.04%
Expected life (years)	5	.25,.50,.75,1
	<u>Stock Options</u>	<u>ESPP</u>
<b>2004 Assumptions:</b>		
Expected dividend yield	0%	0%
Expected volatility	47%	47%
Risk-free interest rate	3.00%	3.00%
Expected life (years)	5	.25,.50,.75,1

The expected life of the ESPP grants represents the calendar quarters from the grant date (January 1) to the purchase date (end of each quarter).

#### *Restricted Stock Grants*

The Company, from time to time, issues shares of restricted common stock to certain officers and key employees of the Company from the stock benefit plans. A summary of the status of unvested restricted stock awards as of December 31, 2006, and changes during 2006, is presented below:

<u>Unvested stock awards</u>	<u>Shares (in thousands)</u>	<u>Weighted Average Grant Date Fair Value</u>
Unvested at January 1, 2006	416,500	\$ 4.71
Awards	35,000	4.81
Cancellations	(65,250)	4.92
Vestings	(137,500)	4.56
Unvested at December 31, 2006	<u>248,750</u>	<u>4.76</u>

The Company recognized \$0.4, \$0.6 and \$0.5 million in compensation cost in 2004, 2005 and 2006, respectively, related to the vesting of restricted stock awards. As of December 31, 2006, there was \$0.8 million of total unrecognized compensation costs related to unvested restricted stock awards, which is expected to be recognized over a weighted average period of 1.9 years

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

### 16. STOCKHOLDERS' EQUITY (continued)

#### *Director Compensation Plans*

The Company also has a compensation plan for its outside directors under which directors may choose to accept fully vested shares of the Company's common stock for all or a portion of their annual retainer and meeting fees, and under which new directors receive an award of 20,000 shares of common stock at the time of their initial election to the Board, 50% of which are vested at the grant date and 25% of which vests on the first and second anniversary of the grant. The value of the shares at the grant date is charged to expense as the shares vest. During the three years 2004 through 2006, the Company issued shares of common stock to directors totaling 19,639, 13,709 and 16,649 respectively, in lieu of payment in cash for their fees, the value of which was charged to operations. Additionally, the non-executive officer directors received a grant of 6,000 fully vested stock options each on the date of the annual stockholders meeting during 2004, 2005 and 2006. Pursuant to the Company's adoption of FAS 123R at the beginning of 2006, the fair value of the 2006 option grants totaling \$59,000 was charged to operations.

### 17. PREFERRED STOCK

The Company has 40,000,000 authorized shares of preferred stock, none of which is currently issued and outstanding.

### 18. RELATED PARTY TRANSACTIONS

As an incentive, the Company entered into an arrangement with a former owner, who also serves as a director to pay him 10% of the amount by which the annual field level cash flow exceeds predetermined targets on certain businesses in California through 2006, with a final payment payable in 2007 equal to a multiple of six times the average of the last three years payments. The business purpose of the arrangement was to incentivise the individual to provide Carriage with high quality acquisition targets and to have input in the competitive strategies of those businesses post-acquisition so that cash flows grow over time. The terms were determined by reference to similar arrangements within the death care industry. The incentives earned by the director totaled approximately \$110,000, \$276,000 and \$344,000 for the years 2004, 2005 and 2006, respectively, and a final payment of \$1,452,000 payable in the first quarter of 2007.

### 19. EARNINGS PER SHARE

The following table sets forth the computation of the basic and diluted earnings per share for 2004, 2005 and 2006:

	2004	2005	2006
	(in thousands, except per share data)		
Numerator:			
Net income (loss) from continuing operations	\$ 9,953	\$ (993)	\$ 3,826
Net income (loss) from discontinued operations	(719)	1,884	(5,242)
Cumulative effect of change in accounting method	—	(22,756)	—
Numerator for earnings per share — net income (loss)	<u>\$ 9,234</u>	<u>\$ (21,865)</u>	<u>\$ (1,416)</u>
Denominator:			
Denominator for basic earnings per share — weighted average shares	17,786	18,334	18,545
Effect of dilutive securities:			
Stock options	474	—	367
Denominator for diluted earnings per share — weighted average shares and assumed	<u>18,260</u>	<u>18,334</u>	<u>18,912</u>
Basic earnings (loss) per share:			
Continuing operations	\$ 0.56	\$ (0.05)	\$ 0.21
Discontinued operations	(0.04)	0.10	(0.29)
Cumulative effect of change in accounting method	—	(1.24)	—
Net income (loss)	<u>\$ 0.52</u>	<u>\$ (1.19)</u>	<u>\$ (0.08)</u>
Diluted earnings (loss) per share:			
Continuing operations	\$ 0.55	\$ (0.05)	\$ 0.20
Discontinued operations	(0.04)	0.10	(0.28)
Cumulative effect of change in accounting method	—	(1.24)	—
Net income (loss)	<u>\$ 0.51</u>	<u>\$ (1.19)</u>	<u>\$ (0.08)</u>

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

### 19. EARNINGS PER SHARE (continued)

Options to purchase 0.2 million shares were not included in the computation of diluted earnings per share for the year ended December 31, 2004, because the effect would be antidilutive as the average market price of the common shares.

Options to purchase 1.2 million shares were not included in the computation of diluted earnings per share for the year ended December 31, 2005, because the effect would be antidilutive and 0.1 million shares because the exercise prices were greater than the average market price of the common shares.

Options to purchase 0.1 million shares were not included in the computation of diluted earnings per share for the year ended December 31, 2006, because the effect would be antidilutive as the exercise prices were greater than the average market price of the common shares.

### 20. MAJOR SEGMENTS OF BUSINESS

Carriage conducts funeral and cemetery operations only in the United States.

	<u>Funeral</u>	<u>Cemetery</u> (in thousands, except number of operating locations)	<u>Corporate</u>	<u>Consolidated</u>
External revenues from continuing operations:				
2006	\$ 114,927	\$ 36,159	\$ —	\$ 151,086
2005	111,643	37,555	—	149,198
2004	108,478	36,115	—	144,593
Net income (loss) from continuing operations:				
2006	\$ 18,923	\$ 2,540	\$ (17,637)	\$ 3,826
2005	18,389	4,265	(23,647)	(993)
2004	17,554	5,442	(13,043)	9,953
Total assets:				
2006	\$ 309,140	\$ 181,225	\$ 74,631	\$ 564,996
2005	322,497	189,684	58,459	570,640
2004	344,940	205,230	14,986	565,156
Depreciation and amortization:				
2006	\$ 5,085	\$ 2,171	\$ 1,432	\$ 8,688
2005	5,035	3,028	1,273	9,336
2004	6,260	3,127	1,260	10,647
Capital expenditures:				
2006	\$ 2,769	\$ 2,154	\$ 1,464	\$ 6,387
2005	2,893	2,846	2,386	8,125
2004	3,484	1,140	1,142	5,766
Number of operating locations at year end:				
2006	131	28	—	159
2005	133	29	—	162
2004	135	30	—	165
Interest expense				
2006	\$ 612	\$ 97	\$ 17,805	\$ 18,514
2005	746	107	17,746	18,599
2004	879	116	15,913	16,908
Income tax expense (benefit) from continuing operations:				
2006	\$ 10,571	\$ 1,307	\$ (9,503)	\$ 2,375
2005	10,059	2,152	(12,667)	(456)
2004	10,149	3,022	(13,090)	81

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)**

**21. SUPPLEMENTAL DISCLOSURE OF STATEMENT OF OPERATIONS INFORMATION**

	<b>For the year ended</b>		
	<b>2004</b>	<b>2005</b>	<b>2006</b>
<b>Revenues Goods:</b>			
Funeral	\$ 47,460	\$ 48,594	\$ 49,451
Cemetery	\$ 26,092	\$ 26,773	\$ 24,385
Total goods	\$ 73,552	\$ 75,367	\$ 73,836
<b>Services:</b>			
Funeral	\$ 61,018	\$ 63,049	\$ 65,476
Cemetery	\$ 10,023	\$ 10,782	\$ 11,774
Total services	\$ 71,041	\$ 73,831	\$ 77,250
<b>Total revenues</b>	<b><u>\$ 144,593</u></b>	<b><u>\$ 149,198</u></b>	<b><u>\$ 151,086</u></b>
<b>Cost of revenues</b>			
<b>Goods:</b>			
Funeral	\$ 44,120	\$ 45,599	\$ 46,297
Cemetery	\$ 19,620	\$ 22,190	\$ 23,009
Total goods	\$ 63,740	\$ 67,789	\$ 69,306
<b>Services:</b>			
Funeral	\$ 35,774	\$ 36,852	\$ 38,521
Cemetery	\$ 7,917	\$ 8,840	\$ 9,207
Total services	\$ 43,691	\$ 45,692	\$ 47,728
<b>Total cost of revenues</b>	<b><u>\$ 107,431</u></b>	<b><u>\$ 113,481</u></b>	<b><u>\$ 117,034</u></b>



## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

### 22. QUARTERLY FINANCIAL DATA (UNAUDITED)

The tables below set forth consolidated operating results by fiscal quarter for the years ended December 31, 2005 and 2006, in thousands, except earnings per share.

	<u>First Quarter</u>	<u>Second Quarter</u>	<u>Third Quarter</u>	<u>Fourth Quarter</u>
<b>2006</b>				
Revenue from continuing operations	\$ 41,042	\$ 37,253	\$ 35,125	\$ 37,666
Gross profit from continuing operations	10,684	8,038	5,647	9,683
Income (loss) from continuing operations	2,263	629	(502)	1,436
Income (loss) from discontinued operations	(3,998)	74	(63)	(1,255)
Net income (loss)	<u>\$ (1,735)</u>	<u>\$ 703</u>	<u>\$ (565)</u>	<u>\$ 181</u>
Basic earnings per common share:				
Income (loss) from continuing operations	\$ 0.12	\$ 0.04	\$ (0.03)	\$ 0.08
Loss from discontinued operations	(0.21)	—	—	(0.07)
Net income (loss) per basic share	<u>\$ (0.09)</u>	<u>\$ 0.04</u>	<u>\$ (0.03)</u>	<u>\$ 0.01</u>
Diluted earnings per common share:				
Income (loss) from continuing operations	\$ 0.12	\$ 0.04	\$ (0.03)	\$ 0.08
Loss from discontinued operations	(0.21)	—	—	(0.07)
Net income (loss) per diluted share	<u>\$ (0.09)</u>	<u>\$ 0.04</u>	<u>\$ (0.03)</u>	<u>\$ 0.01</u>
<b>2005</b>				
Revenue from continuing operations	\$ 40,172	\$ 36,675	\$ 35,091	\$ 37,260
Gross profit from continuing operations	11,522	8,516	7,674	8,005
Income (loss) from continuing operations	(1,563)	92	17	461
Income from discontinued operations	759	140	653	332
Cumulative effect of change in accounting method	(22,756)	—	—	—
Net income (loss)	<u>\$ (23,560)</u>	<u>\$ 232</u>	<u>\$ 670</u>	<u>\$ 793</u>
Basic earnings per common share:				
Income (loss) from continuing operations	\$ (0.09)	\$ 0.01	\$ —	\$ 0.02
Income from discontinued operations	0.04	—	0.04	0.02
Cumulative effect of change in accounting method	(1.24)	—	—	—
Net income (loss) per basic share	<u>\$ (1.29)</u>	<u>\$ 0.01</u>	<u>\$ 0.04</u>	<u>\$ 0.04</u>
Diluted earnings per common share:				
Income (loss) from continuing operations	\$ (0.09)	\$ 0.01	\$ —	\$ 0.02
Income from discontinued operations	0.04	—	0.04	0.02
Cumulative effect of change in accounting method	(1.24)	—	—	—
Net income (loss) per diluted share	<u>\$ (1.29)</u>	<u>\$ 0.01</u>	<u>\$ 0.04</u>	<u>\$ 0.04</u>

- (a) Earnings per share are computed independently for each of the quarters presented. Therefore, the sum of the quarterly per share amounts does not equal the total computed for the year due to rounding and stock transactions which occurred during the periods presented.

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

## 23. SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION

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

	Year Ended December 31,		
	2004	2005	2006
Cash paid for interest and financing costs	\$ 9,854	\$ 33,169	\$ 18,096
Cash paid (refunded) for income taxes	\$ (2)	\$ 275	\$ (312)
Stock issued to directors or officers	\$ 466	\$ 1,338	\$ 168
Net (gain) loss on sale of business assets	\$ 650	\$ 582	\$ (513)
Loss on early extinguishment of debt	\$ —	\$ 978	\$ —
Loss on sale of trust investments	\$ 235	\$ —	\$ —
Net deposits in preneed funeral trust investments	\$ (6,190)	\$ (5,138)	\$ (5,731)
Net deposits in cemetery trust investments	\$ (4,412)	\$ (3,095)	\$ (5,463)
Net deposits in perpetual care trust investments	\$ (393)	\$ (1,155)	\$ (5,227)
Net withdrawals in preneed funeral trust receivables	\$ 1,834	\$ 1,195	\$ 617
Net (deposits) withdrawals in cemetery trust receivables	\$ 1,522	\$ (467)	\$ 1,311
Net withdrawals in preneed funeral contracts	\$ 1,164	\$ 663	\$ 604
Net deposits in preneed funeral trust accounts increasing deferred revenue	\$ 6,300	\$ 2,318	\$ 5,006
Net deposits (withdrawals) in cemetery trust accounts increasing (decreasing) deferred revenue	\$ (2,108)	\$ 10,074	\$ 5,089
Net deposits (withdrawals) in preneed funeral trust accounts increasing (decreasing) noncontrolling interests	\$ (1,284)	\$ 1,304	\$ (1,310)
Net deposits (withdrawals) in cemetery trust accounts increasing (decreasing) noncontrolling interests	\$ 3,919	\$ (379)	\$ 716
Deposits in perpetual care trust accounts increasing noncontrolling interests	\$ 29	\$ 900	\$ 3,120
Proceeds from the issuance of common stock through the employee stock purchase plan	\$ 377	\$ 406	\$ 311
Proceeds from the exercise of stock options	\$ 309	\$ 530	\$ 256

Restricted cash investing and financing activities:

Proceeds from the sale of available for sale securities of the funeral and cemetery trusts	\$ 51,323	\$ 51,775	\$ 73,887
Purchase of available for sale securities of the funeral and cemetery trusts	\$ 59,644	\$ 61,223	\$ 62,323
Net deposits (withdrawals) in trust accounts increasing (decreasing) noncontrolling interests	\$ (878)	\$ (2,123)	\$ (11,789)

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)**

**24. SUBSEQUENT BUSINESS ACQUISITION AND SALES**

Effective January 1, 2007, the Company acquired a combination funeral home and cemetery business and a funeral home business in Texas. The Company acquired substantially all the assets and assumed certain operating liabilities including obligations associated with existing preneed contracts in exchange for \$11.1 million in cash.

On January 16, 2007, the Company completed the sale of a funeral home business that was held for sale at December 31, 2006. The Company received net cash proceeds of \$1.0 million. Losses of less than \$0.1 million were recorded due to additional expenses related to the sale of the business. On February 26, 2007, the Company closed on a sale of a funeral business that was held for sale at December 31, 2006. The sale transaction generated net cash proceeds totaling \$1.4 million and a gain of approximately \$0.7 million.

In November 2006, the Company entered into an Agreement to acquire substantially all the assets and assume certain liabilities of a combination funeral home and cemetery business in California in exchange for a cash payment at closing in the amount of \$8.0 million. The acquisition is expected to close in April 2007.

**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

The Board of Directors and Stockholders  
Carriage Services, Inc.:

We have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated financial statements of Carriage Services, Inc. and subsidiaries for 2006 and 2005 included in this Form 10-K, and have issued our report thereon dated March 9, 2007. Our audits for the years ended December 31, 2006, 2005 and 2004, were made for the purpose of forming an opinion on the basic financial statements taken as a whole. The schedule listed in Part IV, Item 15 (a)(2) for Carriage Services, Inc. and subsidiaries is the responsibility of the Company's management and is presented for purposes of complying with the Securities and Exchange Commission's rules and is not part of the basic financial statements. This schedule has been subjected to the auditing procedures applied in the audit of the basic financial statements and, in our opinion, fairly states in all material respects the financial data required to be set forth therein in relation to the basic financial statements taken as a whole.

As discussed in Note 3 to the consolidated financial statements, the Company changed its method of accounting for preneed selling costs in 2005, and as discussed in Note 1 to the consolidated financial statements, effective January 1, 2006, the Company adopted the provisions of Statement of Financial Accounting Standards No. 123R, Share-Based Payment.

/s/ KPMG LLP

Houston, Texas  
March 9, 2007

**CARRIAGE SERVICES, INC.**  
**SCHEDULE II — VALUATION AND QUALIFYING ACCOUNTS**  
(in thousands)

Description	Beginning of year	Charged to Costs and Expenses	Deduction	Balance End of Year
<b>Year ended December 31, 2004:</b>				
Allowance for bad debts, current portion	\$ 1,807	\$ 575	\$ 1,442	\$ 940
Allowance for cemetery bad debts and contract cancellations, noncurrent portion	\$ 683	\$ 1,610	\$ 1,746	\$ 547
Environmental remediation reserves	\$ 121	\$ —	\$ 18	\$ 103
Employee severance accruals	\$ 1,435	\$ 395	\$ 808	\$ 1,022
Office closing and other accruals	\$ 839	\$ —	\$ 507	\$ 332
<b>Year ended December 31, 2005:</b>				
Allowance for bad debts, current portion	\$ 940	\$ 2,024	\$ 2,027	\$ 937
Allowance for cemetery bad debts and contract cancellations, noncurrent portion	\$ 547	\$ 624	\$ 693	\$ 478
Environmental remediation reserves	\$ 103	\$ 110	\$ 70	\$ 143
Employee severance accruals	\$ 1,022	\$ 355	\$ 1,220	\$ 157
Office closing and other accruals	\$ 332	\$ 3	\$ 265	\$ 70
<b>Year ended December 31, 2006:</b>				
Allowance for bad debts, current portion	\$ 937	\$ 1,932	\$ 1,944	\$ 925
Allowance for cemetery bad debts and contract cancellations, noncurrent portion	\$ 478	\$ 1,948	\$ 1,934	\$ 492
Environmental remediation reserves	\$ 143	\$ 1,033	\$ 824	\$ 352
Employee severance accruals	\$ 157	\$ 451	\$ 482	\$ 126
Office closing and other accruals	\$ 70	\$ —	\$ 70	\$ —

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

None.

**ITEM 9A. CONTROLS AND PROCEDURES**

***Management's Evaluation of Disclosure Controls and Procedures***

Our management, including our principal executive and financial officers, has evaluated the effectiveness of our disclosure controls and procedures to ensure that the information required to be disclosed in our filings under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms, and to ensure that such information is accumulated and communicated to management, including our principal executive and financial officers, as appropriate to allow timely decisions regarding required disclosure. Based on such evaluation, our principal executive and financial officers have concluded that such disclosure controls and procedures were effective, as of December 31, 2006 (the end of the period covered by this Annual Report on Form 10-K).

***Assessment of Internal Control Over Financial Reporting***

Management's report on our internal control over financial reporting is presented on page 30 of this Annual Report on Form 10-K. The report of KPMG LLP relating to management's assessment of the effectiveness of internal control over financial reporting and the effectiveness of internal control over financial reporting, the Consolidated Financial Statements and the financial statement schedule are presented on pages 31, 32 and 65, respectively, of this Annual Report on Form 10-K.

***Changes in Internal Control Over Financial Reporting***

Our management report on internal control over financial reporting for the year ended December 31, 2006 did not report any material weaknesses in our internal control over financial reporting or any changes in our internal control over financial reporting.

**ITEM 9B. OTHER INFORMATION**

None.

**PART III**

**ITEM 10. DIRECTIONS, EXECUTIVE OFFICERS AND CORPORATE GOVERNANCE**

The information required by Item 10 is incorporated by reference to the registrant's definitive proxy statement relating to its 2007 annual meeting of stockholders, which proxy statement will be filed pursuant to Regulation 14A of the Securities Exchange Act of 1934, as amended (the "Exchange Act"), within 120 days after the end of the last fiscal year.

**ITEM 11. EXECUTIVE COMPENSATION**

The information required by Item 11 is incorporated by reference to the registrant's definitive proxy statement relating to its 2007 annual meeting of stockholders, which proxy statement will be filed pursuant to Regulation 14A of the Exchange Act within 120 days after the end of the last fiscal year.

**ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS**

The information required by Item 12 is incorporated by reference to the registrant's definitive proxy statement relating to its 2007 annual meeting of stockholders, which proxy statement will be filed pursuant to Regulation 14A of the Exchange Act within 120 days after the end of the last fiscal year.

**ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS, AND DIRECTOR INDEPENDENCE**

The information required by Item 13 is incorporated by reference to the registrant's definitive proxy statement relating to its 2007 annual meeting of stockholders, which proxy statement will be filed pursuant to Regulation 14A of the Exchange Act within 120 days after the end of the last fiscal year.

**ITEM 14. PRINCIPAL ACCOUNTANT FEES AND SERVICES**

The information required by Item 14 is incorporated by reference to the registrant's definitive proxy statement relating to its 2007 annual meeting of stockholders, which proxy statement will be filed pursuant to Regulation 14A of the Exchange Act within 120 days after the end of the last fiscal year.

**PART IV****ITEM 15. EXHIBITS AND FINANCIAL STATEMENT SCHEDULES****(a) 1 FINANCIAL STATEMENTS**

The following financial statements and the Report of Independent Registered Public Accounting Firm are filed as a part of this report on the pages indicated:

	<u>Page</u>
Management's Report on Internal Control over Financial Reporting	30
Attestation of Independent Registered Public Accounting Firm	31
Report of Independent Registered Public Accounting Firm	32
Consolidated Balance Sheets as of December 31, 2005 and 2006	33
Consolidated Statements of Operations for the Years Ended December 31, 2004, 2005 and 2006	34
Consolidated Statements of Changes in Stockholders' Equity for the Years Ended December 31, 2004, 2005 and 2006	35
Consolidated Statements of Cash Flows for the Years Ended December 31, 2004, 2005 and 2006	36
Notes to Consolidated Financial Statements	37

**(a) 2 FINANCIAL STATEMENT SCHEDULES**

The following Financial Statement Schedule and the Report of Independent Registered Public Accounting Firm on Financial Statement Schedule are included in this report on the pages indicated:

	<u>Page</u>
Report of Independent Registered Public Accounting Firm on Financial Statement Schedule	65
Financial Statement Schedule II — Valuation and Qualifying Accounts	66

All other schedules are omitted as the required information is inapplicable or the information is presented in the Consolidated Financial Statements or related notes.

**(a) 3 EXHIBITS**

The exhibits to this report have been included only with the copies of this report filed with the Securities and Exchange Commission. Copies of individual exhibits will be furnished to stockholders upon written request to Carriage Services, Inc. and payment of a reasonable fee.

<u>Exhibit No.</u>	<u>Description</u>
3.1	Amended and Restated Certificate of Incorporation, as amended, of the Company. Incorporated herein by reference to Exhibit 3.1 to the Company's Annual Report on Form 10-K for its fiscal year ended December 31, 1996.
3.2	Certificate of Amendment dated May 7, 1997. Incorporated by reference to Exhibit 10.2 to the Company's Quarterly Report on Form 10-Q for its fiscal quarter ended September 30, 1997.
3.3	Certificate of Amendment dated May 7, 2002. Incorporated by reference to Exhibit 3.1 to the Company's Quarterly Report on Form 10-Q for its fiscal quarter ended June 30, 2002.
3.4	Certificate of Designation of the Company's Series G Junior Participating Preferred Stock. Incorporated by reference to Exhibit C to the Rights Agreement with American Stock Transfer & Trust Company dated December 18, 2000, which is attached as Exhibit 1 to the Company's Form 8-A filed December 29, 2000.
3.5	Amended and Restated Bylaws of the Company. Incorporated by reference to Exhibit 3.2 to the Company's Registration Statement on Form S-1 (File No. 333-05545).
3.6	Amendments to the Bylaws of the Company effective December 18, 2000. Incorporated by



## Table of Contents

<u>Exhibit No.</u>	<u>Description</u>
	reference to Exhibit 3.9 to the Company's Annual Report on Form 10-K for its year ended December 31, 2001.
4.1	Certificate of Trust of Carriage Services Capital Trust. Incorporated by reference to Exhibit 4.6 to the Company's Form S-3 Registration Statement No. 333-84141.
4.2	Amended and Restated Declaration of Trust of Carriage Services Capital Trust, dated June 3, 1999 among the Company, Wilmington Trust Company, Wilmington Trust Company, and Mark W. Duffey, Thomas C. Livengood and Terry E. Sanford. Incorporated by reference to Exhibit 4.7 to the Company's Form S-3 Registration Statement No. 333-84141.
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4.5	Form of the Company's Convertible Junior Subordinated Debentures due 2029. Incorporated by reference to Exhibit 4.11 to the Company's Form S-3 Registration Statement No. 333-84141.
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4.11	Credit Agreement dated April 27, 2005 among Carriage Services, Inc., as the Borrower, Bank of America, N.A. as the Administrative Agent, Swing Line Lender and L/C Issuer, Wells Fargo Bank of Texas, National Association, as Syndication Agent and Other Lenders. Incorporated by reference to Exhibit 4.5 to the Company's Quarterly Report on Form 10-Q for its fiscal quarter ended June 30, 2005.

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<b>Exhibit No.</b>	<b>Description</b>
4.12	Amendment No. 1 to the Credit Agreement dated August 31, 2005 among Carriage Services, Inc., as the Borrower, Bank of America, N.A. as the Administrative Agent, Swing Line Lender and L/C Issuer, Wells Fargo Bank of Texas, National Association, as Syndication Agent and Other Lenders. Incorporated by reference to Exhibit 4.1 to the Company's Quarterly Report on Form 10-Q for its fiscal quarter ended September 30, 2005.
10.1	Amended and Restated 1996 Stock Option Plan. Incorporated herein by reference to Exhibit 10.24 to the Company's Annual Report on Form 10-K for its fiscal year ended December 31, 1996. †
10.2	Amendment No. 2 to 1996 Stock Option Plan. Incorporated by reference to Exhibit 10.2 to the Company's Form S-8 Registration Statement No. 333-85961. †
10.3	Second Amended and Restated 1996 Stock Incentive Plan. Incorporated by reference to Appendix C to the Company's 2005 Schedule 14A. †
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10.5	1998 Stock Option Plan for Consultants. Incorporated by reference to Exhibit 10.1 to the Company's Form S-8 Registration Statement No. 333-62593. †
10.6	Amendment No. 1 to the 1997 Employee Stock Purchase Plan. Incorporated by reference to Appendix B to the Company's 2005 Schedule 14A. †
10.7	Employment Agreement with Melvin C. Payne, dated November 8, 1999. Incorporated by reference to Exhibit 10.11 to the Company's Annual Report on Form 10-K for its fiscal year ended December 31, 1999. †
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10.15	Indemnity Agreement with George J. Klug dated May 13, 2003. Incorporated by reference to Exhibit 10.5 to the Company's Quarterly Report on Form 10-Q for its quarter ended June 30, 2003. †
10.16	Employment Agreement with George J. Klug dated March 30, 2005. Incorporated by reference to Exhibit 10.2 to the Company's Quarterly Report on Form 10-Q for its quarter ended March 31, 2005. †
10.17	Employment Agreement with Joseph Saporito dated November 4, 2005. Incorporated by reference to Exhibit 10.19 to the Company's Annual Report on Form 10-K for its fiscal year ended December 31, 2005. †
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*12	Calculation of Ratio of Earnings to Fixed Charges.
14	Code of Business Conduct and Ethics. Carriage's Code of Business Conduct and Ethics is available on the website <a href="http://www.carriageservices.com">www.carriageservices.com</a> .
18.1	Preferability letter from registered public accounting firm regarding change in accounting method dated August 1, 2005. Incorporated by reference to Exhibit 18.1 to the Company's Quarterly Report on Form 10-Q for its quarter ended June 30, 2005.
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*32	Certification of Periodic Financial Reports by Melvin C. Payne and Joseph Saporito in satisfaction of Section 906 of the Sarbanes-Oxley Act of 2002.

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(\*) Filed herewith.

(†) Management contract or compensatory plan or arrangement required to be filed as an exhibit hereto.

## SIGNATURES

PURSUANT TO THE REQUIREMENTS OF SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934, THE REGISTRANT HAS DULY CAUSED THIS REPORT ON ITS BEHALF BY THE UNDERSIGNED, THEREUNTO DULY AUTHORIZED ON MARCH 9, 2007.

## CARRIAGE SERVICES, INC.

By: /s/ Melvin C. Payne  
**Melvin C. Payne**  
Chairman of the Board, Chief Executive Officer,  
and President

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

<u>Signature</u>	<u>Title</u>	<u>Date</u>
<u>/s/ Melvin C. Payne</u> <b>Melvin C. Payne</b>	Chairman of the Board, Chief Executive Officer, President and Director (Principal Executive Officer)	March 9, 2007
<u>/s/ Joseph Saporito</u> <b>Joseph Saporito</b>	Executive Vice President, Chief Financial Officer and Secretary (Principal Financial Officer)	March 9, 2007
<u>/s/ Terry E. Sanford</u> <b>Terry E. Sanford</b>	Senior Vice President, Treasurer and Chief Accounting Officer (Principal Accounting Officer)	March 9, 2007
<u>/s/ Joe R. Davis</u> <b>Joe R. Davis</b>	Director	March 9, 2007
<u>/s/ Ronald A. Erickson</u> <b>Ronald A. Erickson</b>	Director	March 9, 2007
<u>/s/ Vincent D. Foster</u> <b>Vincent D. Foster</b>	Director	March 9, 2007
<u>/s/ Mark F. Wilson</u> <b>Mark F. Wilson</b>	Director	March 9, 2007

## Index to Exhibits

<u>Exhibit No.</u>	<u>Description</u>
3.1	Amended and Restated Certificate of Incorporation, as amended, of the Company. Incorporated herein by reference to Exhibit 3.1 to the Company's Annual Report on Form 10-K for its fiscal year ended December 31, 1996.
3.2	Certificate of Amendment dated May 7, 1997. Incorporated by reference to Exhibit 10.2 to the Company's Quarterly Report on Form 10-Q for its fiscal quarter ended September 30, 1997.
3.3	Certificate of Amendment dated May 7, 2002. Incorporated by reference to Exhibit 3.1 to the Company's Quarterly Report on Form 10-Q for its fiscal quarter ended June 30, 2002.
3.4	Certificate of Designation of the Company's Series G Junior Participating Preferred Stock. Incorporated by reference to Exhibit C to the Rights Agreement with American Stock Transfer & Trust Company dated December 18, 2000, which is attached as Exhibit 1 to the Company's Form 8-A filed December 29, 2000.
3.5	Amended and Restated Bylaws of the Company. Incorporated by reference to Exhibit 3.2 to the Company's Registration Statement on Form S-1 (File No. 333-05545).
3.6	Amendments to the Bylaws of the Company effective December 18, 2000. Incorporated by reference to Exhibit 3.9 to the Company's Annual Report on Form 10-K for its year ended December 31, 2001.
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*32	Certification of Periodic Financial Reports by Melvin C. Payne and Joseph Saporito in satisfaction of Section 906 of the Sarbanes-Oxley Act of 2002.

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(\*) Filed herewith.

(†) Management contract or compensatory plan or arrangement required to be filed as an exhibit hereto.

SEPARATION AGREEMENT AND RELEASE

This Separation Agreement and Release is between JAMES J. BENARD, a resident of Fort Bend County, Texas (the "Employee"), and CARRIAGE SERVICES, INC., a Delaware corporation (the "Company").

The Employee and the Company agree as follows:

1. The Employee's employment with the Company and/or one or more of its affiliates (the Company, together with its affiliates, being hereafter collectively referred to as "Carriage"), has terminated or will terminate effective as of July 17, 2006 (the "Separation Date") as a result of the Employee's voluntary resignation. The Employee shall be entitled to receive all base compensation, benefits and accrued vacation, if any, through the Separation Date, but not thereafter. Simultaneously with the parties' execution of this Agreement, the Employee shall tender his resignation, effective as of the Separation Date, as Regional Managing Partner of, together with any and all other positions he may hold with, the Company. He shall also tender his resignation as director and officer of or any other capacity with all other Carriage entities of which he may serve in any such capacity.

Provided the Employee does not revoke this Agreement as provided in Section 15 hereof, the Company shall pay the Employee the sum of \$165,000, less applicable withholdings (the "Severance Payments"). The Severance Payments shall be payable to the Employee in nineteen (19) equal bi-weekly installments in the amount of \$8,461.54 each, beginning on the next regularly scheduled payroll date of the Company after the Company's receipt from the Employee of a properly completed and signed Non-Revocation Statement in the form attached as Exhibit A hereto (the "Non-Revocation Statement"), and continuing on each succeeding payroll date thereafter, until paid in full; with a twentieth and final installment in the amount of \$4,230.74 on the next regularly scheduled payroll date thereafter. In addition, provided Employee does not so revoke, the remaining 5,000 shares of the Company's Common Stock not yet vested under

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Employee's stock bonus grant on January 9, 2003 shall become fully vested in accordance with the letter agreement of even date herewith.

2. Additionally, provided the Employee complies with this Agreement and does not revoke it as provided in Section 15 hereof, if following the Separation Date the Employee becomes eligible to elect continuation coverage under the Consolidated Omnibus Budget Reconciliation Act (COBRA) and properly elects such coverage, the Company shall reimburse the Employee or pay on his behalf the amount of the premiums under COBRA for the Company's group health and hospitalization insurance coverage which the Employee has in effect as of the Separation Date, up to a maximum of \$800 per month, for the period beginning on the effective date of election and continuing through the earlier to occur of (i) whenever the Employee thereafter obtains or is eligible to obtain replacement coverage or (ii) April 16, 2007.

3. In consideration for the Severance Payments, the Employee hereby discharges and releases Carriage and Carriage's past, present and future stockholders, directors, officers, trustees, partners, employees, insurers, agents, successors and assigns (collectively, "Released Parties") from any claim, demand, and/or cause of action whatsoever, whether vicarious, derivative, or direct, presently known or unknown, whether sounding in contract, tort or otherwise, under common law or by statute or regulation, that is based upon facts arising prior to the date hereof with respect to any matter or action related to the Employee's employment with, termination from, and/or affiliation with Carriage, or in connection with any statements made or actions taken in connection with such employment relationship or its termination, including, but not limited to, any claims under the Age Discrimination in Employment Act of 1967, the Americans With Disabilities Act of 1990, the Civil Rights Act of 1964 (Title VII), the Civil Rights Act of 1991, the Family and Medical Leave Act of 1993, the Fair Labor Standards Act, the Employee Retirement Income Security Act of 1974, the Pregnancy Discrimination Act, the Fair Credit Reporting Act, and the Texas Labor Code, all as amended and in effect on the date

hereof, and all claims based on the existence of any contract; breach of any duty or covenant of good faith and fair dealing; slander; defamation; invasion of privacy; detrimental reliance; intentional or negligent infliction of emotional distress; duress; promissory estoppel; negligent misrepresentation; intentional misrepresentation or fraud; assault; battery; conspiracy; negligent hiring, retention, or supervision; any alleged act of harassment or intimidation; or any other claim arising under employment-related statutes, laws, rules and regulations.

4. This Agreement is not a suggestion of or an admission of any wrongdoing or liability on the part of any party. The Employee does not waive any rights or claims that may arise after the date hereof.

5. Except as provided below, this Agreement supersedes and extinguishes the Employment Agreement between the parties dated January 1, 2001, as amended by Amendment No. 1 effective January 1, 2004 (as amended, "Prior Employment Agreement"), as well as any other employment agreement and/or bonus or incentive compensation plan or arrangement, if any, entered into between the Employee and Carriage. Without limiting the generality of the foregoing, and as additional inducement to Employee to enter into and perform this Agreement (provided he does not revoke it), this Agreement supersedes and extinguishes Section 8 (Restrictive Covenants) of the Prior Employment Agreement, from which he shall be released hereby. Notwithstanding the foregoing, however, this Agreement does not affect or supersede Section 6 (Certain Additional Matters) or 9 (Confidential Information) of the Prior Employment Agreement, each of which is hereby ratified and confirmed and shall remain in full force and effect for the respective periods therein specified in accordance with their respective terms.

6. The Employee agrees and covenants not to sue or participate in any suit, charge or proceeding of any kind against Carriage or any of the other Released Parties, based upon any claim, demand, and/or cause of action whatsoever, presently known or unknown, that is based upon facts arising prior to the date hereof with respect to any matter or action related to the

Employee's employment, termination from, leave of absence with, request to return to work to, and/or affiliation with Carriage, or in connection with any statements made or actions taken in connection with such employment relationship or its termination.

7. Group health insurance benefits will continue only through the Separation Date. Subject to Section 2 above, after the Separation Date, the Employee is entitled to continue the Employee's group health insurance coverage at his own expense, in accordance with applicable law.

8. After the Separation Date, Employee agrees to make himself available to answer questions and provide information and assistance with respect to matters in which he was involved during his employment with Carriage. The foregoing will be provided only when requested by Carriage, at no out-of-pocket cost to Employee, when Employee is reasonably available to provide such assistance, and in such a way as to not unreasonably interfere with any new employment he may obtain.

9. The parties acknowledge that the Employee has been employed by the Company in a key executive and management positions with Carriage, in which capacities he has had access to and has actual possession of material inside information concerning Carriage's operations (including but not necessarily limited to its cemetery and combination operations and related sales and marketing programs), and that the disclosure or use of any information obtained by Employee could materially and irreparably harm Carriage's interests. Regardless of whether Employee accepts the other provisions of this Agreement, and without limiting the generality of Section 9 of the Prior Employment Agreement, Employee acknowledges that it is and will remain his fiduciary duty to preserve the confidentiality of all of this information, including all market analyses, standards and models, portfolio profiles, employee and location assessments, financial statements and data, files, documents, studies and presentations, customer lists and files, lists of suppliers and vendors, contracts, contract information, brochures, catalogs, training

materials, computer tapes and diskettes or other portable media, computer-readable files and data stored on any form of storage media whether portable or installed, and data processing reports, business records, personnel data, lists of employees, salary and benefits information and any and all other documents or property over which the Employee had possession of or control over during the course of the Employee's employment with Carriage (all of the foregoing, regardless of form and whether or not labeled as confidential, being hereafter collectively referred to as "Information"), and Employee therefore agrees not to disclose or use the Information in any manner or for any purpose, even after the Separation Date, for so long as the confidential nature thereof shall continue (excluding any disclosure by Employee in breach hereof). In addition, whether or not the Employee accepts the terms of this Agreement, the Employee must return to the Company by no later than the close of business on the Separation Date, or as soon thereafter as is possible with respect to any items not then immediately available, any and all items of the Company's property, including without limitation keys, computers, cell phones, software, calculators, equipment, credit cards, forms, files, manuals, correspondence, contracts, contract information, brochures, catalogs, training materials, computer tapes and diskettes or other portable media, computer-readable files and data stored on any form of storage media whether portable or installed, and data processing reports, and any and all other documents or property over which the Employee had possession of or control over during the course of the Employee's employment with Carriage. In the event it appears that the Employee will be compelled by law or judicial process to disclose any Information, to avoid potential liability the Employee must notify the Company's Chief Executive Officer in writing immediately upon the Employee's receipt of a subpoena or other legal process. The Employee further agrees not to disclose or cause to be disclosed the terms of this Agreement, or the fact that this Agreement exists, except to the Employee's attorneys and/or tax advisors or to the extent otherwise required by law. Employee acknowledges that all materials and other copyrightable works and subject matter

(regardless of whether or not constituting "Information") produced by or for Carriage (regardless of whether by the Employee or others, and regardless of whether or not denoted as copyrighted material) are owned by and proprietary to Carriage and may not be used or reproduced in whole or in part without Carriage's written permission. Employee also agrees not to make any disparaging remarks regarding Carriage or any of the other Released Parties referred to herein.

10. This Agreement contains the entire agreement between the Employee and the Company and cannot be changed, modified, or amended without a written agreement signed by the Employee and the Company.

11. This Agreement is made and shall be enforced pursuant to the laws of the State of Texas.

12. Should any part of this Agreement be found to be void, that determination will not affect the remainder of the Agreement.

13. The Employee waives any right to reinstatement as an employee or any future employment relationship with Carriage following separation from Carriage.

14. The offer made by the Company herein will expire at 12:01 a.m. on the twenty-first day following the date of the offer made herein. The Employee may accept this offer at any time prior to the expiration by signing this Agreement.

15. This Agreement has been entered into voluntarily by the Employee and not as a result of coercion, duress, or undue influence, economic or otherwise. The Employee acknowledges that he has read and fully understands the terms of this Agreement, has been advised to consult with an attorney before executing this Agreement, and the Severance Payments recited in Section 2 are in excess of that to which the Employee might otherwise be entitled to receive from the Company. The Employee represents that he has been given adequate time to consider the terms of the separation as described herein. Following Employee's execution of this Agreement, the Employee shall have a period of seven (7) days to revoke this

Agreement (other than Section 9 above) by delivering to the Company, at its address shown opposite its signature hereof, a written notice revoking this Agreement and specifically referring to the right to do so under this Section 15. If the Employee desires not to so revoke, the Employee will deliver the Non-Revocation Notice after expiration of such seven-day period. Failure to deliver any notice within such seven-day period shall constitute a lapse of the Employee's right to revoke, but the Company's obligation to pay the Severance Payments shall nonetheless remain subject to receipt from the Employee of the signed Non-Revocation Statement. If the Employee revokes this Agreement as aforesaid, the Employee shall forfeit all rights hereunder, including any right to receive the Severance Payments, the release of his obligation under Section 8 of the Prior Employment Agreement or the acceleration of the unvested portion of his shares under his stock bonus grant.

Address:

11 Waters Lake Blvd.  
Missouri City, Texas 77459-6438

/s/ James J. Benard

JAMES J. BENARD

Date 8/2/06

3040 Post Oak Blvd, Suite 300  
Houston, Texas 77056

CARRIAGE SERVICES, INC.

By: /s/ Melvin C. Payne

MELVIN C. PAYNE, Chairman and  
Chief Executive Officer

Date 8/10/06

**NON-REVOCATION STATEMENT**

I, JAMES J. BENARD, acknowledge that at least seven (7) days has expired since the execution of the Separation Agreement and Release between me and Carriage Services, Inc., a Delaware corporation, on the 2nd day of August, 2006, and I knowingly and voluntarily elect not to revoke this Separation Agreement and Release.

EXECUTED this 10 day of August, 2006.

/s/ James J. Benard

JAMES J. BENARD

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July 27, 2006

Mr. James J. Benard  
11 Waters Lake Blvd.  
Missouri City, Texas 77459-6438

Re: Restricted Stock Agreement Under Carriage Services, Inc.  
1995 Stock Incentive Plan

Dear Mr. Benard:

Reference is made to the Restricted Stock Agreement dated on or about January 9, 2003 (the "2003 Agreement"), under which you were granted 20,000 shares ("Restricted Shares") of the Common Stock, \$.01 par value, of Carriage Services, Inc., a Delaware corporation (the "Company"), subject to the restrictions contained in the 2003 Agreement. Capitalized terms used but not defined herein shall have the meanings given such terms in the 2003 Agreement.

Of the Restricted Shares, 15,000 have vested and the remaining 5,000 (the "Unvested Shares") remain subject to forfeiture. In connection with your resignation of employment effective as of July 17, 2006 with the Company and its subsidiaries pursuant to the Separation Agreement and Release dated on or about the date hereof ("Separation Agreement"), this evidences the agreement between you and the Company that the Restrictions on all of the Unvested Shares shall lapse effective as of the date of your resignation. Consequently, the Restrictions described in Section 4 of the 2003 Agreement are hereby terminated, and the Unvested Shares shall not be subject to forfeiture as described in Section 5 of the 2003 Agreement.

The foregoing is subject in all respects to the effectiveness and validity of the Separation Agreement, and if for any reason the Separation Agreement is terminated, including without limitation your revocation thereof, then this letter agreement shall be null and void and the Restrictions, forfeiture conditions and other terms and provisions of the 2003 Agreement shall automatically be reinstated.

This letter agreement shall constitute an amendment to the 2003 Agreement. In accordance with Section 9 of the 2003 Agreement, the Company represents to you that the Compensation Committee of its Board of Directors has consented to this amendment.

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Mr. James J. Benard  
July 27, 2006  
Page 2

This letter has no effect on the Restricted Stock Agreement dated on or about February 3, 2005. Any shares not vested thereunder as of the effective date of termination of your employment shall be forfeited as provided in such Agreement.

This letter agreement shall be binding upon and inure to the benefit of the parties hereto and their respective heirs, successors and assigns.

If the foregoing accurately reflects the agreement between you and the Company with respect to the subject matter hereof, please evidence that agreement by signing in the space provided below.

Very truly yours,

CARRIAGE SERVICES, INC.

By /s/ Melvin C. Payne

MELVIN C. PAYNE, Chairman and  
Chief Executive Officer

AGREED TO AND ACCEPTED  
Effective this 27 day of July, 2006:

/s/ James J. Benard

JAMES J. BENARD

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July 17, 2006

The Board of Directors  
Carriage Services, Inc.

Gentlemen:

I hereby resign as Regional Managing Partner for Cemetery/Combination Operations and as any other officer of, and from any and all other positions I may hold with, the consolidated subsidiaries of Carriage Services, Inc., a Delaware corporation, including those reflected on Schedule I hereto.

Very truly yours,

/s/ James J. Benard

James J. Benard

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# SCHEDULE I

Name

Incorporation

Carriage Funeral Holdings, Inc.

Delaware

Carriage Holding Company, Inc.

Delaware

CFS Funeral Services, Inc.

Delaware

Carriage Cemetery Services, Inc.

Texas

Carriage Services of Oklahoma, L.L.C.

Oklahoma

Carriage Team Florida (Cemetery), LLC

Delaware

Carriage Team Florida (Funeral), LLC

Delaware

Carriage Municipal Cemetery Services of Nevada, Inc.

Nevada

Carriage Investments, Inc.

Delaware

EMPLOYMENT AGREEMENT

THIS AGREEMENT, dated September 11, 2006, is between **CARRIAGE SERVICES, INC.**, a Delaware corporation (the "Company"), and **J. BRADLEY GREEN**, a resident of Harris County, Texas (the "Employee").

1. Employment Term. The Company hereby employs the Employee for a term commencing effective as of October 9, 2006 and, subject to earlier termination as provided in Section 7 hereof, continuing until September 30, 2009 (such term being herein referred to as the "term of this Agreement"). The Employee agrees to accept such employment and to perform the services specified herein, all upon the terms and conditions hereinafter stated.

2. Duties. The Employee shall serve the Company and shall report to, and be subject to the general direction and control of the Chief Financial Officer of the Company. The Employee shall perform the professional, management and administrative duties of Vice President of Human Resources and General Counsel of the Company. The Employee shall also serve as Vice President and Assistant Secretary of any subsidiary of the Company as requested by the Company, and the Employee shall perform such other duties as are from time to time assigned to him by the Chief Financial Officer as are not inconsistent with the provisions hereof.

3. Extent of Service. The Employee shall devote his full business time and attention to the business of the Company, and, except as may be specifically permitted by the Company, shall not be engaged in any other business activity during the term of this Agreement. The foregoing shall not be construed as preventing the Employee from making passive investments in other businesses or enterprises, provided, however, that such investments will not require services on the part of the Employee which would in any way impair the performance of his duties under this Agreement.

4. Compensation. During the term of this Agreement, the Company shall pay the Employee a salary of \$15,000.00 per full calendar month of service completed, appropriately prorated for partial months at the commencement and end of the term of this Agreement. The Employee's salary and benefits will be reviewed annually, but any change therein shall remain in the sole discretion of the Company. The salary set forth herein shall be payable in bi-weekly installments in accordance with the payroll policies of the Company in effect from time to time during the term of this Agreement. The Company shall have the right to deduct from any payment of all compensation to the Employee hereunder (x) any federal, state or local taxes required by law to be withheld with respect to such payments, and (y) any other amounts specifically authorized to be withheld or deducted by the Employee.

5. Benefits. In addition to the base salary under Section 4, the Employee shall be entitled to participate in the following benefits during the term of this Agreement:

(i) Consideration for an annual performance-based bonus within the sole discretion of the Company, as may be recommended by the Chief Financial Officer and

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approved by the Company's Chief Executive Officer, with a maximum bonus target of 30% of base salary.

(ii) A one-time inducement bonus in the amount of \$20,000, payable in four installments of \$5,000 each (in each instance, less applicable withholdings), payable on the first regular payroll date after commencement of employment and continuing on each payroll date thereafter until paid in full.

(iii) An Award of 20,000 shares of the Company's Restricted Stock as of the first day of employment, within the meaning of and subject to the terms and conditions of the Company's 2006 Long Term Incentive Plan ("2006 Plan") and the related Award Agreement to entered into between the Company and the Employee evidencing such Award; provided that such Award shall vest at the rate of 5,000 shares on each of the first through fourth anniversaries of the date of Award.

(iv) Eligibility for consideration of future Awards of Restricted Stock or other incentive-based compensation under the terms of the 2006 Plan or one or more of the Company's other incentive plans, as the Chief Executive Officer in his sole discretion may determine and subject to approval of the Company's Compensation Committee.

(v) Three weeks of paid vacation in each calendar year, subject to the Company's personnel policies respecting such matters.

(vi) Participation in the Company's group health and hospitalization program, and inclusion in such other employee benefits, as are available generally to executive-level employees of the Company.

6. Certain Additional Matters. The Employee agrees that at all times during the term of this Agreement and for a period of two years following any cessation of employment with the Company:

(a) The Employee will not knowingly or intentionally do or say any act or thing which will or may impair, damage or destroy the goodwill and esteem for the Company of its suppliers, employees, patrons, customers and others who may at any time have or have had business relations with the Company.

(b) The Employee will not reveal to any third person any difference of opinion, if there be such at any time, between him and the management of the Company as to its personnel, policies or practices.

(c) The Employee will not knowingly or intentionally do any act or thing detrimental to the Company or its business.

## 7. Termination.

(a) Death. If the Employee dies during the term of this Agreement and while in the employ of the Company, this Agreement shall automatically terminate and the Company shall have no further obligation to the Employee or his estate except that the Company shall pay the Employee's estate that portion of the Employee's base salary under Section 4 accrued through the date on which the Employee's death occurred. Such payment of base salary to the Employee's estate shall be made in the same manner and at the same times as they would have been paid to the Employee had he not died.

(b) Disability. If during the term of this Agreement, the Employee shall be prevented from performing his duties hereunder by reason of disability, and such disability shall continue for a period of six months, then the Company may terminate this Agreement at any time after the expiration of such six-month period. For purposes of this Agreement, the Employee shall be deemed to have become disabled when the Company, upon the advice of a qualified physician, shall have determined that the Employee has become physically or mentally incapable (excluding infrequent and temporary absences due to ordinary illness) of performing his duties under this Agreement. In the event of a termination pursuant to this paragraph (b), the Company shall be relieved of all its obligations under this Agreement, except that the Company shall pay to the Employee (or his estate in the event of his subsequent death) the Employee's base salary under Section 4 through the date on which such termination shall have occurred, reduced during such period by the amount of any benefits received under any disability policy maintained by the Company. All such payments to the Employee or his estate shall be made in the same manner and at the same times as they would have been paid to the Employee had he not become disabled.

(c) Discharge for Cause. Prior to the end of the term of this Agreement, the Company may discharge the Employee for Cause and terminate this Agreement. In such case this Agreement shall automatically terminate and the Company shall have no further obligation to the Employee or his estate other than to pay to the Employee (or his estate in the event of his subsequent death) that portion of the Employee's salary accrued through the date of termination. For purposes of this Agreement, the Company shall have "Cause" to discharge the Employee or terminate the Employee's employment hereunder upon (i) the Employee's commission of any felony or any other crime involving moral turpitude, (ii) the Employee's failure or refusal to perform all of his duties, obligations and agreements herein contained or imposed by law, including his fiduciary duties, to the reasonable satisfaction of the Company, (iii) the Employee's commission of acts amounting to gross negligence or willful misconduct to the material detriment of the Company, or (iv) the Employee's breach of any provision of this Agreement or uniformly applied provisions of the Company's employee handbook or other personnel policies, including without limitation, its Code of Business Conduct and Ethics.

(d) Discharge Without Cause. Prior to the end of the term of this Agreement, the Company may discharge the Employee without Cause (as defined in paragraph (c) above) and terminate this Agreement. In such case this Agreement shall automatically terminate and

the Company shall have no further obligation to the Employee or his estate, except that the Company shall continue to pay to the Employee (or his estate in the event of his subsequent death) the Employee's base salary under Section 4 for a period of twelve months following the date of discharge. In addition, if following the date of such discharge, the Employee becomes eligible to elect continuation coverage under the Consolidated Omnibus Budget Reconciliation Act (COBRA) and properly elects such coverage, the Company shall reimburse the Employee or pay on his behalf the amount of the premiums under COBRA for the Company's group health and hospitalization insurance coverage which the Employee had in effect as of the date of discharge, for so long during such 12-month period as he remains eligible for COBRA coverage. All such payments and benefits to the Employee or his estate shall be made in the same manner and at the same times as they would have been paid to the Employee had he not been discharged.

8. Restrictive Covenants. The Employee acknowledges that in the course of his employment with the Company as a member of the Company's senior executive and management team, he will have access to confidential and proprietary business information of the Company and its affiliates, and will develop through such employment business systems, methods of doing business, and contacts within the death care industry, all of which will help to identify him with the business and goodwill of the Company. Consequently, it is important that the Company protect its interests in regard to such matters from unfair competition. The parties therefore agree that for so long as the Employee shall remain employed by the Company and, if the employment of the Employee ceases for any reason (including voluntary resignation), then for a period of two (2) years thereafter, the Employee shall not, directly or indirectly:

(i) alone or for his own account, or as a officer, director, shareholder, partner, member, trustee, employee, consultant, advisor, agent or any other capacity of any corporation, partnership, joint venture, trust, or other business organization or entity, encourage, support, finance, be engaged in, interested in, or concerned with (x) any of the companies and entities described on Schedule I hereto, except to the extent that any activities in connection therewith are confined exclusively outside the Continental United States, or (y) any other business within the death care industry having an office or being conducted within a radius of fifty (50) miles of any funeral home, cemetery or other death care business owned or operated by the Company or any of its subsidiaries at the time of such termination;

(ii) induce or assist anyone in inducing in any way any employee of the Company or any of its subsidiaries to resign or sever his or her employment or to breach an employment contract with the Company or any such subsidiary; or

(iii) own, manage, advise, encourage, support, finance, operate, join, control, or participate in the ownership, management, operation, or control of or be connected in any manner with any business which is or may be in the funeral, mortuary, crematory, cemetery or burial insurance business or in any business related thereto (x) as part of any of the companies or entities listed on Schedule I, or (y) otherwise within a radius of fifty (50) miles of any funeral home, cemetery or other death care business owned or operated by the Company or any of its subsidiaries at the time of such termination.

Notwithstanding the foregoing, the above covenants shall in no event prohibit the passive ownership of not more than one percent (1%) of the outstanding voting securities of any entity within the death care industry. In addition, the foregoing shall not be construed as restricting the right of the Employee to engage in the practice of law after termination of employment that would cause the Employee to violate Rule 5.06 of the Texas Disciplinary Rules of Professional Conduct, it being acknowledged, however, that as a result of the Employee's having access to confidential and privileged information of the Company and its subsidiaries during the course of employment, the Employee will be presumed to have a conflict of interest preventing him from providing legal services to any of the companies or entities listed on Schedule I for at least the duration of the covenants described in this Section 8.

The foregoing covenants shall not be held invalid or unenforceable because of the scope of the territory or actions subject hereto or restricted hereby, or the period of time within which such covenants respectively are operative, but the maximum territory, the action subject to such covenants and the period of time they are enforceable are subject to any determination by a final judgment of any court which has jurisdiction over the parties and subject matter.

9. Confidential Information; Copyrightable Material. The Employee acknowledges that in the course of his employment by the Company he will receive certain trade secrets, management methods, financial and accounting data (including but not limited to reports, studies, analyses, spreadsheets and other materials and information), operating techniques, prospective acquisitions, employee lists, training manuals and procedures, personnel evaluation procedures, and other confidential information and knowledge concerning the business of the Company and its affiliates (hereinafter collectively referred to as "Information") which the Company desires to protect. The Employee understands that the Information is confidential and he agrees not to reveal the Information to anyone outside the Company so long as the confidential or secret nature of the Information shall continue. The Employee further agrees that he will at no time use the Information in competing with the Company. Upon termination of this Agreement, the Employee shall surrender to the Company all papers, documents, writings and other property produced by his or coming into his possession by or through his employment or relating to the Information and the Employee agrees that all such materials will at all times remain the property of the Company. The Employee acknowledges that all materials and other copyrightable works and subject matter (regardless of whether or not constituting "Information") produced by the Employee within the scope of his employment (regardless of whether or not denoted as copyrighted material) shall be deemed "works made for hire" and shall be owned by and proprietary to the Company and may not be used or reproduced in whole or in part without the Company's prior written consent.

10. Remedies. The parties recognize that the services to be rendered under this Agreement by the Employee are special, unique, and of extraordinary character, and that in the event of the breach by the Employee of the covenants contained in Section 8 or Section 9 hereof, the Company may suffer irreparable harm as a result. The parties therefore agree that, in the event of any breach or threatened breach of any of such covenants, the Company shall be entitled to specific performance or injunctive relief, or both, and may, in addition to and not in lieu of any claim or proceeding for damages, institute and prosecute proceedings in any court of competent jurisdiction to



enforce through injunctive relief such covenants. In addition, the Company may, if it so elects, suspend (if applicable) any payments due under this Agreement pending any such breach and offset against any future payments the amount of the Company's damages arising from any such breach. The Employee agrees to waive and hereby waives any requirement for the Company to secure any bond in connection with the obtaining of such injunction or other equitable relief.

11. Notices. All notices, requests, consents and other communications under this Agreement shall be in writing and shall be deemed to have been delivered on the date personally delivered or three business days after the date mailed, postage prepaid, by certified mail, return receipt requested, or when sent by telex or telecopy and receipt is confirmed, if addressed to the respective parties as follows:

If to the Employee:	Mr. J. Bradley Green 3032 Del Monte Houston, TX 77019
If to the Company:	Carriage Services, Inc. 3040 Post Oak Blvd, Suite 300 Houston, Texas 77056 Attn: Chief Financial Officer

Either party hereto may designate a different address by providing written notice of such new address to the other party hereto.

12. Severability. Whenever possible, each provision of this Agreement shall be interpreted in such manner as to be effective and valid under applicable law but if any provision of this Agreement shall be prohibited by or invalid under applicable law, such provision shall be ineffective to the extent of such provision or invalidity, without invalidating the remainder of such provision or the remaining provisions of this Agreement.

13. Assignment. This Agreement may not be assigned by the Employee. Neither the Employee nor his estate shall have any right to commute, encumber or dispose of any right to receive payments hereunder, it being agreed that such payments and the right thereto are nonassignable and nontransferable.

14. Binding Effect. Subject to the provisions of Section 13 of this Agreement, this Agreement shall be binding upon and inure to the benefit of the parties hereto, the Employee's heirs and personal representatives, and the successors and assigns of the Company.

15. Captions. The section and paragraph headings in this Agreement are for reference purposes only and shall not affect in any way the meaning or interpretation of this Agreement.

16. Complete Agreement. This Agreement represents the entire agreement between the parties concerning the subject hereof and supersedes all prior agreements and arrangements between the parties concerning the subject thereof.

17. Governing Law; Venue. A substantial portion of the Employee's duties under this Agreement shall be performed at the Company's corporate headquarters in Houston, Texas, and this Agreement has been substantially negotiated and is being executed and delivered in the State of Texas. This Agreement shall be construed and enforced in accordance with and governed by the laws of the State of Texas. Any suit, claim or proceeding arising under or in connection with this Agreement or the employment relationship evidenced hereby must be brought, if at all, in a state district court in Harris County, Texas or federal district court in the Southern District of Texas, Houston Division. Each party submits to the jurisdiction of such courts and agrees not to raise any objection to such jurisdiction.

18. Counterparts. This Agreement may be executed in multiple original counterparts, each of which shall be deemed an original, but all of which together shall constitute one and the same instrument.

IN WITNESS WHEREOF, the parties hereto have executed this Agreement on the date and year first above written.

CARRIAGE SERVICES, INC.

By: /s/ Joseph Saporito  
JOSEPH SAPORITO, Executive Vice President  
and Chief Financial Officer

/s/ J. Bradley Green  
J. BRADLEY GREEN

SCHEDULE I  
TO  
EMPLOYMENT AGREEMENT  
(J. BRADLEY GREEN)

1. The following entities, together with all Affiliates thereof:

Service Corporation International  
Alderwoods Group, Inc.  
Stewart Enterprises, Inc.  
Keystone Group Holdings, Inc.  
Meridian Mortuary Group, Inc.  
StoneMor Partners LP  
Hamilton Group, Inc.  
Century Group  
Saber Group  
Thomas Pierce & Co.

For purposes of the foregoing, an “Affiliate” of an entity is a person that directly or indirectly controls, is under the control of or is under common control with such entity.

2. Any new entity which may hereafter be established which acquires any combination of ten or more funeral homes and/or cemeteries from any of the entities described in 1 above.
3. Any funeral home, cemetery or other death care enterprise which is managed by any entity described in 1 or 2 above.

**CONTINGENT ASSET SALE AGREEMENT**  
Conejo Mountain Funeral Home & Memorial Park  
Camarillo, California 93012

CONTINGENT ASSET SALE AGREEMENT (“Agreement”) dated this 22nd day of November, 2006, by and among **CARRIAGE CEMETERY SERVICES, INC.**, a Texas corporation (“Buyer”), and **SCI FUNERAL SERVICES, INC.**, an Iowa corporation (“SCI Funeral Services”);

**W I T N E S S E T H:**

WHEREAS, there is currently pending a transaction (the “Alderwoods Transaction”) described in and to be accomplished pursuant to an Agreement and Plan of Merger dated April 2, 2006 by and among Service Corporation International (“SCI Parent”), Coronado Acquisition Corporation and Alderwoods Group, Inc. (“Alderwoods Parent”);

WHEREAS, upon the closing of the Alderwoods Transaction (the “Alderwoods Merger Closing”), SCI Funeral Services will be an affiliate of Alderwoods Group (California), Inc., a California corporation (“Seller”);

WHEREAS, Buyer desires to purchase certain assets of the Seller;

WHEREAS, contingent upon the Alderwoods Merger Closing, SCI Funeral Services will cause the Seller to assume all obligations as the “Seller” under the terms of this Agreement and to be bound by the terms of this Agreement, and upon such assumption, SCI Funeral Services will be released of all liability arising under this Agreement, all as set forth below;

WHEREAS, Seller owns and operates a funeral business and cemetery business and conducts such business under the name Conejo Mountain Funeral Home & Memorial Park located at 2052 Howard Road, Camarillo, California 93012 (the “Business”);

WHEREAS, the names Conejo Mountain Funeral Home and Conejo Mountain Memorial Park (whether separately or in combination with each other) are hereinafter referred to as the “Trade Names”;

WHEREAS, SCI Funeral Services and Buyer desire to establish, contingent upon the Alderwoods Merger Closing, the terms for the sale and transfer from Seller to Buyer of the Assets (hereafter defined), in exchange for cash, upon the terms and subject to the conditions herein set forth; and

WHEREAS, this Agreement sets forth the terms and conditions to which the parties have agreed;

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NOW, THEREFORE, in consideration of the premises and the mutual covenants, agreements, representations and warranties herein contained, the parties, intending to be legally bound hereby, agree as follows:

**TERMS OF CONTINGENCY**

A. SCI Funeral Services shall promptly advise Buyer of the occurrence of the Alderwoods Merger Closing and agrees that, contingent upon the Alderwoods Merger Closing, within ten (10) days after the date of the Alderwoods Merger Closing (the "Alderwoods Merger Closing Date"), SCI will cause (x) the Seller (i) to execute the Joinder (the "Seller Joinder") following the signature page of this Agreement whereby the Seller will assume all obligations as a "Seller" under this Agreement, and (ii) to deliver the executed Seller Joinder to Buyer and (y) SCI California Funeral Services, Inc., a California corporation ("SCI California"), to execute and deliver to Buyer the guaranty of Seller's obligations under this Agreement (the "Guaranty") following the signature page of this Agreement. Buyer agrees that subject to and upon the occurrence of Alderwoods Merger Closing, Seller's execution of the Seller Joinder and SCI California's execution of the Guaranty, Buyer will thereupon become obligated to purchase the Assets (defined below) of Seller subject to the terms and conditions of this Agreement.

B. Buyer acknowledges that SCI Funeral Services does not and will not own the Assets and that the sole obligation of SCI Funeral Services under this Agreement is to cause the Seller to execute the Seller Joinder and SCI California to execute the Guaranty within ten (10) days after the Alderwoods Merger Closing Date, but only if and when the Alderwoods Merger Closing occurs. If the Alderwoods Merger Closing Date has not occurred on or before December 15, 2006, then either SCI Funeral Services or Buyer, at its option, may terminate this Agreement upon fifteen (15) days prior written notice to the other of its election to terminate this Agreement and, in such event, no party shall have any further liability or obligation under this Agreement, provided that no such termination will be effective if the Alderwoods Merger Closing Date occurs during such 15-day notice period; in which event SCI Funeral Services will immediately cause the Seller to assume the obligations as a "Seller" under this Agreement. None of Alderwoods Parent, SCI Parent, SCI Funeral Services, nor Buyer, nor any of its respective affiliates, shall have any liability to any other party if the Alderwoods Merger Closing is delayed or never occurs for any reason whatsoever. In no event shall the foregoing operate to extend the Closing past the Outside Closing Date specified in Section 2.1, and this Agreement shall automatically terminate if Buyer has not received the Seller Joinder and the Guaranty on or before the fifth business day preceding the Outside Closing Date.

C. SCI Funeral Services and Buyer expressly agree that even though the terms of this Agreement as set forth below in Articles I-X are written as being effective on the date hereof, such terms will only become effective on the date, if ever, that Seller executes the Seller Joinder and SCI California executes the Guaranty, and then such provisions will be effective only between Seller and Buyer (and, pursuant to the Guaranty, SCI California); provided however, that (i) SCI Funeral Services and Buyer agree that the provisions of Section 8.6 and Article X shall apply to and govern this Terms of Contingency Section, (ii) once Seller executes the Seller Joinder, the representations and warranties of Seller hereunder shall be effective as of and relate back to the effective date of this Agreement, and (iii) notwithstanding when the Alderwoods Merger Closing Date or Seller Joinder occurs, SCI Funeral Services shall permit Buyer beginning no later than the day after the date of this Agreement to have the access described in Section 5.2 and to enable the Survey described in Section 7.2 and inspections described in Section 7.3 to be conducted.

## ARTICLE I

### Purchase and Sale

Section 1.1. Transfer of Assets. Subject to the terms and conditions of this Agreement, Seller does hereby agree to sell, transfer, convey and deliver to Buyer, and Buyer does hereby agree to purchase and accept from Seller, all of the assets, property and rights located at, used in connection with or arising out of the Business, including without limitation those described below, excluding only the Excluded Assets described in Section 1.2:

- (a) Fee simple title to the real property described in Schedule 1 to Exhibit A to this Agreement (the “Real Property”);
- (b) All furniture, fixtures, equipment, and other tangible personal property owned by Seller located at the Real Property which is necessary to operate the Business including, without limitation, those items listed on Schedule 2 to Exhibit A to this Agreement;
- (c) All vehicles listed on Schedule 3 to Exhibit A to this Agreement;
- (d) All merchandise inventory located at the Business, including but not limited to that described in Schedule 4 to Exhibit A to this Agreement, plus or minus any changes in said inventories which result from the ordinary course of the operation of the Business subsequent to the date of such listing and until the Effective Time and all Services in Progress (as hereinafter defined);
- (e) All rights of the Business in all contracts, agreements and commitments listed on Schedule 5 to Exhibit A to this Agreement;

(f) All preneed funeral and/or cemetery merchandise and/or service agreements generated in the operation of the Business (the "Preneed Agreements"), including, without limitation, those described in Schedules 7 and/or 8 to Exhibit A to this Agreement, including contracts and accounts receivable associated therewith;

(g) All interest of Seller in all proceeds of insurance policies relating to or arising from the Preneed Agreements, including those described in Schedule 7 to Exhibit A to this Agreement;

(h) All interest of Seller in and to all bank, trust, investments or other funds or accounts relating to or arising from the Preneed Agreements, including those described in Schedule 8 to Exhibit A to this Agreement;

(i) All funeral at need accounts and notes receivable, and all cemetery preneed and at need accounts and notes receivable, in each case generated in the operation of the Business including, without limitation, those listed on Schedule 9 to Exhibit A to this Agreement, plus or minus any changes in said receivables which result from the ordinary course of the operation of the Business subsequent to the date(s) of such listing(s) and until the Effective Time (as hereafter defined), but not including any receivables due from insurance companies or trust funds as a result of the Preneed Agreements Serviced (as hereafter defined) by the Business prior to the Effective Time;

(j) All utility and other deposits previously paid to and/or now held by third parties in connection with the operation of the Business;

(k) The goodwill of Seller in the Business, together with all lists of present or former customers of the Business, all business books and records (whether in tangible or electronic format) that are beneficial and useful to Buyer in continuing the Business, the telephone and fax numbers and listings for the Business and all internet domain names (if any), all transferable government licenses and permits of the Business, and all of Seller's right, title and interest in and the right to use the Trade Names throughout the trade areas in which the Business is currently doing business, and any other names so similar as to require consent of Seller to their rightful use, and all goodwill associated therewith; and

(l) All other assets, rights and properties owned or held by Seller used in the operation of, or in connection with, the Business or located thereon, excluding those described in Section 1.2.

All property to be sold by Seller to Buyer described above shall be hereinafter collectively referred to as the "Assets." At the Closing referred to in Section 2.1, the Seller shall

convey to the Buyer the Assets free and clear of any and all liens, security interests, pledges, encumbrances, leases (including vehicle leases) or title restrictions of any kind (collectively, "Liens"), other than the Permitted Encumbrances against Real Property determined in accordance with Section 7.2.

Section 1.2. Excluded Assets. Seller shall not transfer, convey or assign to Buyer the following assets: (a) non-preneed related cash and cash equivalents, subject to Section 1.6(b) below, (b) accounts receivable related to funeral or cemetery Preneed Agreements that have matured and been Serviced (as defined below) prior to the Effective Time, (c) computer software and similar rights, (d) corporate records, minutes and records of shareholders' and directors' meetings, and (e) all other assets of the Seller which are not used exclusively or primarily in the ownership, operation or maintenance of the Business and which are not necessary or useful to the continued operation of the Business in a manner consistent with the Seller's past practices including training, promotional materials, procedure and policy manuals and other similar intellectual property rights (together the "Excluded Assets"). Except as specifically excepted above, it is intended that the assets, properties and rights of the Business to be sold to the Buyer shall include all of the assets, properties and rights reflected in the Schedules to Exhibit A to this Agreement, other than inventory and accounts receivable that are disposed of, and/or Preneed Agreements that are Serviced (as defined below) or transferred/refunded, in each case in the ordinary course of business prior to the Effective Time, but including all similar assets, properties and rights that may have been acquired in the ordinary course of business since the date of such listings and prior to the Effective Time.

Section 1.3. Consideration for Assets Payable at the Closing. On the terms and subject to the conditions of this Agreement, Buyer, in consideration for the transfer and delivery to it of the Assets as herein provided, will, in addition to the assumption of liabilities set forth in Section 1.4 below, pay to Seller at the Closing the sum of Eight Million and No/100 Dollars (\$8,000,000.00) (the "Purchase Price"), in cash, to be delivered by bank wire transfer to such account as Seller shall designate to Buyer at least one business day prior to the Closing Date.

Section 1.4. Assumption of Liabilities. From and after the Effective Time, Buyer agrees to assume and perform only the following liabilities and obligations (collectively, the "Assumed Liabilities"):

(a) The obligations of Seller under and pursuant to the terms and conditions of the Preneed Agreements, including any contracts associated therewith as well as all Services in Progress, as defined below, but excluding obligations under any Preneed Agreements not



disclosed in Schedules 7 and/or 8 to Exhibit A unless such undisclosed Preneed Agreements are properly funded (by trust funds, insurance or otherwise) to legally required levels which will become available to Buyer upon Servicing thereof ("Undisclosed Preneed Obligations"); and

(b) The obligations of the Business under and pursuant to the terms and conditions of those contracts included in Schedule 5 to Exhibit A to this Agreement.

The assumption by the Buyer of the Assumed Liabilities shall not enlarge any rights or remedies of any third parties under any contracts or arrangements with the Seller. Nothing herein shall prevent the Buyer from contesting in good faith any of the Assumed Liabilities, but such right to contest shall not affect Buyer's obligation to indemnify Seller from the Assumed Liabilities, as set forth herein.

Section 1.5. Limitations on Assumption. Notwithstanding Section 1.4 above, the Buyer will not assume and does not agree to pay or discharge any obligations or liabilities of the Seller not specifically included in the Assumed Liabilities and, in particular, Buyer shall not assume or agree to pay or discharge any of the following:

(a) any notes or accounts payable of any kind, regardless of whether entered into in the ordinary course of the Business;

(b) any federal, state or local tax of any type, whether arising by reason of the sale of the Assets (except as otherwise set forth herein) or by operation of the Business prior to the Effective Time;

(c) any losses, costs, damages or expense based upon or arising from any claims, litigation, legal proceedings or other actions against the Seller or the Business, whether asserted or unasserted, known or unknown, based upon any set of facts occurring prior to the Effective Time, including but not limited to litigation (if any) disclosed on Exhibit A hereto;

(d) the liabilities and obligations under any warranties to customers with respect to goods or products sold or services provided by the Seller or the Business prior to Effective Time;

(e) all personal injury, product liability claims, claims of environmental damage, claims of hazards to health, strict liability, toxic torts, enforcement proceedings, cleanup orders and other similar actions or claims instituted by private parties or governmental agencies, with respect to the conduct of the Business by and operations of the Seller prior to the Effective Time;

(f) all wages, salaries, compensation, employment taxes and employee benefit costs arising and accrued prior to the Effective Time;

(g) Undisclosed Preneed Obligations; and

(h) any other liability or obligation not specifically included within the Assumed Liabilities.

Section 1.6. Prorations; Services in Progress; Transaction Taxes.

(a) At Closing, real and personal property taxes, as well as rents under leases and utility bills, and payments under the contracts included in Assumed Liabilities, shall be prorated as of the Effective Time, the Seller being charged and credited for all of same up to such date and Buyer being charged and credited for all of same on and after such time.

(b) All revenues from and direct costs for merchandise paid to third parties associated with Services in Progress will be allocated to the Buyer. For purposes of this Agreement, "Services in Progress" means any "at need" funeral or cemetery related services (including preneed maturities) for which a contract has been entered into, but which has not been Serviced, as of the Effective Time. For purposes of this Agreement, a funeral or cemetery related service is deemed "Serviced" when the body or remains have been cremated or interred. Seller shall account to Buyer for the amount of any cash or other payments received by it for Services in Progress. Buyer shall be responsible for the delivery of any merchandise remaining after Closing to be delivered under Serviced contracts, whether preneed or at-need, but shall be entitled to all trust withdrawals associated with that merchandise.

(c) Seller shall pay all transfer taxes, and Buyer shall pay all sales taxes, deed stamps and the like, in each case that arise directly as a result of the transactions provided for in this Agreement.

Section 1.7. Allocation of Purchase Price. The parties agree that the Purchase Price shall be allocated among the categories of Assets as set out in Exhibit B to this Agreement, for all accounting and tax purposes, and that they shall not take any position inconsistent therewith without the other party's prior consent.

Section 1.8. Effective Time. The "Effective Time" of the transfer of the Assets shall be 12:01 a.m. on the Closing Date.

## ARTICLE II

### Closing

Section 2.1. Closing. The closing of the transaction provided for in this Agreement (the "Closing") shall take place at the offices of Seller, 1929 Allen Parkway, Houston, Texas 77019, at 11:00 o'clock a.m. on the later to occur of (i) February 7, 2007, or (ii) the fifth business day following the later to occur of (x) the date that all Regulatory Approvals are obtained for Buyer's acquisition of the Business, as described in Section 6.5, or (y) the date on which Buyer

receives from Seller its Seller Joinder and from SCI California the Guaranty, under “Terms of Contingency” above (the “Closing Date”), or at such other location, time and date as the parties shall mutually agree, but in no event later than March 15, 2007 (“Outside Closing Date”). In the event of any postponement thereof, all references in this Agreement to the Closing Date shall be deemed to refer to the time and to the date to which the Closing Date shall have been so postponed as herein provided.

Section 2.2. Instruments of Conveyance and Transfer. At the Closing, Seller shall deliver to Buyer such warranty deeds, bills of sale, endorsements, lease and other assignments, motor vehicle registrations, internet domain name transfers, and other good and sufficient instruments of transfer, conveyance and assignment, in form reasonably satisfactory to Buyer, as shall be effective to vest in Buyer good and marketable title to the Assets. Seller’s warranty of title under such deeds shall extend back to the date of acquisition of the Real Property by Seller and any predecessor-in-interest that is or was affiliated with SCI Parent, Alderwoods Parent or The Loewen Group, Inc., but not before. Both Seller and Buyer shall execute and deliver such other documents and pay such expenses as called for by this Agreement or which are usual and customary and which are necessary to close the transaction provided for herein. Seller shall take all such steps as may be reasonably required to put Buyer in actual possession and control of the Assets and the Business as of the Closing.

### ARTICLE III

#### Representations and Warranties by Seller

Seller hereby represents and warrants to Buyer as follows:

##### Section 3.1. Organization; Standing; Authorization; Capacity.

(a) Seller is a corporation duly organized, validly existing and in good standing under the laws of the State of California, with all requisite corporate power and authority to own and to conduct the Business as it is now being conducted. By the 15<sup>th</sup> day after the later of (i) the date of this Agreement or (ii) the Alderwoods Merger Closing Date (the “Approval Date”), the execution, delivery and performance of this Agreement by Seller shall have been duly and effectively authorized by the board of directors of Seller, and no further action or other authorization or consent is required. Seller shall take all commercially reasonable actions necessary to obtain such board authorization by the Approval Date, and shall provide written evidence thereof to Buyer by the Approval Date. This Agreement has been duly executed and delivered by Seller, and subject to the contemplated board authorization referenced above,

constitutes the valid and binding obligation of Seller, enforceable against Seller in accordance with its terms.

(b) Neither the execution or delivery of this Agreement by Seller nor consummation of the transactions contemplated hereby will result in a breach, violation or default by Seller of or under any judgment, decree, mortgage, agreement, indenture or other instrument or agreement, rule, regulation or statute applicable to Seller or to which Seller is a party or by which Seller, the Business or any of the Assets are bound.

Section 3.2. Financial Information. The income and expense statements for each business location comprising the Business for the twelve months ended December 31, 2003, 2004 and 2005, and for the six months ended June 30, 2006, as well as the reports of cemetery acreage, space sales (units) and property inventory at the Business, copies of all of which are provided hereto as a part of Exhibit C, fairly present and accurately reflect in all material respects the results of operations of each such location for the periods then ended and the acreage, units and inventory of the Business as of the dates shown on such reports. However, such income and expense statements historically have been prepared for in house use only, and not for publication, and do not include inter-company items, adjustments and other items required in statements prepared in accordance with generally accepted accounting principles. Expenses for merchandise and other items reflected in the income and expense statements may be less than those available to Buyer for the same items. Except to the extent disclosed in this Agreement and such financial statements, there is no liability or obligation (whether accrued, absolute, contingent or otherwise) which is or might become an obligation of or Lien against any Business or any of the Assets.

Section 3.3. Tax Matters.

(a) Seller has (separately, or as a part of a consolidated group) filed all federal, state and local income, sales, ad valorem, intangible, franchise tax and employee benefit plan returns/reports which are required to be filed by it with respect to the Business as of the Effective Time, and has reported all taxable income and loss, and paid all taxes required to be paid or taxes due pursuant to any assessment received by Seller, including both penalties and interest.

(b) Seller has properly withheld from employees' compensation all taxes required to be withheld by it and has timely remitted all such withholdings to the proper taxing authorities.

(c) All amounts received by Seller on sales by the Business which are required under applicable state law to be trusted have been deposited in trust, and all federal, state and local

income tax returns and information returns required to be filed concerning such trusts and the income from such trusts have been filed.

Section 3.4. Rights of Third Parties. Other than as disclosed in Schedule 5 to Exhibit A to this Agreement or included within the Permitted Encumbrances (as provided for in Section 7.2 of this Agreement), no third party has any lease, license, easement, or agreement or other right, recorded or unrecorded, arising by law or otherwise, giving such third party any right or interest to use, occupy or possess any real or personal property of Seller included in the Assets.

Section 3.5. Title to Assets. Seller has good and marketable title to all of the Assets, subject to no Lien, except for Permitted Encumbrances. All assets, rights and properties presently used in the conduct of the Business are owned or validly leased by Seller and are included within the Assets (except for the Excluded Assets described in Section 1.2). The Seller is in actual possession and control of all properties owned or leased by it which are presently used in the conduct of the Business.

Section 3.6. Description of Properties, Contracts and Personnel Data. On or before the third business day preceding the Closing Date, the following Schedules to Exhibit A to this Agreement shall be delivered by Seller to Buyer on a compact disk, which delivery shall constitute Seller's certification that such Schedules, which shall thereupon be incorporated herein by reference, conform to the requirements of this Agreement. Each such Schedule shall set forth true and complete information as to the matters described below, all as of the date of such delivery, unless otherwise indicated thereon (but in no event shall any information be as of a date more than sixty (60) days prior to the Closing Date). Items appropriately disclosed on one Schedule (or Exhibit) need not also be disclosed on any other Schedule (or Exhibit), provided, however, that the relevance or applicability of disclosure as to each other Schedule is reasonably apparent; and by way of example, any reference to "lease" in regard to vehicles on Schedule 3 to Exhibit A shall not mean that Buyer is thereby assuming or taking subject to any such lease obligations.

(a) Real Property – Schedule 1 to Exhibit A. A legal description of all real property included in the Assets and a copy of each real property lease included in the Assets.

(b) Equipment, Machinery, Furniture, Etc. – Schedule 2 to Exhibit A. A list of all major items of equipment, machinery, furniture and fixtures, whether owned or leased, included in the Assets.

(c) Automobile Equipment – Schedule 3 to Exhibit A. A list of all automobiles, trucks, and other vehicles included in the Assets.

(d) Merchandise Inventory – Schedule 4 to Exhibit A. A description of the merchandise inventory included in the Assets.

(e) Contracts – Schedule 5 to Exhibit A. A list of all contracts, agreements and commitments of Seller or the Business included in the Assets, including without limitation lease agreements covering items described in these Schedules and all outstanding no-compete, employment, consulting, confidentiality and other similar agreements with current and former employees, consultants and owners, as well as the Business's cemetery rules and regulations (if not otherwise obtained by [as confirmed by Buyer in writing] or delivered by Seller to Buyer prior to Closing), all as amended and then in effect, which list includes copies of all such documents. Contracts for interment rights and funeral and/or cemetery merchandise or services will not be included in this Schedule.

(f) Personnel – Schedule 6 to Exhibit A. A list of the names, position, date of hire and current annual salary or hourly salary rate for each employee of the Business.

(g) Preneed Insurance Policies – Schedule 7 to Exhibit A. A list of all insurance policies used to fund Preneed Agreements, including (where available) policy number, insured and owner names, issue date, face amount of insurance, and other data normally included in Seller's internal records in a compilation of insurance policies.

(h) Preneed Trust Funds – Schedule 8 to Exhibit A. A list of all uninsured Preneed Agreements included in the Assets, including contract number and/or customer name, sale date, contract price and other data normally included in Seller's internal records in a compilation of Preneed Agreements. Also, the trust liability (or similar) report for each trust account relating to the Business, indicating the location of each and the amount held in trust, with detail (where available) of principal, income or earnings, withdrawals and outstanding balance, and whether or not included in a commingled trust; copies of the trust agreements, as amended and currently in effect (for only those trusts which will be continued, and not replaced or substituted for, by Buyer); and copies of the most recent date available bank statements or other periodic report of the Trustee for each trust, and the audit or other reports furnished to or prepared by the state regulatory agency which oversees such trusts.

(i) Accounts Receivable – Schedule 9 to Exhibit A. A list of all accounts and notes receivable included in the Assets.

Section 3.7, Litigation. Except as disclosed to the Buyer in Schedule 10 to Exhibit A (if any exists) and except for any Decision and Order issued by the Federal Trade Commission ("FTC") in connection with the Alderwoods Transaction ("Decision and Order"), there are no

claims, actions, suits, proceedings or investigations pending or, to the knowledge of the Seller, threatened against or affecting the Seller (with respect to the operation of the Business) or any of the Assets, at law or in equity or before or by any court, governmental body or arbitration panel, except for any such claim, action, suit, proceeding or investigation which would not, individually or in the aggregate, have an adverse effect on the business, operations or (in Seller's reasonable judgment) prospects of the Business (taken as a whole) or any substantial portion of the Assets, or which would prevent the carrying out of this Agreement, declare unlawful the transactions contemplated by this Agreement, cause such transactions to be rescinded, or require Buyer to divest itself of the Assets or the Business.

Section 3.8. Court Orders and Decrees. Except as disclosed to the Buyer in Schedule 10 to Exhibit A and except for any Decision and Order, there is not outstanding or, to the knowledge of Seller, threatened any order, writ, injunction or decree of any court, governmental agency or arbitration tribunal against or affecting Seller, relating to the Assets or the Business.

Section 3.9. Trade Names. Seller has the legal right and title to use the Trade Names in all trade areas in which the Business conducts business. To Seller's knowledge, neither the Trade Names (as they are used in the trade areas in which the Business conducts business) nor any other intellectual property included in the Assets infringes upon the intellectual property rights of any other person, and no other person is infringing upon the Trade Names (as they are used in the trade areas in which the Business conducts business) or other intellectual property rights included in the Assets.

Section 3.10. Contracts and Leases. All contracts, agreements, leases and commitments included in the Assets are in good standing and in full force and effect, valid and enforceable in accordance with their respective terms, and neither the Seller, nor, to the knowledge of the Seller, any of the other parties thereto (but specifically excluding customer/purchaser obligations under Preneed Agreements), are in default thereunder or breach thereof.

Section 3.11. Preneed and Trust Accounts. All funds received by the Business under or in connection with Preneed Agreements, as well as all funds designated for endowment or perpetual care, have been deposited on a timely basis in appropriate accounts and/or insurance contracts to the extent required by applicable laws and regulations and have been administered and reported in accordance with the terms of agreements with the purchasers, under applicable trust agreements, and as required by applicable laws and regulations. All Preneed Agreements and endowment or perpetual care obligations are funded by trust or insurance products; no preneed liability is covered by bond, letter of credit or other similar credit support.

Section 3.12. Licenses and Continuation of the Business. Seller and all personnel at the Business who are engaged in licensed activity are in possession of all licenses, permits, certificates of occupancy and authorizations which under all applicable laws, regulations, rules and ordinances are necessary to enable Seller to own and operate the Business as the same is now being conducted, and all of the same are in full force and effect.

Section 3.13. Compliance with Laws. The Business is currently being (and until the Closing will be) operated in compliance with all federal, state, municipal and other statutes, rules, ordinances and regulations applicable to the Business and the Assets, except for any such noncompliance which would not, individually or in the aggregate, have a material adverse effect on the condition, business, operations or (in Seller's reasonable judgment) prospects of the Business or any substantial portion of the Assets.

Section 3.14. Environmental Matters. The Business is presently being operated in compliance in all material respects with all applicable federal, state, and local environmental statutes and regulations, and to Seller's knowledge, there is no existing regulatory requirement with a future compliance date that will require material operational changes or material capital expenditures at the facilities of the Business. Since the date that the Business was acquired by Seller or its predecessor affiliated with SCI Parent or Alderwoods Parent (the "Acquisition Date"), no "hazardous substance," as that term is defined in the federal Comprehensive Environmental Response, Compensation and Liability Act, no petroleum or petroleum products and no "solid waste," as that term is defined in the Federal Resource Conservation and Recovery Act, has been leaked, spilled, deposited or otherwise released, on the Real Property. Any such substances that have been generated or used on or about the Real Property since the Acquisition Date have been used, managed and disposed of in accordance with all environmental laws.

Section 3.15. Accounts Receivable. At Closing the accounts receivable to be included within the Assets will be valid and legally enforceable obligations of the account parties whose names are listed in the books and records of the Business, legally (but not necessarily financially) collectible in accordance with their terms, subject to bankruptcy, insolvency, moratorium, or other similar laws affecting creditors' rights generally.

Section 3.16. Absence of Changes or Events. Since June 30, 2006, the Business has been operated in the ordinary course and, without limiting the generality of the foregoing, there has not been:

- (a) any material adverse change in the condition, operations, properties or (in Seller's reasonable judgment) prospects of the Business, taken as a whole;



(b) any material damage, destruction or losses against the Business or any waiver of any rights of material value to the Business, taken as a whole;

(c) any claim or liability for any material damages for any actual or alleged negligence or other tort or breach of contract against or affecting the Business;  
or

(d) any transaction or event entered into or affecting the Business other than in the ordinary course of the business.

Section 3.17. Full Disclosure. The representations and warranties made by the Seller hereunder or in any Schedules or certificates furnished to the Buyer pursuant hereto, do not and will not contain any untrue statement of a material fact.

Section 3.18. Transfer of Assets. On the Closing Date, Seller will convey to Buyer all of the assets that Seller is required to transfer to Buyer pursuant to any Decision and Order, and Seller shall have obtained all approvals and consents necessary to make such transfer.

Section 3.19. No Other Representations or Warranties. Except as expressly stated in this Agreement, Seller makes no other representation or warranty of any kind whatsoever.

#### ARTICLE IV

##### Representations and Warranties of Buyer

Buyer hereby represents and warrants to Seller as follows:

##### Section 4.1. Authority.

(a) Buyer is a corporation duly organized, validly existing and in good standing under the laws of the State of Texas, duly qualified to transact business as a foreign corporation within the State of California, and with all requisite corporate power and authority to own and conduct the Business as it is now being conducted. By the Approval Date, the execution, delivery and performance of this Agreement by Buyer shall have been duly authorized and consented to by the board of directors of Buyer and no other or additional consent or authorization is required by law. Buyer shall take all commercially reasonable actions necessary to obtain such board authorization by the Approval Date, and shall provide written evidence thereof to Seller by the Approval Date. The Closing of the transaction contemplated by this Agreement will not result in a breach, violation or default by Buyer of or under any judgment, decree, mortgage, agreement, indenture or other instrument applicable to Buyer.

(b) This Agreement has been duly executed and delivered by Buyer, and subject to the contemplated board authorization referenced above, constitutes the valid and binding obligation of Buyer, enforceable against Buyer in accordance with its terms.

Section 4.2. Adequacy. Buyer acknowledges that the Assets and the intellectual property to be transferred pursuant to this Agreement will enable Buyer to operate the Business and that no other assets are needed from Seller to do so.

Section 4.3. No Other Representations or Warranties. Except as expressly stated in this Agreement, Buyer makes no other representation or warranty of any kind whatsoever.

## ARTICLE V

### Covenants

Section 5.1. Buyer's Access to Website. Prior to the Closing, Seller shall electronically post online all, or nearly all, of the contents of Exhibit A and Exhibit C to this Agreement at <https://dre103606.bmcgroup.com/Login.aspx?ReturnUrl=%2fDefault.aspx> (the "Website") in order to permit Buyer to timely conduct its due diligence of the Business. Seller will periodically update such Exhibits and Schedules to this Agreement as updated information is available and will post all of such Exhibits and Schedules and updates thereto on the Website. The final versions of such Exhibits and Schedules, as they exist on the Closing Date, will be delivered by Seller to Buyer at least three business days prior to Closing as contemplated in Section 3.6 above, and the same shall supersede any disclosures made on the Website.

Section 5.2. Access to Business. From and after the date of this Agreement, Seller will give Buyer and its representatives full and free access to all on-site properties, books and records of the Business and to its personnel, so that Buyer may have full opportunity to make such investigation as it shall desire to make of the affairs of the Business and the Assets, provided that such investigation shall not unreasonably interfere with the operations of the Business. Such access shall include the opportunity to interview employees of the Business and to inspect the personnel files and other documentation relating to any such employee, to the extent permissible under applicable laws.

Section 5.3. Conduct of Business Pending Closing. From and after the date of this Agreement and pending the Closing and except as otherwise permitted by this Agreement or as consented to by Buyer in writing, Seller covenants that:

(a) Seller will conduct the Business only in the ordinary course which, without limitation, shall include compliance in all material respects with all applicable laws and regulations, and the maintenance in force of all insurance policies;

(b) Seller shall preserve its business organization intact and use commercially reasonable efforts to maintain for the Business the goodwill of suppliers, customers and others having business relations with the Business; and

(c) Seller shall not (i) commit any act or permit the occurrence of any event or the existence of any condition of the type described in Section 3.16; (ii) alter, amend, cancel or modify in any respect any of the contracts, leases and commitments included in the Assets, or the standard form of, and terms and conditions applicable to, Preneed Agreements; (iii) sell or otherwise dispose of any of the assets required to be described on Schedule 2 or 3 of Exhibit A; (iv) hire, fire, reassign or make any other change in key personnel of the Business; or (v) take any other action which would cause any of the representations and warranties by the Seller in this Agreement not to be true and correct in all material respects on and as of the Closing Date with the same force and effect as if such representations and warranties had been made on the Closing Date.

Section 5.4. Reasonable Efforts. Subject to the terms and conditions of this Agreement, each of the parties hereto agrees to use reasonable efforts, to take, or cause to be taken, all reasonable actions, and to do, or cause to be done, all things necessary and appropriate to satisfy all conditions of and to consummate the transaction contemplated by this Agreement, including cooperating with the other parties to this Agreement and obtaining any necessary third party and governmental consents and approvals.

Section 5.5. Further Assurances. From time to time after the Closing, at the request of Buyer, and without further consideration, but at no out-of-pocket cost to Seller, Seller will execute and deliver such additional instruments and will take such other actions as Buyer reasonably may require to convey, assign, transfer and deliver the Assets and the Business and otherwise carry out the terms of this Agreement.

Section 5.6. Buyer's Trustee and Preneed Trust Funds. Prior to Closing, Buyer shall secure all licenses, permits and other governmental authorizations and approvals required by the State of California as a prerequisite to Buyer selling Preneed Agreements or accepting funds paid by customers toward Preneed Agreements with the Business. Buyer shall, prior to Closing, select and designate a trustee or trustees ("Buyer's Trustee") that is qualified under state law to receive all bank, trust or other funds or accounts, excluding insurance premium payments, containing amounts that have been received by the Seller pursuant to preneed agreements for funeral or cemetery merchandise and/or services ("Preneed Trust Funds") or which are being held as endowment care trust funds ("Endowment Care Funds"). As soon as practicable after the Closing, all Preneed Trust Funds and Endowment Care Funds shall be transferred for safekeeping to Buyer's Trustee, and Buyer agrees that it shall be Buyer's responsibility to ensure that all such funds will be held, administered and withdrawn only in accordance with state and

federal law. All Preneed Trust Funds and Endowment Care Funds shall be transferred to Buyer's Trustee in cash, and to the extent that the same are currently held or invested other than in cash, it shall be Seller's responsibility to issue such instructions and take such other action so that the same is reduced to cash by the time required for transfer as provided above. The parties further agree that after the Closing and prior to the transfer to Buyer's Trustee of the Preneed Trust Funds and the Endowment Care Funds, Seller and Seller's trustee shall have the right to continue to administer all such Funds including making deposits and withdrawals and to receive all reports and communications from Seller's trustee all as if the sale provided for in this Agreement had not closed. Should Buyer fail to designate a qualified Trustee or to otherwise accept the transfer of the Preneed Trust Funds within the later of six (6) months from and after the Closing Date or thirty (30) days after Seller has provided Buyer notice that Seller is prepared to transfer the Preneed Trust Funds ("Notice Period"), Seller may continue to administer the Preneed Trust Funds and Buyer shall pay to Seller \$150.00 as an administration fee for each day that Seller continues to administer the Preneed Trust Funds after the Notice Period. Should Buyer designate a qualified Trustee which is prepared to accept such transfer within six (6) months following Closing, and if Seller has not caused the Preneed Trust Funds or Endowment Care Funds to be transferred prior to expiration of such six (6) month period, Seller shall pay to Buyer a fee of \$150.00 for each day after expiration of such six (6) month period until transfer has occurred.

Section 5.7. Post Closing Trust Fund Distributions. The parties agree that if as of the Closing Date, Seller has earned or is entitled to receive funds from either the Preneed Trust Funds or the Endowment Care Funds being transferred to Buyer's Trustee pursuant to Section 5.6 above which have not been paid to Seller as of the Closing Date, the parties will work together to obtain for Seller all such funds, allowing Seller reasonable access to the books and records of the Business and the preparation and execution by Buyer of any forms, reports or similar documentation necessary or appropriate for such purpose. Likewise, if as of the Closing Date, the Preneed Trust Funds or Endowment Care Funds are not funded as required by law or additional amounts are legally required to be funded in connection with the liquidation of non-cash holdings as described in Section 5.6, it shall be Seller's responsibility to fund such additional amounts.

Section 5.8. Transfer of Data and Systems; Post Closing Access. Upon or within 90 days following Closing, Seller shall be entitled to obtain and/or retain any financial or other non-customer information pertaining to the Business as Seller shall desire, provided that Seller shall not disclose any such information or use it in competition against the Business. At the Closing,

the parties shall arrange for and coordinate the transfer of all customer data and information related to the Business from Seller's systems (whether located at the Business, at Seller's corporate office, or elsewhere) to Buyer's systems, in a form of electronic media, either on HMIS or converted into such other format as shall be reasonably acceptable to the Buyer, but without cost to the Seller. In addition, for such 90 day period, Buyer shall provide and allow Seller reasonable access to the facilities in which the Business is conducted and the Real Property as reasonably necessary to collect and remove any other Excluded Assets. Any such access shall be conducted under the supervision of a Buyer representative.

Section 5.9. Post Closing Transfers. Immediately after the Closing, Buyer shall cause financial responsibility for all utilities, internet services, facsimile numbers, cellular telephone numbers, standard telephone numbers and listings, and any other third party services ("Third Party Services") used in the Business to be transferred to the Buyer. Should financial responsibility for Third Party Services fail to be transferred within thirty (30) days after the Closing Date, Seller may terminate those Third Party Services without liability of any kind to Buyer.

Section 5.10. Accounts Receivable. The parties anticipate that subsequent to the Closing, Buyer may receive payments of accounts and notes receivable that are not included in the Assets pursuant to Section 1.2(b). Buyer shall notify Seller upon receipt of any such payments, and Seller shall notify Buyer in case Seller receives any payments on notes or accounts receivable that are included in the Assets or other payments that are for Buyer's account, and the parties shall establish a procedure for the delivery of all such payments to proper party. Each party will account to the other party as to any such collections received by it.

Section 5.11. Customer Records; Trade Names. Seller represents that as of Closing it has not provided to any other person any customer information included in the books and records sold to Buyer hereunder, and it shall not use any information used or obtained by it prior to Closing for the purpose of soliciting any customers of the Business. Following the Closing, for so long as Buyer and its successors and assigns is using the Trade Names in whole or in part in the Business, Seller shall not cause or permit it or its affiliates to use or advertise any Trade Name (or any other names or logos deceptively similar thereto) in any trade areas in which the Business is currently doing business.

Section 5.12. Employment Matters. On the Closing Date, the Buyer may (but shall not be required to) offer employment to each employee of the Business. The employees so offered employment who accept shall, as of the Effective Time, cease to be employees of the Seller and

thereupon become employees of the Buyer. Seller shall be responsible for satisfying all claims, if any, of such employees as to accrued vacation, health benefits, workers compensation claims, termination and severance benefits, withdrawal liability and vested rights under any pension, profit sharing or other employee benefit plans of Seller or its affiliate, all arising and accrued prior to and through the day immediately preceding the Effective Time, and in no event shall the Buyer have any liability or responsibility in respect thereof.

Section 5.13. Certain Transitional Matters. Following the Closing, Seller shall make available the reasonable use of its staff and employees who are familiar with the Business to answer questions and provide information to enable Buyer to integrate the operations, facilities and personnel included with the Business with the other funeral and cemetery operations of Buyer and its affiliates. In addition, Buyer may have, for a period of up to 45 days following the Closing, the use of the Seller's standard preneed contract forms currently in effect and being used in the Business ("Preneed Contract Forms"), until such time (within such 45-day period) as Buyer obtains applicable regulatory approval for the use of Buyer's own preneed contract forms, as well as the use of the Seller's sales presentation materials currently in effect and being used in the Business ("Sales Presentation Materials"), until such time (within such 45-day period) as Buyer trains the sales counselors at the Business in the use of Buyer's own sales presentation materials. The consent to the limited-term use of the Preneed Contract Forms and Sales Presentation Materials (collectively, "Seller Materials") constitutes a non-transferable license only and does not constitute any conveyance of any proprietary interest therein to Buyer. Any proprietary rights in the Seller Materials do not constitute a portion of the "Assets" within the meaning hereof. Buyer will continue to have the right to retain copies of all preneed contracts entered into before the Closing and during the 45-day period referred to above. The Seller Materials may be used only for the limited purposes described herein and only at the Business. Buyer shall clearly delete all references to Seller in connection with their usage of the Seller Materials, including (without limitation) its corporate or other proprietary names and logos. Seller makes no representation or warranty regarding the sufficiency or legality of or otherwise regarding Buyer's use of the Seller Materials. The foregoing reservation does not, however, affect the representations of Seller contained herein with respect to any Seller Materials used prior to the Closing.

Section 5.14. Due Diligence Review. The parties acknowledge that Buyer shall not have had the full opportunity to complete its due diligence review of the Business and the Assets by the time this Agreement has been executed and delivered. Buyer's determination of the

Purchase Price hereunder is based upon the accuracy of the representations and warranties contained herein as well as the absence of any fact, event or change in the Assets, operations, financial condition or prospects of the Business which, in the course of Buyer's due diligence review, could have a material adverse effect on the value thereof to the Buyer. Buyer's due diligence review specifically includes, but is not limited to, the state of the relationship between the Business and its employees, client families and former owners and the extent to which Buyer is able to obtain at or prior to Closing satisfactory arrangements with key employees and former owners regarding the continuation of their relationships (if any) with the Business. If, prior to Closing, Buyer determines from its due diligence review that any such fact, event or change has come to its attention, it will bring the same to Seller's attention. In such event, or if Seller updates the Schedules pursuant to Section 3.6, then the parties will negotiate in good faith concerning any proposed adjustment to the Purchase Price or the other terms and conditions set forth herein. If the parties have not reached agreement as to the foregoing within ten business days thereafter (but in no event past the Outside Closing Date), then Buyer may terminate this Agreement upon written notice to Seller, but unless Buyer otherwise has a right to terminate under Section 9.1(c)(ii) through (vii) below, it shall nevertheless be required to thereupon pay the Break-Up Fee contemplated in Section 9.1(d) below. Buyer shall be deemed to have waived this Section 5.14 if it elects to close the transactions hereunder without Seller's agreement to any such adjustment.

**Section 5.15. No Shop.** For so long as this Agreement remains in effect, Seller shall not enter into any agreements or commitments, or further initiate, solicit or encourage any offers, proposals or expressions of interest, or otherwise hold any discussions with any potential buyers, investment bankers or finders, with respect to the possible sale or other disposition of all or any substantial portion of the assets and business of the Business, other than with the Buyer.

**Section 5.16. No Solicitation.**

(a) For a period of two (2) years after the Closing Date, neither the Seller nor any of its affiliates shall solicit to employ any individual who is, as of the date of this Agreement, an employee of the Business, unless such employee is not hired by Buyer upon Closing or such employee's employment is terminated by Buyer after the Closing; provided, however, that nothing in this Section 5.16(a) shall prohibit the Seller or its affiliates from (i) publishing a general solicitation of employment in any newspaper, magazine, trade publication or other media not targeted specifically at employees of the Business, or (ii) hiring an employee of the Business

who applies for employment with Seller, so long as such employee was not solicited by Seller, or its affiliates, in violation of this Section.

(b) For a period of one year after the Closing Date, neither the Buyer nor any of its affiliates shall solicit to employ any individual who is, as of the date of this Agreement, an employee of the Seller or any of its affiliates at any location(s) within a fifty (50) mile radius of the location of the Business, other than employees whose work primarily relates to the Business, unless such employee's employment is terminated by the Seller; provided, however, that nothing in this Section 5.16(b) shall prohibit the Buyer or its affiliates from (i) publishing a general solicitation of employment in any newspaper, magazine, trade publication or other media not targeted specifically at Seller's employees, or (ii) hiring an employee of Seller or one of its affiliates who applies for employment with Buyer, so long as such employee was not solicited by Buyer in violation of this Section.

(c) Both Buyer and Seller agree that upon the breach or threatened breach of the provisions of this Section, the remedies at law of the party threatened or subjected to such breach will be inadequate, and that the party threatened by or subjected to such breach shall be entitled to an injunction or injunctions to prevent such breaches and to enforce specifically the provisions hereof, in addition to any other remedy to which that party may be entitled at law or equity.

Section 5.17. New Funeral Home Construction. Seller is in the process of constructing a new funeral home ("New Home") on the Real Property. Seller has advised Buyer that Seller expects that construction of the New Home will be completed on or before December 31, 2006. Upon execution of this Agreement, to the extent not already included in the Schedules to this Agreement, Seller shall provide to Buyer copies of all construction contracts, plans, specifications and other materials and documents associated with construction of the New Home ("Construction Documents"). Notwithstanding the timing of the Closing hereunder, Seller shall remain responsible for completion of construction of the New Home in accordance with the applicable Construction Documents, and shall use such diligence as it would have were it retaining ownership of the Business to cause all architects, contractors, design firms, project managers and other third parties under privity to Seller with respect to the construction of the New Home to complete their work in a timely and proper fashion. Buyer shall allow representatives of Seller such reasonable access to the Real Property as may be reasonably necessary for Seller to exercise its responsibilities under this Section. Following completion of construction of the New Home, Seller shall transfer to and allow assumption by Buyer of all applicable Construction Documents, including any warranties given thereunder. Seller shall



cause and direct all architects, contractors, design firms, project managers and other third parties in privity to Seller with respect to the construction of the New Home to look solely to Seller for all fees, costs, reimbursements and other amounts payable in connection with the construction project (all of which Seller agrees to pay, and against which to indemnify Buyer, including any mechanics and materialmen's liens arising therefrom) . Seller represents that there has not been since June 30, 2006, and covenants and agrees that there shall not be between the date hereof and the date that construction is complete, any material changes or alterations to the Construction Documents, or otherwise to the plans for and/or the construction of the New Home. For purposes hereof, construction of the New Home shall not be considered complete until all of the following shall have occurred: (i) a final Certificate of Occupancy has been issued by the building department or equivalent arm of the local or municipal governmental agency having jurisdiction over the New Home; (ii) all work to be performed pursuant to the Construction Documents has been completed to the extent that Buyer may use and occupy the New Home in the normal conduct of the Business, specifically including (but not limited to) the finishing of all structural elements, walls, ceilings, flooring, ventilation, heating, air cooling, water, plumbing, lighting and electric power facilities; (iii) the New Home shall have been rendered in new and unblemished condition, except for those minor items constituting punch list items to be submitted to contractors which do not materially interfere with Buyer's normal use and occupancy of the New Home or necessary access to facilities, such punch list to specify the anticipated completion date of each item shown thereon; and (iv) there shall have been installed in the New Home all furniture, fixtures and other furnishings required for the normal use and occupancy of the New Home for its intended purpose and as originally planned for the New Home.

Section 5.18. Restrictive Covenants. Seller acknowledges that Buyer would not be willing to acquire the Assets hereunder without assurances that the Business will be protected from unfair competition. For this reason, Seller has agreed, for itself and on behalf of SCI Parent, Alderwoods Parent and their respective affiliates (collectively, "SCI Entities"), that:

(a) No SCI Entity shall, directly or indirectly, for itself or as agent on behalf of any other person, for a period commencing on the Closing Date and ending five years thereafter (as extended for the period in which any SCI is in material violation of this covenant), anywhere within the Restricted Market Area (as defined below), open, construct, acquire, operate, manage, consult with or be involved in the management of any Death Care Business (as defined below).

(b) For purposes of the foregoing, the “Restricted Market Area” means a five-mile radius surrounding the Business. The foregoing reference to “Restricted Market Area” is not, however, intended to restrict or qualify any other reference to “market area” in this Agreement.

(c) A “Death Care Business” includes a funeral home, mortuary, cemetery, crematory, columbarium, mausoleum or other similar business engaged in the handling and final disposition of human remains.

(d) The above covenants shall not be held invalid or unenforceable because of the scope of the territory or actions subject thereto or restricted thereby, or the period of time within which such covenants are operative; but any judgment of a court of competent jurisdiction may define the maximum territory and actions subject to and restricted thereby and the period of time during which such covenants are enforceable.

(e) Buyer shall be entitled to specific performance hereof or injunctive relief or both, by temporary or permanent injunction or such other appropriate judicial remedy, writ or order as may be entered into by a court of competent jurisdiction, in case of any actual or threatened breach of the foregoing covenants, in addition to any damages that the Buyer may be legally entitled to recover.

Section 5.19. Regulatory Cooperation. Each of the parties shall assist and cooperate with one another to effect promptly the transactions contemplated by this Agreement. Buyer shall as promptly as practicable use its commercially reasonable efforts to (i) prepare and furnish all necessary applications, information and documentation (including furnishing all information requested by the FTC), and take all other actions that may be necessary to demonstrate to the FTC that Buyer is an acceptable purchaser of the Assets, and that Buyer will effectively compete using the Assets; and (ii) obtain FTC approval of Buyer as an acceptable purchaser of the Assets and assist in causing the FTC Decision and Order issued in connection with the Alderwoods Transaction to become final without modification. Without limiting the generality of the foregoing, Buyer shall do whatever is reasonably necessary, proper or advisable to assist and cooperate with Seller in obtaining necessary consents, approvals or orders necessary to consummate the transactions contemplated by this Agreement. Subject to such cooperation by Buyer, Seller agrees to file its petition with the FTC for approval of the transactions hereunder by no later than December 22, 2006.

Section 5.20. Decision and Order. Seller hereby grants to Buyer any of the rights that it is required to grant to Buyer pursuant to any Decision and Order. Seller agrees to keep Buyer reasonably informed as to the progress of its negotiations concerning the Decision and Order,

and to promptly advise Buyer of any material developments, insofar as the same involves the Business, the Assets or Buyer, and to promptly provide a copy thereof to Buyer once signed.

Section 5.21. Unique Preneed Merchandise. If any Preneed Agreements call for the delivery of products not available to Buyer because of exclusivity arrangements with Seller or its affiliates, Seller will make arrangements with Buyer to enable Buyer to purchase that merchandise, either from Seller or directly from Seller's vendor, to enable Buyer to fulfill those Preneed Agreements, at prevailing commercial prices and terms.

## ARTICLE VI

### Conditions to Respective Obligations of Buyer and Seller

The respective obligations of each of Buyer and Seller under this Agreement are subject to the conditions that:

Section 6.1. Representations and Warranties True When Made and At Closing. All of the representations and warranties of the other party shall be true and correct in all material respects on and as of the date of this Agreement and the Closing Date (unless made as of another designated date).

Section 6.2. Performance of Obligations. The obligations of the other party hereto shall have been discharged in all material respects prior to or on the Closing Date.

Section 6.3. Closing Certificates. Each party hereby agrees that it shall deliver to the other party a written instrument signed by an officer of the other party certifying that the conditions specified in Sections 6.1 and 6.2, as to such party, have been satisfied, and delivery of such certificate by each party shall be a condition to other party's obligations hereunder.

#### Section 6.4. Board Approvals.

(a) The transactions contemplated by this Agreement shall have been approved by the Board of Directors of Seller.

(b) The transaction contemplated by this Agreement shall have been approved by the Board of Directors of the Buyer.

Section 6.5. Third Party Consents and Governmental Approvals. Each party shall have received such evidence as it shall have determined is reasonably necessary or appropriate to the effect that all consents, approvals and authorizations have been obtained in order to consummate the transactions described herein, including without limitation the consent of any landlords, lessors or other parties to contracts and commitments included in the Assets, and of all governmental authorities having jurisdiction, including but not limited to, the approval of the

FTC, pursuant to any Decision and Order and/or any other decree or order it may issue specifically with regard to the transaction contemplated hereby (collectively, the “Regulatory Approvals”), to the extent required at or prior to Closing. The parties shall use commercially reasonable efforts to timely obtain all such consents, approvals and authorizations. For purposes hereof, the FTC Decision and Order and/or any other decree or order which may be issued by the FTC regarding the transaction hereunder specifically shall not be deemed to have been “obtained” until after it has become final, including expiration of any applicable comment periods.

## ARTICLE VII

### Additional Conditions Precedent to Obligations of Buyer

All obligations of Buyer which are to be discharged under this Agreement at the Closing are subject to the performance at or prior to the Closing of all agreements contained herein which are to be performed by Seller at or prior to the Closing, and to the following additional conditions (unless expressly waived in writing by Buyer at any time prior to the Closing).

Section 7.1. No Material Adverse Change. There shall not have occurred any material damage to or destruction of any of the buildings and improvements at the Business, nor any other event or occurrence that individually or in the aggregate could reasonably be expected to have a material adverse effect on the condition, business, operations or (in Buyer’s reasonable judgment) prospects of the Business or any substantial portion of the Assets, or which would prevent the carrying out of this Agreement.

Section 7.2. Title to Real Estate. Seller shall obtain and provide to Buyer, one-half at Buyer’s expense and one-half at Seller’s expense, a commitment for title insurance (collectively, “Title Commitments”) in the amount allocated to Real Property as shown on Exhibit B, from Commerce Title Company, or another title company acceptable to Buyer (the “Title Company”), showing title to each parcel of owned Real Property to be good, marketable and vested in Seller, and describing all Liens (including easements, rights-of-way, reservations, restrictions, outstanding mineral interests and other matters affecting the Real Property or the title thereto). Buyer may further obtain, at its own expense and if it so chooses, an ALTA survey (collectively “Survey”) prepared by a licensed surveyor approved by Buyer and acceptable to the Title Company, with respect to each parcel of Real Property, which shall be sufficient for the Title Company to delete the survey exception contained in the Title Commitments, save and except for the phrase “shortages in area,” and otherwise be in form and content reasonably acceptable to

Buyer. Buyer shall have ten (10) business days from receipt of the Title Commitments and Surveys within which to notify Seller and the Title Company in writing of its objections to the matters affecting the Real Property and the title thereto reflected in the Title Commitments ("Title Objections"), other than as to Permitted Encumbrances. "Permitted Encumbrances" shall mean (i) encroachments, protrusions, boundary line discrepancies, easements, covenants, rights-of-way and other encumbrances or restrictions which do not, individually or in the aggregate, materially restrict or interfere with the use of the Real Property as the same is currently being used, or (as to any acreage described as "undeveloped acres" on the Cemetery Acreage Report described in Section 3.2 above) contemplated to be used as developed cemetery property, (ii) Liens for real property taxes not yet due or payable, (iii) any matters shown on the Title Commitments not objected to by Buyer as provided for above or, if objected to by Buyer, later waived by Buyer as provided for below and (iv) Liens that are created, suffered or assumed by Buyer. Seller shall have thirty (30) days after receipt of the Title Objections (but in no event after the fifth business day preceding Closing) to cure such objections, during which period the Closing will be postponed if necessary (but in no event past the Outside Closing Date). Seller shall not unreasonably withhold its consent to any request from the Title Company or the Buyer concerning Title Objections. Upon cure of the Title Objections, the parties shall perform this Agreement according to its terms. If such Title Objections are not cured to Buyer's reasonable satisfaction within such fifteen (15) day period, Buyer shall have the option either (a) to terminate this Agreement, or (b) to waive any Title Objection, and, in such event, proceed to close this Agreement and the transaction provided for herein.

At Closing or soon thereafter as practicable, the Title Company shall issue, one-half at Buyer's expense and one-half at Seller's expense, its title insurance policy consistent with its previous Title Commitments approved by Buyer.

Section 7.3. Inspections. Prior to Closing, Buyer shall have the right, at Buyer's expense, to obtain such inspections of the Real Property or any portion thereof as it deems appropriate including, but not limited to:

(a) Inspections of the buildings, the roofs, heating, ventilating, and air conditioning systems, and electrical and plumbing systems and otherwise associated with the buildings' condition and compliance with OSHA, ADA and other applicable rules and regulations; and

(b) Inspections for the purpose of performing a Phase One environmental assessment and such other inspections and assessments (including Phase Two environmental assessments) the necessity for which is reasonably indicated in the Phase One assessment.

If as a result of such inspections any matter is discovered that materially reduces the value of the Business taken as a whole, Buyer shall have the right to object to such finding prior to Closing. Any such matter discovered as a result of such inspections and not objected to by Buyer shall be deemed to be accepted by Buyer and Buyer shall have no further right to object thereto or assert a claim against Seller as a result thereof. For a period of thirty (30) days following receipt of any objection by Buyer (but in no event after the fifth business day preceding Closing), Seller shall have the option but not the obligation to cure any of the above described matters objected to by Buyer, during which period the Closing will be postponed if necessary (but in no event past the Outside Closing Date). If Buyer's objections are not cured within such thirty (30) day period, Buyer shall have the option either (a) to not close this Agreement, or (b) to waive Buyer's objections, and, in such event, proceed to close this Agreement and the transaction provided for herein.

## ARTICLE VIII

### Survival of Representations, Warranties and Covenants; Indemnification

Section 8.1. Nature of Representations. For purposes of this Agreement, the contents of all exhibits, certificates, Schedules, and other items incorporated herein by reference shall, in addition to the representations and warranties made in this Agreement, constitute representations and warranties made in this Agreement by Seller or Buyer, as the case may be.

Section 8.2. Survival of Representations, Warranties and Covenants. The representations, warranties and covenants of the parties made in this Agreement shall survive the Closing and any investigation by the parties with respect thereto, and shall continue in full force and effect thereafter as follows:

(a) The representations and warranties set out in Sections 3.1, 3.5 (first sentence only), 4.1 and 10.4, for a period extending until 30 days following expiration of the statute of limitations pertaining to written agreements in the State of Texas (including any suspensions, tollings or extensions thereof and application of the discovery rule);

(b) The representations and warranties set forth in Section 3.14, for a period extending until 30 days following expiration of the statute of limitations under applicable federal and state environmental laws (including any suspensions, tollings or extensions thereof and application of the discovery rule);

(c) All other representations and warranties made in this Agreement, for a period of two (2) years after the Closing Date; and

(d) All covenants and agreements made in this Agreement, including without limitation those set forth in Sections 1.4 and 1.5, for the period specified in this Agreement, or if no period is specified, then for a period equal to the statute of limitations pertaining to written agreements in the State of Texas (including any suspensions, tollings or extensions thereof and application of the discovery rule).

(e) No representation, warranty, covenant or agreement shall expire as to which a claim has been submitted in writing to the party against which recourse is sought hereunder prior to the time called for expiration as provided above.

(f) No representation or warranty of Seller under Article III shall survive the Closing as to which the Seller demonstrates by a preponderance of the evidence was actually known to be materially untrue as of the Closing Date by a person identified on Exhibit E. No representation or warranty of Buyer under Article IV shall survive the Closing as to which the Buyer demonstrates by a preponderance of the evidence was actually known to be materially untrue as of the Closing Date by a person identified on Exhibit F.

Section 8.3. Indemnification by Seller.

(a) Seller agrees to indemnify and hold Buyer, its affiliates, officers, directors and employees, and their respective successors and assigns, harmless from all damages, liabilities, obligations, claims, adverse results, losses or expenses (including, without limitation, interest and penalties, reasonable attorneys' fees and expenses, any one such item being herein called a "Loss" and all such items being herein collectively called "Losses") suffered or paid, directly or indirectly, as a result of or arising out of:

(i) any breach or default in the performance by the Seller of any covenant or agreement of the Seller contained in this Agreement or any related document executed pursuant hereto;

(ii) any breach of warranty or inaccurate or erroneous representation made by the Seller herein; and

(iii) the failure of the Seller to fully pay and discharge as and when same are due all obligations, liabilities and/or duties relating to or arising from the Business other than the Assumed Liabilities.

(b) The Seller shall reimburse the Buyer an amount satisfactory to compensate the Buyer for any Loss arising from an event or circumstance to which the foregoing indemnities

relate. Provided, however, Buyer acknowledges that the afore-described indemnification responsibilities of the Seller hereunder shall be, notwithstanding the prior terms hereof, limited as follows:

(i) In order to avoid double recovery by Buyer, Seller will be entitled to receive as a credit against the amount owed to the Buyer under the foregoing indemnification provisions an amount (if any) equal to the net proceeds actually received by Buyer under any insurance policy for a Loss for which the Seller agreed to indemnify the Buyer under this Section 8.3; provided, however, that if Buyer has the right to receive insurance proceeds in respect of such an indemnifiable claim but has not actually received those proceeds at the time an indemnity payment is due from Seller hereunder, Seller shall be obligated to pay the full amount of Losses to Buyer in accordance with this Agreement, and upon Buyer's receipt of such insurance proceeds, then to the extent that such proceeds serve to reduce Losses actually paid by Seller in accordance with this subparagraph (i), Buyer shall remit the amount thereof to Seller.

(ii) Buyer shall have no claim for indemnification hereunder until the total amount of all Losses which would otherwise be subject to indemnification hereunder exceeds \$90,000, and then only to the extent of such excess; and in no event shall the aggregate amount of all Losses subject to indemnification under this Section 8.3 exceed 100% of the Purchase Price; provided, however, that the foregoing limitations shall in no event apply to any claims arising out of or in connection with Section 1.5, 8.3(a)(ii) (insofar as it relates to Section 5.17) or 8.3(a)(iii) hereof.

(iii) the indemnification obligations of the Seller hereunder shall be exclusive remedy of the Buyer with respect to any matter subject to indemnification hereunder.

Section 8.4. Indemnification by Buyer.

(a) Buyer agrees to indemnify and hold Seller, Seller's successors and assigns, harmless from all Losses suffered or paid, directly or indirectly, as a result of or arising out of:

(i) any breach or default in the performance by the Buyer of any covenant or agreement of the Buyer contained in this Agreement or any related document executed pursuant hereto;

(ii) any breach of warranty or inaccurate or erroneous representation made by the Buyer herein; and



(iii) the failure of the Buyer to fully pay and discharge as and when same are due the Assumed Liabilities; and

(iv) obligations, liabilities and/or duties relating to or arising from Buyer's ownership and operation of the Business from and after the Effective Time (except as to any matter as to which Seller is obligated to provide indemnification hereunder).

(b) The Buyer shall reimburse the Seller an amount satisfactory to compensate the Seller for any Loss arising from an event or circumstance to which the foregoing indemnities relate. Provided, however, Seller acknowledges that the afore-described indemnification responsibilities of the Buyer hereunder shall be, notwithstanding the prior terms hereof, limited as follows:

(i) in no event shall the aggregate amount of all Losses subject to indemnification under this Section 8.4 exceed 100% of the Purchase Price; provided, however, that the foregoing limitations shall in no event apply to any claims arising out of or in connection with Section 1.4 or 8.4(a)(iii) hereof; and

(ii) the indemnification obligations of the Buyer hereunder shall be exclusive remedy of the Seller with respect to any matter subject to indemnification hereunder.

Section 8.5. Assertion of Claims. No claim shall be brought by any Indemnitee (as defined below) against any Indemnitor (as defined below) under this Article VIII, and no Indemnitee shall be entitled to receive any payment with respect thereto, unless the Indemnitee gives the Indemnitor written notice of the existence of any such claim, specifying in reasonable detail the basis therefor, prior to the expiration of the applicable time period set forth in Section 8.2 above. Except as set forth in this Article VIII, if the Indemnitee and Indemnitor fail to reach a mutually acceptable resolution of such claim within thirty (30) days after the giving of such notice, the Indemnitee shall have the right to commence legal proceedings for the enforcement of their rights pursuant to Section 8.6 hereof.

Section 8.6. Dispute Resolution.

(a) Any and all disputes among the parties to this Agreement (defined for the purpose of this provision to include their principals, agents and/or affiliates) arising out of or in connection with the negotiation, execution, interpretation, performance or nonperformance of this Agreement and the transaction contemplated herein shall be solely and finally settled by arbitration, which shall be conducted in Houston, Texas by a single arbitrator selected by the

parties. The arbitrator shall be a lawyer familiar with business transactions of the type contemplated in this Agreement who shall not have been previously employed or affiliated with any of the parties hereto. If the parties fail to agree on the arbitrator within thirty (30) days of the date one of them invokes this arbitration provision, either party may apply to the American Arbitration Association to make the appointment.

(b) The parties hereby renounce all recourse to litigation and agree that the award of the arbitrator shall be final and subject to no judicial review, absent fraud or manifest error. The arbitrator shall conduct the proceedings pursuant to the Commercial Arbitration Rules of the American Arbitration Association, as now or hereafter amended (the "Rules").

(c) The arbitrator shall decide the issues submitted (i) in accordance with the provisions and commercial purposes of this Agreement, and (ii) with all substantive questions of law determined under the laws of the State of Texas (without regard to its principles of conflicts of laws). The arbitrator shall promptly hear and determine (after giving the parties due notice and a reasonable opportunity to be heard) the issues submitted and shall render a decision in writing within sixty (60) days after the appointment of the arbitrator.

(d) The parties agree to facilitate the arbitration by (i) conducting arbitration hearings to the greatest extent possible on successive days, and (ii) observing strictly the time periods established by the Rules or by the arbitrator for submission of evidence or briefs.

(e) Judgment on the award of the arbitrator may be entered in any court having jurisdiction over the party against which enforcement of the award is being sought and the parties hereby irrevocably consent to the jurisdiction of any such court for the purpose of enforcing any such award. The arbitrator shall divide all costs (other than fees and expenses of counsel) incurred in conducting the arbitration in the final award in accordance with what the arbitrator deems just and equitable under the circumstances.

(f) The parties hereto agree that the provisions of this Section 8.6 shall not be construed to prohibit any party from obtaining, in the proper case, specific performance or injunctive relief with respect to the enforcement of any covenant or agreement of another party to this Agreement.

#### Section 8.7. Defense of Claims.

(a) If any claim or action by a third party arises after the Closing Date for which an Indemnitor is liable under the terms of this Agreement, then the Indemnatee shall notify the Indemnitor promptly after such claim or action arises and is known to the Indemnatee (provided no failure or delay in providing such notice shall impair Indemnatee's right or Indemnitor's

obligations hereunder except to the extent such failure or delay has materially prejudiced Indemnitor's ability to defend such claim or action), and, provided Indemnitor in writing accepts responsibility for indemnity hereunder, shall give the Indemnitor a reasonable opportunity: (i) to take part in any examination of any books and records; (ii) to conduct any proceedings or negotiations in connection therewith and necessary or appropriate to defend the Indemnatee; (iii) to take all other required steps or proceedings to settle or defend any such claim or action; and (iv) to employ counsel to contest any such claim or action in the name of the Indemnatee or otherwise. If the Indemnitor wishes to assume the defense of such claim or action, it shall give written notice to the Indemnatee and within 10 days thereafter, Indemnatee shall permit, and Indemnitor shall thereafter assume, the defense of any such claim or liability, through counsel reasonably satisfactory to the Indemnatee; provided that the Indemnatee may participate in such defense (including involvement in strategic decisions, including but not limited to public relations issues) at its own expense. Any such settlement by Indemnitor shall require Indemnatee's prior written consent (which shall not be unreasonably withheld), unless Indemnatee is being released in accordance with such settlement, such settlement involves only the payment of money, and Indemnitor has assumed sole responsibility for such payment. In addition, Indemnatee's consent shall be required if such settlement would not require all adverse parties to maintain the confidentiality of such settlement and to refrain from making any public statements in connection therewith.

(b) If the Indemnitor shall not assume the defense of any such claim or action, the Indemnatee may defend against any such claim or action in such manner as it may deem appropriate (provided that the Indemnitor may participate in such defense at its own expense); provided, however, that the Indemnatee may not settle such claim or action, without the prior written consent of the Indemnitor. If no settlement of such claim or action is made, the Indemnitor, jointly and severally, shall satisfy any judgment rendered with respect to such claim or in such action, before the Indemnatee is required to do so, and pay all expenses, legal or otherwise, including attorneys' fees and costs reasonably and necessarily incurred by the Indemnatee in the defense of such claim or action.

Section 8.8. Insurance Cooperation. The parties shall cooperate with each other to maximize the availability of insurance coverage under the policies maintained by Seller immediately preceding the Closing Date for claims or actions by third parties which may be subject to indemnification pursuant to Sections 8.3 and 8.4, and, if the insurance carrier for such policies agrees to defend such claim, such defense shall be tendered to such insurance carrier and

the rights of the parties between themselves regarding the assumption and control of such defense shall be subject to the reasonable requirements of such insurance carrier.

Section 8.9. Definitions.

(a) In the case of a claim of indemnification brought pursuant to Section 8.3, "Indemnatee" shall mean Buyer and its affiliates, officers, directors and employees, and their respective successors and assigns, and in the case of a claim of indemnification brought pursuant to Section 8.4, it shall mean Seller and Seller's successors or assigns.

(b) In the case of a claim of indemnification brought pursuant to Section 8.3, "Indemnitor" shall mean Seller, and in the case of a claim of indemnification brought pursuant to Section 8.4, it shall mean Buyer.

ARTICLE IX

Termination

Section 9.1. Termination of Agreement. The parties may terminate this Agreement only as provided below:

(a) Mutual Consent. The Buyer and the Seller may terminate this Agreement by mutual written consent at any time prior to the Closing;

(b) Termination by Seller. The Seller may terminate this Agreement prior to Closing by delivering written notice of termination to Buyer, if:

(i) the approval of the board of directors of Seller required by Section 6.4(a) is not obtained on or before the Approval Date, and has still not been obtained on or before delivery of such termination notice;

(ii) the approval of the board of directors of Buyer required by Section 6.4(b) is not obtained on or before the Approval Date, and Seller has not received notice of such board approval as required in Section 4.1(a) on or before delivery of such termination notice;

(iii) if any Regulatory Approvals required by Section 6.5 are not obtained on or before February 28, 2007, so long as Seller has expended commercially reasonable efforts to obtain such approvals;

(iv) if at any time the Buyer is in material breach of any of its representations, warranties or obligations under this Agreement, which breach has not been cured (if capable of being cured) within thirty (30) calendar days after the Seller has given written notice of such material breach to Buyer (but in no event past the fifth business day preceding the Outside Closing Date);

(v) if Buyer has failed by December 15, 2006 to secure adequate financing to consummate the transactions set forth in this Agreement, provided that Buyer may demonstrate adequate financing by having available to it or its affiliates in cash, liquid investments or availability under its line of credit an amount not less than the Purchase Price;

(vi) if the FTC conditions its approval of this Agreement or the transaction contemplated hereby in a manner that has a material adverse effect on the benefits that Seller expects to derive from the transaction contemplated by this Agreement, or the FTC staff advises the parties that Buyer is not an acceptable purchaser of the Assets or that the Agreement is not acceptable, and despite the parties' good faith efforts to modify such agreement, negotiations with the FTC staff have terminated without a mutually acceptable resolution; or

(vii) if for any other reason, the Closing shall not have occurred on or before March 15, 2007.

(c) Termination by Buyer. The Buyer may terminate this Agreement prior to Closing by delivering written notice of termination to Seller:

(i) if the approval of the board of directors of Buyer required by Section 6.4(b) is not obtained on or before the Approval Date, and has still not been obtained on or before delivery of such termination notice;

(ii) if the approval of the board of directors of Seller required by Section 6.4(a) is not obtained on or before the Approval Date, and Buyer has not received notice of such board approval as required in Section 3.1 on or before delivery of such termination notice;

(iii) if any Regulatory Approvals required by Section 6.5 are not obtained on or before February 28, 2007, so long as Buyer has expended commercially reasonable efforts to obtain such approvals;

(iv) if at any time the Seller is in material breach of any of its representations, warranties or obligations under this Agreement, which breach has not been cured (if capable of being cured) within thirty (30) calendar days after the Buyer has given written notice of such material breach to Buyer (but in no event past the fifth business day preceding the Outside Closing Date);

(v) under Section 7.2 hereof;

(vi) under Section 7.3 hereof; or

(vii) if at any time the Schedules to Exhibit A hereto (as they exist on the Website and/or in the compact disk to be delivered at Closing as contemplated in Section 3.6) are different from the information that was contained on the Website (according to a written document control list delivered by Seller to Buyer as of 5:00 p.m. CST on the business day immediately preceding on the date of this Agreement, which shall include all documents on the Website to which Buyer has access) to such an extent that the difference would (in the reasonable judgment of a third party) have a material adverse effect on the value of the Business and the Assets to be purchased hereunder.

(d) Break-Up Fee. In the event that this Agreement terminates for any reason other than (I) a termination by the parties in accordance with Section 9.1(a), (II) a termination by Seller in accordance with Section 9.1(b)(i), Section 9.1(b)(iii) or Section 9.1(b)(vi), or (III) a termination by Buyer in accordance with Section 9.1(c)(ii), Section 9.1(c)(iii), Section 9.1(c)(iv), Section 9.1(c)(v), Section 9.1(c)(vi) or Section 9.1(c)(vii), Buyer shall be obligated to pay Seller a break-up fee equal to ten percent (10%) of the Purchase Price (the "Break-Up Fee"). The parties agree that the Break-Up fee is reasonable in that it reimburses Seller for its costs in connection with the proposed transaction and compensates Seller for lost opportunity costs associated with the pursuit of the proposed transaction. The Break-Up Fee shall be the sole recourse and remedy against Buyer for any failure for Closing to occur hereunder as specified in this Section 9.1, including but not limited to any such failure constituting or caused by any breach hereof by Buyer.

(e) Effect of Termination. In the event of a termination of this Agreement pursuant to Section 9.1(a)-(c) above, this Agreement shall forthwith become void and have no effect, without liability on the part of any party or its affiliates, directors, officers or stockholders, except that (i) Buyer's obligation to pay the Break-Up Fee solely under the circumstances described in Section 9.1(d), and (ii) Sections 8.6, 10.1, 10.2, 10.3, 10.4 and 10.5 hereof, shall survive such termination.

## ARTICLE X

### Miscellaneous

Section 10.1. Notices. All notices provided for hereunder shall be in writing and shall be deemed to be given:

(a) When delivered to the individual, or to an officer of the party, to which the notice is directed;

(b) Three (3) days after the same has been deposited in the United States mail, sent Certified or Registered mail with Return Receipt Requested, postage prepaid and addressed as provided in this Section; or

(c) When delivered by a generally recognized overnight delivery service (including United States Express Mail), with receipt acknowledged and with all charges prepaid by the sender addressed as provided in this Section. Notices shall be directed as follows:

- (1) if to SCI Funeral Services (with notices being sent to SCI Funeral Services only before the Alderwoods Merger Closing Date), to:

President  
SCI Funeral Services, Inc.  
1929 Allen Parkway  
Houston, Texas 77019

with a copy to:

General Counsel  
Service Corporation International  
1929 Allen Parkway  
Houston, Texas 77019

- (2) if to Seller (with notices being sent to Seller only on and after the Alderwoods Merger Closing Date), to:

President  
Alderwoods Group (California), Inc.  
1929 Allen Parkway  
Houston, Texas 77019

with a copy to:

General Counsel  
Service Corporation International  
1929 Allen Parkway  
Houston, Texas 77019

- (3) if to Buyer, to:

Carriage Cemetery Services, Inc.  
3040 Post Oak Blvd, Suite 300  
Houston, Texas 77056  
Attn: President

with a copy to:

Thompson & Knight, LLP  
333 Clay, Suite 3300  
Houston, Texas 77002  
Attn: W. Christopher Schaeper

or at such other place or places or to such other person or persons as shall be designated by like notice by any party hereto.

Section 10.2. Expenses. Each party hereto shall pay its own expenses, including without limitation, fees and expenses of its agents, representatives, counsel, auditors, and accountants incidental to the preparation and carrying out of this Agreement.

Section 10.3. Attorney's Fees. In the event of any controversy, claim or dispute between or among any of the parties hereto arising out of or relating to this Agreement, or any default or breach or alleged default or breach hereof, the prevailing party shall be entitled to be reimbursed by the other party for its reasonable attorney's fees and costs associated therewith.

Section 10.4. Brokers. Buyer warrants that it has not engaged the services of a broker in connection with the transactions described in this Agreement. Buyer agrees to indemnify Seller against any claim by any third person for any commission, brokerage or finder's fee or other payments based upon any alleged agreement or understanding between such third party and Buyer, whether expressed or implied. Seller warrants that it has not engaged the services of a broker in connection with the transactions described in this Agreement, other than Johnson Consulting Agreement, the fees and expenses of which shall be solely Seller's responsibility. Seller agrees to indemnify Buyer against any claim by Johnson Consulting Group or any other person for any commission, brokerage or finder's fee or any other payment based upon any alleged agreement or understanding between such third person and Seller, whether expressed or implied.

Section 10.5. Publicity. The parties shall consult with each other prior to issuing any press release or any written public statement with respect to this Agreement or the transactions contemplated hereby, and shall not issue any such press release or public statement prior to such consultation.

Section 10.6. Parties in Interest. This Agreement shall inure to the benefit of and be binding upon the parties hereto and their respective successors and permitted assigns. This Agreement shall not be assigned by any party hereto without the prior written consent of the other parties. Notwithstanding the foregoing, (i) prior to Closing, Buyer may designate one or more of its affiliates to acquire all or any portion of the Business, provided that any such assignee shall assume any Assumed Liabilities applicable to the portion of the Business being so purchased, and (ii) following the Closing, Buyer (or such affiliate) may assign all or any portion



of this Agreement, including its rights and interests in the representations, warranties, covenants and indemnities hereunder, without the consent of the Seller to a successor-in-interest in all or any portion of the Business (whether by merger, sale of assets or otherwise); provided that in either such event, Buyer shall not thereby be relieved of its obligations hereunder. Nothing in this Agreement, expressed or implied, is intended to confer upon any third person any rights or remedies under or by reason of this Agreement.

Section 10.7. Entire Agreement; Amendment. This Agreement together with the other agreements and the Decision and Order provided for herein embody the whole agreement of the parties. There are no promises, terms, conditions, or obligations other than those contained herein. All previous negotiations between the parties, either verbal or written, not herein contained are hereby withdrawn and annulled. This Agreement shall supersede all previous communications, representations, or agreements, either verbal or written, between the parties hereto. Exhibits A and C (and the Schedules in Exhibit A) shall be provided and, if applicable, updated in the manner described in Sections 3.6 and 5.1. Exhibits B, D, E and F shall be mutually agreed upon in writing by the parties on or before the fifth business day before the Closing Date, whereupon they shall be incorporated into this Agreement. This Agreement may not be amended except by an instrument in writing signed on behalf of each party hereto.

Section 10.8. Captions; Counterparts. The section and subsection headings contained in this Agreement are for reference purposes only and shall not affect in any way the meaning or interpretation of this Agreement. This Agreement may be executed simultaneously in two or more counterparts, each of which shall be deemed an original, but all of which together shall constitute one and the same instrument.

Section 10.9. Tax Identification Numbers. Buyer's Federal Tax Identification Number is 76-0592642. Seller's Federal Tax Identification Number is 94-2268419.

Section 10.10. Governing Law. This Agreement shall be construed and enforced in accordance with the laws of the State of Texas.

(Remainder of Page Intentionally Left Blank)



IN WITNESS WHEREOF, the undersigned parties hereto have duly executed this Agreement on the date first above written.

**Buyer:**

**CARRIAGE CEMETERY SERVICES, INC.**

By: /s/ Melvin C. Payne

**MELVIN C. PAYNE**, Chairman and Chief Executive  
Officer

**SCI Funeral Services:**

**SCI FUNERAL SERVICES, INC.**

By: /s/ Curtis G. Briggs

**CURTIS G. BRIGGS**, President

**JOINDER OF SELLER**

ALDERWOODS GROUP (CALIFORNIA), INC. hereby joins in this Agreement to confirm its assumption of the obligations of "Seller" in accordance with the terms of "Terms of Contingency" Section set forth above.

**Seller:**

**ALDERWOODS GROUP (CALIFORNIA), INC.**

By: /s/ Curtis G. Briggs

Date: November 30, 2006

**GUARANTY**

SCI CALIFORNIA FUNERAL SERVICES, INC., for good and valuable consideration, the receipt and sufficiency of which are hereby acknowledged, hereby joins in the execution of this Agreement to evidence its unconditional and irrevocable guaranty of the obligations of the Seller in this Agreement.

**Guarantor:**

**SCI CALIFORNIA FUNERAL SERVICES, INC.**

By: /s/ Curtis G. Briggs

Date: November 30, 2006

**ASSET PURCHASE AGREEMENT**

THIS AGREEMENT, dated as of December 15, 2006, is by and among CARRIAGE CEMETERY SERVICES, INC., a Texas corporation (the “Purchaser”), and SEASIDE CEMETERY, INC., a Texas corporation (the “Company”);

**W I T N E S S E T H:**

WHEREAS, the Company owns and operates (i) the Seaside Funeral Home (the “Seaside Home”) and the Seaside Memorial Park (the “Seaside Cemetery”), both located at 4357 Ocean Drive in Corpus Christi, Nueces County, Texas, (ii) the Corpus Christi Funeral Home located at 2409 Baldwin Blvd in Corpus Christi, Nueces County, Texas (the “Corpus Christi Home” and, together with the Seaside Home, hereafter referred to as the “Homes”), and (iii) the Sunshine Cemetery located at 2501 Rodd Field Road in Corpus Christi, Nueces County, Texas (“Sunshine Cemetery” and, together with the Seaside Cemetery, hereafter referred to as the “Cemeteries”); and

WHEREAS, the parties desire that the Purchaser acquire substantially all of the assets, rights, and properties of the Homes and the Cemeteries (collectively, the “Businesses”) from the Company, and that the parties enter into certain related transactions, on the terms and subject to the conditions hereafter set forth;

NOW, THEREFORE, the parties agree as follows:

**1. Purchase and Sale of Assets.**

1.1. Transfer of Assets by the Company. Subject to the provisions of this Agreement, the Company agrees to sell, and the Purchaser agrees to purchase, at the Closing referred to in Section 2.1, all of the properties, assets, rights and business of the Businesses of every kind and description, tangible and intangible, real, personal or mixed, wherever located (collectively, the “Assets”), as they shall exist at the Effective Time (as defined in Section 2.2), including, but not limited to, all of the following-described assets, rights and properties (but excluding those described in Section 1.2):

(i) all preneed and at-need notes and accounts receivable of the Cemeteries, all preneed notes and accounts receivable of the Homes, and all at-need accounts receivable of the Homes, other than the Retained At-Need Funeral Receivables described in Section 1.2(iii) below;

(ii) inventories of caskets (if any), vaults, urns, accessories and monuments of the Homes, inventories of vaults, crypts, markers, bases and monuments of the Cemeteries, and all other goods and inventories of the Businesses;

(iii) fee simple title to all of the real estate and improvements of the Businesses described on Schedule 3.5 (collectively, the “Real Property”); the Real Property specifically includes, but is not limited to, the “Ocean Drive Entrance Tract” (herein so called and so identified on Schedule 3.5) to be acquired by the Company prior to the Closing and included in the Assets to be transferred to the Purchaser, as contemplated in Section 7.8 below;

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(iv) machinery, equipment, motor vehicles, furniture, fixtures, supplies, tools and the other Fixed Assets and property, plant and equipment, including those described on Schedule 3.8 hereto;

(v) all preneed contracts of the Businesses, and all rights under policies of insurance available to fund preneed obligations, together with all cash, securities and other investments to fund preneed and perpetual care obligations (whether in on deposit in the applicable preneed or perpetual care account, awaiting deposit or in transit);

(vi) the agreements, leases and commitments described on Schedule 3.9, excluding any thereon as not being transferred to the Purchaser;

(vii) all rights of the Company to the names "Seaside Funeral Home," "Seaside Memorial Park," "Corpus Christi Funeral Home," and "Sunshine Cemetery," and all other trade names used in the Businesses, together with all derivatives thereof, and all trademarks, trade names, patents, processes, copyrights, know-how and similar intangible rights;

(viii) all goodwill associated with the foregoing and otherwise with the Businesses;

(ix) all permits and licenses of the Businesses, to the extent transferable;

(x) all books, records, work papers, brochures and literature necessary for the continued operation of or otherwise located at the Businesses (whether in tangible or electronic format), customer lists, computers and computer software, the telephone and fax numbers and listings for the Businesses, and all internet domain names (specifically including [www.seasidefuneral.com](http://www.seasidefuneral.com) and [www.seasidefuneralcemetery.com](http://www.seasidefuneralcemetery.com)); and

(xi) all other assets, rights and properties owned or leased by the Company that are used in or necessary for the Businesses at the Effective Time, excluding those described in Section 1.2.

At the Closing, the Company shall convey to the Purchaser the Assets free and clear of any and all liens, security interests, pledges, encumbrances or other title restrictions of any kind (collectively, "Liens"), other than (i) Permitted Exceptions against Real Property described on Schedule 3.3, and (ii) vehicle leases listed on Schedule 3.9.

1.2. Retained Assets. Notwithstanding the foregoing, the following properties, assets, rights and interests (collectively, the "Retained Assets") are hereby excluded from the purchase and sale contemplated hereby and are therefore not included in the Assets:

(i) all cash on hand or on deposit, including but not limited to bank account balances, certificates of deposit and marketable securities, whether at Bank of America, N.A. or elsewhere, excluding, however, the cash, securities and other investments to fund preneed and perpetual care obligations which are included in the Assets described in Section 1.1(v) above;

(ii) accounts receivable of the Homes arising from the at-need sale of funeral services and merchandise, and for vaults and interment fees, to the extent services have been performed or merchandise has been delivered in which the date of death has

occurred prior to the Effective Time, whether such receivables are payable from insurance proceeds, trust funds or other form of payment, and for which payment is collected (as provided in Section 1.11 below) within 120 days after the Effective Time (collectively, "Retained At-Need Funeral Receivables");

(iii) all other interests in real property owned or leased by the Company other than the Real Property, specifically including but not limited to the Company's interests in the Lake Placid Estates Property described in Section 7.9; and

(iv) any other assets and properties that are not used in connection with or are necessary for the operation of the Businesses.

1.3. Purchase Price. The purchase price for the Assets shall be \$11,105,000 (the "Purchase Price"). Of the Purchase Price, (i) an amount sufficient to discharge certain indebtedness of the Company, as determined pursuant to Section 1.4, shall be paid to the holders of such indebtedness, (ii) the sum of \$750,000 (the "Escrow Amount") shall be placed into escrow on the Closing Date and thereafter maintained and disbursed in accordance with Section 10.4 and the Escrow Agreement described therein, (iii) there shall be deducted from the Purchase Price the amount agreed to by the parties to complete the Seaside Cemetery fence under Section 1.15, as well as any adjustments for prorations agreed to by the parties under Section 1.7, and (iv) the balance of the Purchase Price shall be paid to the Company in cash at Closing by wire transfer to such account as the Company shall designate in writing at least three business days prior to the Closing. The Purchase Price shall be subject to adjustment as provided in Section 7.7.

1.4. Adjustment for Unassumed Liabilities. Prior to the Closing, the Company shall deliver to the Purchaser a written statement, certified by the Company to be accurate and complete, setting forth a description, and the outstanding balance as of the Effective Time, of all (i) liabilities and obligations of the Company for borrowed money and indebtedness secured by Liens against any of the Assets, and (ii) accounts and trade payable of the Businesses, including an aging thereof (collectively, "Unassumed Liabilities"). At Closing, the Purchaser shall pay out of the Purchase Price such portion thereof as shall be required to pay and discharge all Unassumed Liabilities specified in clause (i) and those specified in clause (ii) which as of the Effective Time are more than 30 days past due. Notwithstanding such payment, the Company shall remain responsible for paying any remaining Unassumed Liabilities. Payments under this Section 1.4 shall be deemed downward adjustments in the Purchase Price as provided in Section 1.3.

1.5. Assumption of Liabilities. The Purchaser, upon the sale and purchase of the Assets, shall, subject to Section 1.6 below, assume and agree to pay or discharge the following liabilities and obligations of the Company (collectively, the "Assumed Liabilities"):

(i) liabilities under those preneed contracts of the Businesses that are included in the Assets, and for perpetual care at the Cemeteries, which are funded to the extent required by applicable law (specifically including preneed liabilities for the delivery of markers, for which preneed income is not required to be trusted and as to which no amounts have been funded into trust);

(ii) obligations arising after the Effective Time under the agreements, leases and commitments of the Businesses described in Schedule 3.9 (other than agreements,

leases and commitments, if any, which are indicated on such Schedule as not to be assumed by the Purchaser);

(iii) obligations to provide mausoleum spaces for crypts sold on a pre-construction basis under the contracts listed on Schedule 1.5(iii);

(iv) obligations in respect of employee reserves and residuals, as further described on Schedule 3.17; and

(v) vacation and sick leave of employees of the Businesses accrued in the ordinary course of the Businesses, subject to proration as described in Section 1.7 below.

The assumption by the Purchaser of the Assumed Liabilities shall not enlarge any rights or remedies of any third parties under any contracts or arrangements so assumed. Nothing herein shall prevent the Purchaser from contesting in good faith any of the Assumed Liabilities. At Closing, the Purchaser shall deliver to the Company an instrument, dated the Effective Time and reasonably satisfactory in form and substance to it, pursuant to which the Purchaser will assume the Assumed Liabilities.

1.6. Limitations on Assumption. Notwithstanding Section 1.5 above, the Purchaser will not assume and does not agree to pay or discharge any obligations or liabilities of the Company not specifically included in the Assumed Liabilities. In particular, without limiting the generality of the definition of “Unassumed Liabilities” under Section 1.4 above, the Purchaser shall not assume or agree to pay or discharge any of the following, whether known or unknown:

(i) any notes or accounts payable or other obligations for borrowed money;

(ii) any trade payables of any kind, regardless of whether entered into in the ordinary course of business, no-compete payments, and amounts payable to any employee benefit plan or to any preneed or perpetual care trust;

(iii) any federal, state or local tax of any type, whether arising by reason of the sale of the Assets or by operation of the Businesses prior to the Closing Date;

(iv) any losses, costs, damages or expense based upon or arising from any claims, litigation, legal proceedings or other actions against the Company based upon any set of facts occurring prior to the Closing, including without limitation any litigation disclosed on Schedule 3.14;

(v) the liabilities and obligations under any warranties to customers with respect to goods or products sold or services provided by the Company prior to Closing;

(vi) all personal injury, product liability claims, claims of environmental damage, claims of hazards to health, strict liability, toxic torts, enforcement proceedings, cleanup orders and other similar actions or claims instituted by private parties or governmental agencies, if any, with respect to the operation of the Businesses prior to Closing; or

(vii) any other liability or obligation not specifically included within the Assumed Liabilities.



1.7. Certain Prorations. All prepaid expenses and deposits, and all expenses for which liability has accrued but whose payment is not yet due as of the Effective Time (including but not limited to (i) utility deposits and charges, including electricity, water and sewer charges, (ii) transferable business and license fees, including any retroactive adjustments thereof, (iii) real and personal property taxes in connection with the Assets, (iv) employee wages and operating expenses, and (v) similar prepaid and deferred items), together with all revenues and expenses arising from the operation of the Businesses, shall be prorated and adjusted between the Company and the Purchaser in accordance with the principle that the Company shall retain all revenues and shall be responsible for all expenses allocable to the conduct of the Businesses up to 11:59 p.m. on December 31, 2006, and the Purchaser shall be entitled to all revenues and shall be responsible for all expenses allocable to the conduct of said Business after the Effective Time. Revenues and expenses shall be allocated according to the date of death of the deceased; provided that the Company shall be responsible to pay all amounts due for markers to be delivered after the Effective Time to the extent it has received payment from the customer prior to the Effective Time. Utility services will be transferred to the Purchaser's name on the Closing Date. If the actual amounts to be prorated are not known as of the Closing Date, the prorations shall be made on the basis of the best evidence then available, and thereafter, within thirty (30) days after actual figures are received, a cash settlement will be made between the Company and the Purchaser.

1.8. Instruments of Transfer. At the Closing, the Company shall deliver to the Purchaser such instruments of transfer, assignment and conveyance, including (without limitation) general warranty deeds, bills of sale, lease assignments and assignments of motor vehicle registrations, all dated as of the Effective Time, transferring title to the Assets to the Purchaser as may reasonably be requested by the Purchaser. Such instruments shall be reasonably satisfactory in form and substance to the Purchaser and shall vest in the Purchaser good and marketable title to all the Assets, free and clear of all Liens other than (i) Permitted Exceptions against Real Property and (ii) vehicle leases listed on Schedule 3.9.

1.9. Delivery of Records, Contracts and Trust Funds. At the Closing, the Company will deliver to the Purchaser all of the leases, contracts, commitments and rights of the Businesses constituting a portion of the Assets, with such assignments thereof and consents to assignment as the Purchaser shall deem necessary to assure the Purchaser of their full benefit. Simultaneously with such deliveries, the Company shall take all requisite steps to put the Purchaser in actual possession and operating control of the Assets and all of the records, books and other data necessary for the operation of the Businesses. In addition, at the Closing, the Company and the Purchaser shall take all necessary or appropriate action to cause the transfer of the preneed and perpetual care trust funds referred to in Section 3.10 including, without limitation, the obtaining of any governmental and third party consents and the substitution of fund trustees.

1.10. Taxes. Any sales or transfer taxes which may be payable in connection with the sale of the Assets under this Agreement shall be paid by the Company.

1.11. Retained At-Need Funeral Receivables. The Purchaser shall have the exclusive (even as to the Company) right and control over the collection of Retained At-Need Funeral Receivables. For each full or partial calendar month during the 120-day period following the Effective Time in which any Retained At-Need Funeral Receivables are collected, the Purchaser shall remit 100% of such collections to the Company by no later than the 15th day of the following month. The Purchaser shall pursue collection of Retained At-Need Funeral

Receivables by substantially the same efforts as used on its collection of other accounts receivable, but in no event shall the Purchaser be required to institute suit or refer any account to a collection agency. Any collections on Retained At-Need Funeral Receivables following expiration of such 120-day period shall be for the account of the Purchaser.

1.12. Employee Matters. On the Closing Date, the Purchaser may (but shall not be required to) offer employment to each employee of the Businesses listed on Schedule 3.17. Each such employee so offered employment who accepts shall, effective as of the Closing Date, cease to be an employee of the Company and shall thereupon become an employee of the Purchaser. The Company shall be responsible for satisfying all claims, if any, of such employees as to health benefits, workers compensation claims, termination and severance benefits, and any withdrawal liability and vested rights under any pension or profit sharing plans, all arising and accrued to the Closing Date, and in no event shall the Purchaser have any liability or responsibility in respect thereof.

1.13. Lockbox/ACH Services. The Company shall permit the Purchaser to utilize the Company's existing lockbox account and ACH wire services at American Bank in Corpus Christi, for transitional purposes until such time (not to exceed 180 days following the Effective Time) that the Purchaser is able to have customer payments redirected to the Purchaser's own accounts. The parties shall coordinate with one another such that the Purchaser receives out of such accounts or funds transfers all cash which is included in the Assets or otherwise for its account in accordance with this Agreement, and that the Company receives any cash included in or arising from the Retained Assets or which is otherwise for its account in accordance with this Agreement.

1.14. Lakeside Perpetual Care Fund. The parties acknowledge that the Company has established a perpetual care account or fund with Bank of America, N.A. (the "Lakeside PC Account") that was intended for the conversion of Sunshine Cemetery from a family cemetery into a perpetual care cemetery and the expansion thereof into the Lake Placid Estates Property. The Company deposited the principal sum of \$50,000 into the Lakeside PC Account, has not withdrawn any of the principal thereof, initially applied for the establishment of a perpetual care cemetery but has not sold any spaces or other property at this location. The Assets shall include the Company's interests in the Lakeside PC Account only insofar as it shall be necessary for the Purchaser to comply with applicable law with respect to its ownership and operation of the Sunshine Cemetery (without the Purchaser having to fund any amounts thereto), provided that the Purchaser will not itself sell any spaces or other property in Sunshine Cemetery on a perpetual care basis supported by the Lakeside PC Account. It is the Company's intent to seek to withdraw its application and permission to dissolve the Lakeside PC Account and cause the distribution of all funds therein. The Purchaser agrees to reasonably cooperate with the Company in such efforts, at no out-of-pocket cost to the Purchaser. If the Company demonstrates to the Purchaser's reasonable satisfaction that it has received all applicable consents and approvals required to permit the dissolution of the Lakeside PC Account and the distribution of all funds therein, the Purchaser shall take all such action reasonably requested of it so that such funds may be distributed to the Company or its designee.

1.15. Perimeter Fence. The Company is in the process of completing construction of a fence along the Airline Road side of the Seaside Cemetery. The Company represents that it has previously purchased and has on hand at the Seaside Cemetery all materials necessary to complete such construction, and such materials shall be included in the Assets. The Company has heretofore been utilizing Seaside Cemetery personnel for such construction. If construction

of the fence is not complete by the Closing Date, then at or prior to the Closing, the parties shall mutually agree as to the number of labor hours which are estimated to be required to complete construction and the weighted average cost per hour, and the product of such hours to completion multiplied by such average cost shall be deducted from the Purchase Price, and the Purchaser shall be responsible for completing such construction following the Closing.

1.16. Further Assurances. The Company shall from time to time after the Closing, without further consideration, execute and deliver such instruments of transfer, conveyance and assignment (in addition to those delivered pursuant to Section 1.8), and shall take such other action, as the Purchaser may reasonably request to more effectively transfer, convey and assign to and vest in the Purchaser, and to put the Purchaser in actual possession and control of, each of the Assets.

## 2. The Closing.

2.1. Time and Place. The closing of the transactions contemplated under this Agreement (the "Closing") shall occur at the offices of Welder Leshin, L.L.P., 800 N. Shoreline, Suite 300-N, Corpus Christi, Texas 78401 at 9:00 a.m. on January 5, 2007, or at such other date, time or place as may be mutually agreed upon by the parties, but in no event later than January 31, 2007 (subject to Section 7.4, hereafter the "Outside Closing Date"). The date and time on which Closing actually occurs is herein called the "Closing Date." All action to be taken at the Closing as hereinafter set forth, and all documents and instruments executed and delivered, and all payments made with respect thereto, shall be considered to have been taken, delivered or made simultaneously, and no such action or delivery or payment shall be considered as complete until all action incident to the Closing has been completed.

2.2. Effective Time. The parties agree that, regardless of when Closing actually occurs, the purchase and sale of the Assets hereunder shall be deemed to have occurred for all tax, accounting and other purposes as of 12:01 a.m. on January 1, 2007 (the "Effective Time"), and the parties agree to reflect the Effective Time for such purposes in all tax returns and reports in connection therewith. The Company shall take reasonable measures between the Effective Time and the Closing Date to minimize the amount of deposits made into Company accounts, recognizing that if Closing occurs, revenues after the Effective Time are for the Purchaser's account. In any event, if Closing occurs, the parties shall coordinate with one another at and following Closing so that all business activity between the Effective Time and the Closing shall be for the Purchaser's account.

2.3. Non-Competition Agreement. In addition to the purchase and sale of the Assets, at the Closing Michael L. Mintz and Henry Nuss, residents of Nueces County, Texas (together, the "Directors") and the Purchaser shall each execute and deliver to the other a Non-Competition Agreement to be dated the Effective Time and in substantially the form attached as Exhibit 2.2 (the "Non-Competition Agreement"). The parties acknowledge that the Directors are members of the Board of Directors of the Company, have had and continue to have access to the trade secrets, customer information and other confidential and proprietary information of the Businesses and have become identified with the goodwill of the Homes and the Cemeteries, and that the Purchaser would be unwilling to consummate the transactions hereunder but for the Directors' covenants and agreements under the Non-Competition Agreement.

3. Representations and Warranties of the Company. The Company represents and warrants to and agrees with the Purchaser that:

3.1. Organization and Existence. The Company is a corporation duly organized, validly existing and in good standing under the laws of the State of Texas, with all requisite corporate power to enter into and perform its obligations under this Agreement.

3.2. Financial Information. The Company has delivered to the Purchaser (i) the unaudited (compiled) statements of assets, liabilities and stockholders' equity-income tax basis of the Company at December 31, 2005 and 2004 and the related unaudited (compiled) statements of revenues, expenses and retained earnings and cash flows-income tax basis for the respective twelve-month periods of operations of the Company then ended, together with the footnotes thereto and the compilation report thereon of Jennings, Hawley & Co., P.C. dated April 21, 2006, and (ii) the unaudited balance sheet of the Company at September 30, 2006 and the related unaudited income statement for the nine-month period of operations then ended. All of such financial statements are, to the Company's knowledge, true and correct, have been prepared in accordance with the books and records of the Company, and present fairly the respective financial positions of the Company at the dates thereof and the respective results of its operations for the periods then ended in accordance with the accounting basis used by the Company for federal income tax purposes. Schedule 3.2 accurately sets forth for the twelve-month periods ended December 31, 2004 and 2005 and for the ten months ended October 31, 2006, to the Company's knowledge, (i) for each Home the number of contracts entered into in which human remains have been prepared for final disposition or delivery, and among such contracts the number or percentage in which disposition is by burial, cremation or other means, and (ii) for each Cemetery, the number of interments performed. Schedule 3.2 also accurately sets forth, to the Company's knowledge for each Cemetery, the area which has been platted, developed and dedicated for cemetery use, the area which is undeveloped but usable, the area which is unusable for development, and the approximate minimum number of unsold individual grave spaces, unsold niches, unsold mausoleum crypts and unsold lawn crypts.

3.3. Title to and Status of Assets. All assets, rights and properties required in the operation of the Businesses are owned or validly leased by the Company and are included within the Assets. The Company is in actual possession and control of all properties owned or leased by it which are required in the operation of the Businesses, and the Company has good and marketable title to all of the Real Property and the other Assets, free and clear of all Liens other than (i) Liens described on Schedule 3.3 that are to be released at or prior to Closing, (ii) easements and other title exceptions to the Real Property described on Schedule 3.3 as "Permitted Exceptions" (herein so called), (iii) vehicle leases described on Schedule 3.9, and (iv) the Ocean Drive Entrance Tract, which the Company shall acquire prior to Closing as contemplated in Section 7.8 and as to which at Closing the Company will have good and marketable title, free and clear of all Liens other than Permitted Exceptions.

3.4. Absence of Changes or Events. Since September 30, 2006, there has not been, to the Company's knowledge:

- (i) any material adverse change in the financial condition, operations, properties or prospects of the Businesses;
- (ii) any material damage, destruction or losses against the Businesses or any of its properties;

(iii) any claim made against the Company alleging material damages for alleged negligence or other tort or breach of contract by or affecting the Company;

(iv) any sale, transfer or other disposition of, or agreement to sell, transfer or otherwise dispose of, any of the inventories or other assets or properties of the Company, except herein or in the ordinary course of business;

(v) any labor strike or labor dispute, or the entering into of any collective bargaining agreement, with respect to employees of the Company; or

(vi) any other material transaction or event entered into or affecting the Company other than in the ordinary course of the Businesses.

3.5. Real Property. Schedule 3.5 sets forth a legal description of all parcels of real property included in the Real Property, and also briefly describes each building and major structure and improvement thereon. No person other than the Company has any interest in, or other right to occupy any portion of, the Real Property (except as disclosed on Schedule 3.3, and except for the lease of the flower shop disclosed on Schedule 3.9). The Real Property is the only interest in real property required for the conduct of the business of the Businesses as presently conducted. There is not, to the Company's knowledge, any pending or threatened proceeding for the taking or condemnation of the Real Property or any portion thereof. The Company is not a "foreign person" or a "United States real property holding corporation" (as defined in Section 1445(f)(3) of the Internal Revenue Code of 1986, as amended [the "Code"], and the regulations issued thereunder). The Company shall deliver at Closing a non-foreign affidavit in recordable form containing such information as shall be required by Code Section 1445(b)(2) and the regulations issued thereunder. All bills and other payments due with respect to the Company's operation and maintenance of the Real Property have been (or on the Closing Date will be) paid, and no Liens or other claims for the same will be in force against any part of the Real Property.

3.6. Tax Matters. All federal, state, county, local and other taxes due and payable on or before the date of this Agreement in respect of the operation of the Company and the ownership of the Assets have been paid. All tax returns and reports required to be filed for all such taxes have been filed with all taxing authorities, and all such tax returns and reports are, to the Company's knowledge, true and correct. True and correct copies of the federal income tax returns filed by the Company for each of its last three taxable years have been furnished to the Purchaser. No assessments of deficiencies have been made against the Company which are presently pending or outstanding. No agreements, waivers or extensions of time are in effect for the assessment of deficiencies in respect of the business or any of the Assets. Following the Closing, the Company shall be responsible for accurately and completely preparing, signing and filing all tax returns and paying all taxes in respect of the assets and operations of the Company through the Effective Time and for the sale of the Assets.

3.7. Accounts Receivable; Inventory. The accounts receivable of the Businesses are, and on the Closing Date will be, valid and legally enforceable obligations of the account parties and are not subject to any claim of offset or deduction against the Company. The Company does not own any of its inventory of caskets; all such inventory is held on consignment. At the Closing, the Company will deliver to the Purchaser a list of (i) all accounts receivable of the Businesses, segregated according to those included in the Assets and those retained by the Company among the Retained Assets, in each case as of a date no earlier than January 1, 2007, and after giving effect to any bad debt reserves or charge-offs taken by the Company in 2007 as

show on such list, and (ii) a list of its consigned inventory of caskets and a list of the Cemeteries' inventory of vaults and granite bases, as of the Effective Time.

3.8. Fixed Assets. Schedule 3.8 lists all motor vehicles and other material items of equipment, fixtures, furniture and other fixed assets used in the operation of the Businesses ("Fixed Assets"), all of which are included in the Assets. ALL IMPROVEMENTS ON THE REAL PROPERTY, AND ALL FIXED ASSETS OF THE BUSINESSES, ARE BEING SOLD TO THE PURCHASER HEREUNDER "AS IS," IN THEIR PRESENT CONDITION, WITHOUT REPRESENTATION OR WARRANTY WHATSOEVER REGARDING THEIR PHYSICAL CONDITION, MERCHANTABILITY OR FITNESS FOR ANY PARTICULAR PURPOSE.

3.9. Contracts and Commitments. Schedule 3.9 sets forth a complete description of:

(i) all (i) contracts or commitments for capital expenditures for the Company involving obligations aggregating in excess of \$5,000, (ii) leases under which personal property is leased by the Company and which are not cancelable by either party thereto without penalty upon notice of 30 days or less or pursuant to which rentals exceed \$1,000 per annum or \$5,000 in the aggregate, or (iii) contracts and agreements of the Company which do not terminate or are not terminable by the Company upon notice of 30 days or less or which involves an obligation on its part in excess of \$1,000 per annum or \$5,000 in the aggregate;

(ii) any other contract and commitment of the Company entered into outside the ordinary course of business; and

(iii) all other contracts and commitments of the Company to be included in the Assets and transferred to and assumed by the Purchaser at Closing.

Each contract and other document required to be described in Schedule 3.9 is, to the Company's knowledge, valid and in full force and effect, with neither party in default thereunder. A true and correct copy of each document listed on Schedule 3.9 has been delivered to the Purchaser by the Company.

3.10. Preneed Contracts and Trust Accounts. Schedule 3.10 accurately lists, to the Company's knowledge, as of the date of this Agreement (or as of a date no older than 45 days prior to the date hereof), all preneed agreements included in the Assets, including contract number, customer name, sale date, contract price and other data normally included in the Company's internal records in a compilation of preneed agreements; a list of all insurance policies used to fund preneed agreements, including policy number, insured and owner names, issue date, current and face amount of insurance, and other data included in the Company's internal records in a compilation of insurance policies (and for each carrier providing such insurance benefits, the contact information for the carrier, including contact person, address and phone number); and the trust liability report for each trust account (preneed and perpetual care) relating to the Businesses, indicating the location of each and the amount held in trust, with detail of principal, income or earnings, withdrawals and outstanding balance. The Company has separately provided to the Purchaser true and complete copies of the trust agreements for such trusts, as amended and currently in effect, together with bank statements or other periodic report of the trustee for each trust, tax returns, and the audit or other reports furnished to or prepared by the state regulatory agency which oversees such trusts. All preneed contracts required to be listed on Schedule 3.10 (x) have largely been, to the Company's knowledge, entered into in the

normal course of business at regular retail prices, or pursuant to a sales promotion program, solely for use by the named customers and members of their families on terms not more favorable than shown on the specimen contracts which have been delivered to the Purchaser, (y) are subject to the rules and regulations of the Businesses as now in force (copies of which have been delivered to the Purchaser), and (z) on the date hereof are in full force and effect, subject to no offsets, claims or waivers, and the Company is not in default thereunder. All funds received by the Company under preneed contracts and for perpetual care which are required to have been deposited have been, to the Company's knowledge, deposited in the appropriate accounts and administered and reported in accordance with the terms thereof as required by applicable laws and regulations. The aggregate market value of such preneed accounts, trusts and other deposits is equal to or greater than the aggregate cost to provide the services and merchandise covered thereby (it being understood that the foregoing does not apply to markers, for which preneed income is not required to be trusted). The services heretofore provided by the Businesses have been, to the Company's knowledge, generally rendered in a professional and competent manner consistent with prevailing professional standards, practices and customs.

3.11. IP Rights. Schedule 3.11 accurately and completely lists all trade names used in the operation of the Businesses. The Company owns such intellectual property rights as are necessary to the conduct of the Businesses as presently conducted, including without limitation the use of the trade names referred to in Section 1.1(vii). The Company has not been charged with infringement of any intellectual property rights of any other person, nor does the Company know of any infringement of the Company's trade names.

3.12. Insurance and Claims. The Company maintains such policies of insurance in such amounts, and which insure against such losses and risks, as it reasonably deems appropriate. Valid policies for such insurance will remain outstanding and duly in force at all times until the Closing.

3.13. Licenses, Permits, Etc. Schedule 3.13 lists all licenses, franchises, permits, certificates, consents, rights and privileges currently held by or issued to the Company, and by each funeral director and embalmer of the Homes and each employee holding an insurance agent's license, which are all that the Company reasonably deems necessary or appropriate for the operation of the Businesses. All such items are in full force and effect.

3.14. Litigation. There are no claims, actions, suits, proceedings or investigations pending or, to the Company's knowledge, threatened against the Company affecting the Businesses or the Company, or any of the Assets, at law or in equity or before or by any court or federal, state, municipal or other governmental department, commission, board, agency or instrumentality, except for lawsuit disclosed on Schedule 3.14. To its knowledge, the Company is not subject to, and its assets are not affected by, any continuing court or administrative order, writ, injunction or decree, except for findings arising in Texas Department of Banking audits that have been fulfilled and which the Company has previously disclosed to the Purchaser; nor is the Company in default with respect to any order, writ, injunction or decree issued by any court or foreign, federal, state, municipal or other governmental department, commission, board, agency or instrumentality.

3.15. Compliance with Laws. To the Company's knowledge, the Businesses are currently operating in all material respects with federal, state, municipal and other statutes, rules, ordinances and regulations applicable to them and the Assets (including without limitation all

occupational safety and health rules, regulations and laws, and laws and regulations applicable to preneed contracts and trust accounts, including the so-called “FTC Funeral Rule”).

3.16. Environmental Matters. The Purchaser will have full opportunity under Section 7.7 to conduct environmental site assessments of the Real Property and perform other due diligence in connection therewith. The following representations of the Company are therefore qualified in their entirety (i) by any information obtained by the Purchaser in such investigations and (ii) to the extent of the Company’s knowledge.

The Company has complied and is in compliance in all material respects with all Environmental Laws (as hereinafter defined). The Company has not received any written notice that the Businesses or the Real Property is subject to any liabilities or investigatory, remedial or corrective obligations arising under any Environmental Laws. There does not exist on any portion of the Real Property any underground storage tank or surface impoundments (the Company has disclosed to the Purchaser the existence of a removed underground storage tank for which a final site closure report was filed in July 2002); any asbestos-containing material that is in friable or frayed condition; or any materials or equipment containing polychlorinated biphenyls. The Company has not treated, stored, disposed of, arranged for or permitted the disposal of, transported, handled, or Released any substance, including without limitation any Hazardous Materials, or owned or operated any facility or property, so as to give rise to liabilities for response costs, natural resource damages or attorneys fees pursuant to the Comprehensive Environmental Response, Compensation and Liability Act of 1980 (“CERCLA”), as amended, or similar state Environmental Laws, except for formaldehyde and other chemicals used in the ordinary course of the conduct of the Businesses, which the Company has obtained, used, stored and disposed of in accordance with all Environmental Laws. For purposes of this Section 3.16:

“Environmental Laws” means all laws concerning pollution or protection of the environment (including without limitation all those relating to the presence, use, production, generation, handling, transportation, treatment, storage, disposal, distribution, labeling, testing, processing, discharge, Release, threatened Release, control or cleanup of any Hazardous Materials, substances or wastes, chemical substances or mixtures, pesticides, pollutants, contaminants, toxic chemicals, petroleum products or byproducts, asbestos, polychlorinated biphenyls, noise or radiation).

“Hazardous Materials” means any hazardous, toxic, dangerous or other waste, substance of material defined as such in, regulated by or for purposes of any Environmental Law.

“Release” has the meaning set forth in CERCLA.

3.17. Employees. Schedule 3.17 correctly and completely lists the names and annual or hourly rates of salary and other compensation of all the employees and agents of the Company, and the outstanding balance of and method for calculating employee reserves and residuals. By the time of Closing, the Purchaser will have interviewed each of the Company’s employees and made such decisions as it has deemed appropriate under Section 1.12. Schedule 3.17 also sets forth each such employee’s tenure for purposes of determining vacation time and sick leave, and upon hiring any such employee under Section 1.12, the Purchaser agrees to give each such employee credit on the same basis as that vacation and sick leave is provided for Purchaser’s other employees, crediting such employee’s longevity to the beginning date of such employee’s employment by the Company. Schedule 3.17 also lists all employment, agency, compensation, noncompetition, confidentiality, severance, bonus and other similar agreements with employees



and agents of the Businesses, true and complete copies of which have been delivered to the Purchaser. By the time of Closing, the Company shall have fully funded all obligations accrued through Closing under its 401(k) or profit sharing plan and shall have provided the Purchaser with reasonable assurance thereof. There are not pending nor, to the Company's knowledge, threatened against the Company any general labor disputes, strikes or concerted work stoppages, and there are no discussions, negotiations, demands or proposals that are pending or have been conducted or made with or by any labor union or association with respect to any employees of the Company. The Company believes that the relations between the Company and its employees are good.

3.18. Books and Records. To the Company's knowledge, all books and records of the Company have been maintained in all material respects in accordance with good business practice and in accordance with all laws, regulations and other requirements applicable to the Businesses.

3.19. Finders. The Company is not a party to or in any way obligated under any contract or other agreement, and there are no outstanding claims against the Company, for the payment of any broker's or finder's fee in connection with the origin, negotiation, execution or performance of this Agreement.

3.20. Authority. The execution, delivery and performance of this Agreement by the Company has been duly authorized by all necessary corporate action required on its part. This Agreement is legally binding and enforceable against the Company in accordance with its terms. Neither the execution, delivery nor performance of this Agreement by the Company will result in a violation of the Articles of Incorporation or Shareholders' Agreement governing the Company, nor violate any order, writ, injunction or decree of any court, administrative agency or governmental body.

3.21. Schedules. The Schedules referred to in this Section 3 will be prepared in a separate binder or volume, signed for identification by the President of the Company and will be delivered in the manner described in Section 7.6.

4. Representations and Warranties of the Purchaser. The Purchaser represents and warrants to and agrees with the Company that:

4.1. Organization and Existence. The Purchaser is a corporation duly organized, validly existing and in good standing under the laws of the State of Texas, and has all requisite corporate power to enter into and perform its obligations under this Agreement.

4.2. Authority of the Purchaser. The execution, delivery and performance by the Purchaser of this Agreement have been duly authorized by all necessary corporate action required on its part. This Agreement is valid and binding upon the Purchaser and enforceable against it in accordance with their respective terms. Neither the execution, delivery or performance by the Purchaser of this Agreement will conflict with or result in a violation or breach of any term or provision of, nor constitute a default under, the Articles of Incorporation or bylaws of the Purchaser or under any indenture, mortgage, deed of trust or other contract or agreement to which it is a party or by which the Purchaser or its property is bound, or violate any order, writ, injunction or decree of any court, administrative agency or governmental body.

4.3. Finders. The Purchaser is not a party to or in any way obligated under any contract or other agreement, and there are no outstanding claims against it, for the payment of

any broker's or finder's fee in connection with the origin, negotiation, execution or performance of this Agreement.

5. Covenants of the Company Pending Closing. The Company covenants with the Purchaser that:

5.1. Conduct of Business. From the date of this Agreement to the Closing Date, the Businesses will be operated only in the ordinary course, and, in particular, without the prior written consent of the Purchaser, the Company will not:

- (i) cancel or permit any insurance to lapse or terminate, unless renewed or replaced by like coverage;
- (ii) commit any act or permit the occurrence of any event or the existence of any condition of the type described in Section 3.4;
- (iii) enter into, modify or renew any contract, agreement or commitment of the type described in Section 3.9;
- (iv) hire, fire, reassign or make any other change in key personnel of the Company, or increase the rate of compensation or make any other material changes in the terms of their employment; or
- (v) take any other action which would cause any of the representations and warranties made in Section 3 hereof not to be true and correct in all material respects on and as of the Closing Date with the same force and effect as if the same had been made on and as of the Closing Date.

The Company may, without the Purchaser's prior approval, pay cash bonuses or compensation to employees of the Businesses as the Company deems appropriate, to the extent related to the sale of Assets hereunder, provided that (i) such bonuses or compensation are completely fulfilled by the Company out of the cash included in Retained Assets, and (ii) any communications to employees regarding such bonuses or compensation (as well as any other communications to employees relating to the sale of Assets or their possible employment following the Closing) shall be conducted jointly with the Purchaser.

5.2. Access to Information. Prior to Closing, the Company has given, and will continue to give, to the Purchaser and its counsel, accountants and other representatives, full and free access to all of the properties, books, contracts, commitments and records of the Company so that the Purchaser may have full opportunity to make such investigation as it shall desire to make of the Businesses and the affairs of the Company and the Assets. The Company has provided, and will also continue to provide, the Purchaser and its representatives with access to all employees of the Businesses to afford the Purchaser the opportunity to conduct such interviews and evaluations as the Purchaser deems appropriate.

5.3. Consents and Approvals. The Purchaser shall be responsible for obtaining all consents, approvals, authorizations and other actions of or by any administrative agency, bureau or other governmental authority, including without limitation the Texas Department of Banking and the Texas Funeral Commission, and for any declaration, filing, or registration with any public body, governmental or regulatory authority, that is necessary or required as a condition to the Purchaser's operation of the Businesses being purchased pursuant to this Agreement. The

Company will cooperate with the Purchaser in its efforts to obtain the necessary consents and approvals of other persons which may be required to be obtained on their part to consummate the transactions contemplated by this Agreement, including the giving of such notices as may be required under applicable law as requested by the Purchaser.

5.4. No Shop. For so long as this Agreement remains in effect, the Company agrees that it will not enter into any agreements or commitments, or initiate, solicit or encourage any offers, proposals or expressions of interest, or otherwise hold any discussions with any potential buyers, investment bankers or finders, with respect to the possible sale or other disposition of all or any substantial portion of the Assets, the sale of all or a controlling interest in the stock of the Company, or the merger or consolidation of the Company, other than with the Purchaser. If the Company or anyone acting on its behalf (including either Director) receives from any third party any inquiry regarding such a transaction, the Company shall promptly notify the Purchaser.

5.5. Employee Training; Systems Installation. To help prepare for and facilitate the transition of the Businesses to the Purchaser's ownership at and following the Effective Date, the Purchaser intends prior to Closing to begin providing certain training to select employees of the Businesses and to begin installation of certain of the Purchaser's management information systems. The Company agrees to allow the Purchaser to provide such training and installation. All training modules and all such systems shall remain the sole and exclusive property of the Purchaser, but the Purchaser's training and installation shall be at its sole cost, expense and risk. The Company shall not be required to incur any out-of-pocket expenses in connection with such training and installation. The Company makes no representation or warranty whatsoever regarding the compatibility of the Businesses' systems with those of the Purchaser. If this Agreement is terminated for any reason, the Purchaser will be entitled to remove, at its sole risk and expense, all training modules and systems so provided or installed by it.

6. Covenants of the Purchaser Pending Closing. The Purchaser covenants with the Company that:

6.1. Consents and Approvals. The Purchaser will use its best efforts to obtain the necessary consents and approvals of other persons which may be required to be obtained on its part to consummate the transactions contemplated in this Agreement.

6.2. Confidentiality. Prior to the Closing, the Purchaser and its representatives will hold in confidence all data and information obtained with respect to the Businesses from any representative or employee of the Company, including the accountants or legal counsel of the Company, or from any books, records or computer files of any of them, in connection with the transactions contemplated by this Agreement. If the transactions contemplated hereby are not consummated, neither the Purchaser nor its representatives shall use such data or information or disclose the same to others, except as such data or information is published or is a matter of public knowledge or is required by an applicable law or regulation to be disclosed. If this Agreement is terminated for any reason, all written data and information obtained by the Purchaser from the Company or their representatives in connection with the transactions contemplated by this Agreement shall be returned to the Company.

7. Conditions to Obligations of the Purchaser. The obligations of the Purchaser under this Agreement shall be subject to the following conditions, any of which may be expressly waived by the Purchaser in writing:

7.1. Representations and Warranties True; Covenants Performed. The Purchaser shall not have discovered any material error, misstatement or omission in the representations and warranties made by the Company in Section 3 hereof; the representations and warranties made by the Company herein shall be deemed to have been made again at and as of the time of Closing and shall then be true and correct; the Company shall have performed and complied with all agreements and conditions required by this Agreement to be performed or complied with by them at or prior to the Closing; and the Purchaser shall have received a certificate, signed by the President of the Company, to the effect of the foregoing provisions of this Section 7.1.

7.2. Opinion of Counsel. The Company shall have caused to be delivered to the Purchaser an opinion of Welder Leshin, L.L.P., counsel for the Company, dated the Closing Date, in substantially the form of Exhibit 7.2.

7.3. Consents and Approvals. The Purchaser shall have obtained all consents and approvals of other persons and governmental authorities to the transactions contemplated by this Agreement.

7.4. No Loss or Damage. Prior to the Closing there shall not have occurred any loss or damage to any substantial portion of the Assets, regardless of whether such loss or damage was insured. In the event of any such loss or damage, the Company shall promptly inform the Purchaser, and the Company shall be allowed a reasonable time thereafter (not to exceed sixty (60) days after the Outside Closing Date) within which to repair or replace such loss or damage. The Company, however, shall be under no obligation to repair or replace such loss. In the event the Company does not promptly begin such repair or replacement or do not complete such repair or replacement within said 60-day period, the Purchaser may (in its sole discretion) either (a) complete the sale contemplated by this Agreement (with such Assets in their damaged condition) and receive an assignment of the Company's insurance claim or claims relating to such loss or damage, or (b) terminate this Agreement without any obligation to pay any amounts to the Company.

7.5. Approval by Counsel. All actions, proceedings, instruments and documents required to carry out the transactions contemplated by this Agreement or incidental thereto and all other related legal matters shall have been approved by counsel for the Purchaser.

7.6. Pre-Acquisition Review; Schedule Delivery. The Purchaser and its representatives shall have completed a pre-acquisition review of the financial information, books and records, and properties and assets of the Company and the Businesses and shall have discovered no change in the business, assets, operations, financial condition or prospects of the Company or the Businesses which could, in the sole determination of the Purchaser, have an adverse effect on the value to the Purchaser of the Assets and business being acquired hereunder. In addition, the Company shall have delivered to the Purchaser the Schedules to this Agreement in the manner described in Section 3.21 on or before January 3, 2007, the disclosures in which shall be as of such date (except to the extent that a different date is called for in the applicable Section), and the disclosures in such Schedules shall be acceptable to the Purchaser in its sole determination. Also, the lists of accounts receivable and inventory delivered to the Purchaser under Section 3.7 shall be acceptable to the Purchaser.

7.7. Environmental, OSHA and Structural Reports. There shall have been conducted, at the Purchaser's expense, (i) a Phase I (and, if deemed necessary by Purchaser, a Phase II) environmental inspection of the Businesses and the Real Property by an environmental consulting firm selected by Purchaser, (ii) a health and safety inspection of the Businesses by a person (who may be an employee of the Purchaser) or firm selected by the Purchaser and who is qualified and experienced in such matters in the funeral industry, and (iii) a structural inspection of the Businesses by an engineering firm selected by the Purchaser. If any remedial or corrective actions are recommended as a result of such inspections, then the cost thereof in an amount not to exceed \$50,000 in the aggregate shall be deducted from the Purchase Price; if the cost of such actions exceeds \$50,000, then the Purchaser may (in its sole discretion) either (a) proceed with Closing and deduct \$50,000 from the Purchase Price, or (b) terminate this Agreement without any obligation to pay any amounts to the Company. In any event, it shall be a condition to the Purchaser's obligations hereunder that the results of the reports of such firms or persons shall be satisfactory to Purchaser in its sole discretion.

7.8. Ocean Drive Entrance Tract. The Company shall have acquired fee simple title to the Ocean Drive Entrance Tract and be prepared to transfer title thereto to the Purchaser, together with all other Real Property, free and clear of all Liens other than Permitted Exceptions.

7.9. Lake Placid Estates Property. There shall have been imposed in favor of the Purchaser on the real property located within the Lake Placid Estates Subdivision and the related real property connecting Lake Placid Estates to Sunshine Cemetery, all as further described on Schedule 7.9 (collectively, the "Lake Placid Estates Property") a restriction prohibiting the use thereof as a funeral home, mortuary, crematory, cemetery or related business for 25 years after the Closing Date, pursuant to a written instrument signed and notarized by the Company or other owner of the Lake Placid Estates Property, suitable for recordation and in form and content reasonably satisfactory to the Purchaser. In addition, the Purchaser shall be reasonably satisfied that no prior Liens exist against the Lake Placid Estates Property which would have priority over such deed restriction, or that any holders of such Liens shall have consented to such deed restriction.

7.10. Title Insurance. The Purchaser shall have received a Owner's Policy of Title Insurance issued to Purchaser insuring its ownership interest in the Real Property. Such policy shall have been issued in an agreed-upon amount by First American Title Insurance Company or another title company reasonably acceptable to the parties (the "Title Company") and shall be subject only to Permitted Exceptions and any standard printed exceptions included in a Texas standard form Policy of Title Insurance; provided, however, that such policy shall have deleted any exceptions regarding restrictions or be limited to restrictions that are Permitted Exceptions, any standard exceptions pertaining to discrepancies, conflicts or shortages in area shall be deleted except for "shortages in area", and any standard exceptions for taxes shall be limited to subsequent years. All premiums and other costs associated with issuing such policy shall be borne equally between the Company and the Purchaser.

7.11. Survey. The Purchaser shall have received an ALTA/ACSM survey prepared by a licensed surveyor approved by the Purchaser and acceptable to the Title Company, with respect to each parcel of the Real Property, which survey shall comply with any applicable standards under Texas law, be sufficient for Title Company to delete any survey exception contained in the Owner's Policy of Title Insurance referred to in Section 7.10, and otherwise be in form and content acceptable to Purchaser. The fees and costs associated with such survey shall be borne equally between the Company and the Purchaser.

7.12. Lien Releases. The holders of any Liens against any of the Assets shall have executed and delivered written releases of such Liens, all in recordable form and otherwise acceptable to the Purchaser.

7.13. Shareholder Consent. The Purchaser shall have received a written instrument, reasonably acceptable to the Purchaser, signed by every shareholder of the Company in which such shareholders acknowledge the transactions contemplated by this Agreement and the exhibits hereto (specifically including but not limited to the Non-Competition Agreement, including the consideration payable to the Directors thereunder), and such shareholders provide their consent thereto and waive any dissenters' rights in connection therewith.

7.14. Non-Competition Agreement. The Directors shall have executed and delivered the Non-Competition Agreement to the Purchaser.

8. Conditions to Obligations of the Company. The obligations of the Company under this Agreement shall be subject to the following conditions, any of which may be expressly waived by the Company in writing:

8.1. Representations and Warranties True; Covenants Performed. The Company shall not have discovered any material error, misstatement or omission in the representations and warranties made by the Purchaser in Section 4 hereof; the representations and warranties made by the Purchaser herein shall be deemed to have been made again at and as of the time of Closing and shall then be true and correct; the Purchaser shall have performed and complied with all agreements and conditions required by this Agreement to be performed or complied with by it at or prior to the Closing; and the Company shall have received a certificate, signed by an executive officer of the Purchaser, to the effect of the foregoing provisions of this Section 8.1.

8.2. Opinion of Counsel. The Purchaser shall have caused to be delivered to the Company an opinion of Thompson & Knight, LLP, counsel for the Purchaser, dated the Closing Date, in substantially the form of Exhibit 8.2.

8.3. Consents and Approvals. The Purchaser shall have obtained all consents and approvals of other persons and governmental authorities to the transactions contemplated by this Agreement.

8.4. Approval by Counsel. All actions, proceedings, instruments and documents required to carry out the transactions contemplated by this Agreement or incidental thereto and all other related legal matters shall have been approved by counsel for the Company.

8.5. Non-Competition Agreement. The Purchaser shall have executed and delivered the Non-Competition Agreement to the Directors and shall have paid to them the consideration called for thereunder to be paid to them on the Closing Date.

9. Nature and Survival of Representations and Warranties; Damage Claims for Breach.

9.1. Nature of Statements. All statements contained in this Agreement or any Schedule hereto shall be deemed representations and warranties only of the party executing or delivering the same.

9.2. Survival of Representations and Warranties. Regardless of any investigation made at any time by or on behalf of any party hereto, all covenants, agreements, representations and warranties made hereunder or pursuant hereto or any Schedule hereto or in connection with the transactions contemplated hereby and thereby shall not terminate but shall survive the Closing and continue in effect thereafter for a period of 540 days following the Closing, at which time said covenants, agreements, representations and warranties shall terminate for all purposes (except as to any covenant, agreement, representation or warranty as to which a written claims notice has been delivered prior to expiration of such 540-day period, in which case the same shall continue to survive and remain in effect until such claim has been finally resolved).

9.3. Damage Claims. In case of either party's breach of any covenant, agreement, representation or warranty made hereunder or pursuant hereto or any Schedule hereto or in connection with the transactions contemplated hereby and thereby, the other party shall be entitled to recover all such losses, damages, liabilities, obligations, costs or expenses, including attorneys fees, court costs, and interest (or the time value of money) from the date the Loss is incurred (any one such item being herein called a "Loss" and all such items being herein collectively called "Losses"), as shall be available to it under this Agreement and/or the laws of the State of Texas, (i) provided that any such covenant, agreement, representation or warranty shall not have expired as provided in Section 9.2, (ii) subject to the limitations described in Section 9.4 below, and (iii) provided that the exclusive remedy for recovering Losses shall be pursuant to the Escrow Agreement described in Section 10.4. Any recovery hereunder shall include any indemnification rights for third party claims as described in Section 10 below.

9.4. Certain Limitations. Each party agrees that it shall not assert a claim against the other party for damages arising under this Agreement or for third party indemnification until the aggregate of all Losses claimed by it shall be at least \$50,000, but once such threshold has been reached, such party shall be entitled to recover all of its Losses to which it is entitled hereunder, including the first \$50,000. The foregoing shall not apply to claims arising in respect of Assumed Liabilities or Unassumed Liabilities. In no event shall the Purchaser be entitled to assert any claim in respect of the accounts receivable included in the Assets unless at least 25% in face amount of such accounts receivable, as reflected in the statement to be delivered to the Purchaser under Section 3.7, prove to be uncollectible.

#### 10. Third Party Indemnification.

10.1. Indemnification by the Company. The Company agrees to indemnify and hold harmless the Purchaser and its successors and permitted assigns from and against any and all Losses to any third party incurred by any of them or to which any of them may become subject, which are caused by or arise out of (i) any breach or default in the performance by the Company of any covenant or agreement of the Company contained in this Agreement, (ii) any breach of warranty or inaccurate or erroneous representation made by the Company herein, in any Schedule delivered to the Purchaser pursuant hereto or in any certificate or other instrument delivered by or on behalf of the Company pursuant hereto, (iii) any claim made against the Purchaser in respect of any of the Unassumed Liabilities, and (iv) any and all actions, suits, proceedings, claims, demands, judgments, costs and expenses (including reasonable legal fees) incident to any of the foregoing.

10.2. Indemnification by the Purchaser. The Purchaser agrees to indemnify and hold harmless the Company and its successors and permitted assigns from and against any and all Losses to any third party incurred by any of them or to which any of them may become subject,

which are caused by or arise out of (i) any breach or default in the performance by the Purchaser of any covenant or agreement of the Purchaser contained in this Agreement, (ii) any breach of warranty or inaccurate or erroneous representation made by the Purchaser herein or in any certificate or other instrument delivered by or on behalf of the Purchaser pursuant hereto, (iii) any claim made against the Company in respect of the Assumed Liabilities, and (iv) any and all actions suits, proceedings, claims, demands, judgments, costs and expenses (including reasonable legal fees) incident to any of the foregoing.

10.3. Third Party Claims. If any third person asserts a claim against an indemnified party hereunder that, if successful, might result in a claim for indemnification against an indemnifying party hereunder, the indemnifying party shall be given prompt written notice thereof and shall have the right (i) to participate in the defense thereof and be represented, at his, her or its own expense, by advisory counsel selected by him, her or it, and (ii) to approve any settlement if the indemnifying party is, or will be, required to pay any amounts in connection therewith. Notwithstanding the foregoing, if within ten business days after delivery of the indemnified party's notice described above, the indemnifying party indicates in writing to the indemnified party that, as between such parties, such claims shall be fully indemnified for by the indemnifying party as provided herein, then the indemnifying party shall have the right to control the defense of such claim, provided that the indemnified party shall have the right (i) to participate in the defense thereof and be represented, at his, her or its own expenses, by advisory counsel selected by him, her or it, and (ii) to approve any settlement if the indemnified party's interests are, or would be, affected thereby.

10.4. Escrow. Of the Purchase Price, the sum of \$750,000 shall be placed into escrow pursuant to an Escrow Agreement to be entered into on the Closing Date among the Company, the Purchaser and Wells Fargo Bank, N.A. or another financial institution with banking offices in Nueces County, Texas having total assets of at least \$100 million and otherwise mutually acceptable to the parties, which shall act as escrow agent, such Escrow Agreement to be in substantially the form attached as Exhibit 10.4 hereto (the "Escrow Agreement"). The amount so held under the Escrow Agreement shall be maintained as security for the payment of any and all claims by Purchaser and its successors and permitted assigns against the Company arising under or in connection with this Agreement, subject to the limitations contained in section 9.4 hereof. Subject to the terms of the Escrow Agreement, (i) on the 270<sup>th</sup> day following the Closing Date, one-half of such escrow amount, less the amount of any Losses for which distributions to Purchaser have already been made out of escrow or for which there are claims then pending, shall be distributed to the Company, and (ii) on the 540<sup>th</sup> day following the Closing Date, the balance of such escrow amount, less the amount of any such Losses theretofore distributed to Purchaser or subject to pending claims, shall be distributed to the Company. Interest earned on such escrow account shall be disbursed in accordance with disbursements of principal. IF CLOSING OCCURS, THE PURCHASER ACKNOWLEDGES THAT ITS SOLE RECOURSE FOR ANY LOSSES ARISING HEREUNDER SHALL BE PURSUANT TO THE ESCROW AGREEMENT, AND THAT IN NO EVENT SHALL THE COMPANY OR ANY OF ITS SHAREHOLDERS OR THE DIRECTORS HAVE ANY LIABILITY FOR ANY SUCH LOSSES IN EXCESS OF AMOUNTS AVAILABLE THEREFOR UNDER THE ESCROW AGREEMENT.

11. Termination.

11.1. Best Efforts to Satisfy Conditions. The Company agrees to use its best efforts to bring about the satisfaction of the conditions specified in Section 7 hereof, and the Purchaser



agrees to use its best efforts to bring about the satisfaction of the conditions specified in Section 8 hereof.

11.2. Termination. This Agreement may be terminated prior to Closing by:

(a) the mutual written consent of the Company and the Purchaser;

(b) the Purchaser if a material default shall be made by the Company in the observance or in the due and timely performance by any of the Company's covenants herein contained, or if there shall have been a material breach or misrepresentation by the Company of any of the Company's warranties and representations herein contained, or if the conditions of this Agreement to be complied with or performed by the Company at or before the Closing shall not have been complied with or performed at the time required for such compliance or performance and such noncompliance or nonperformance shall not have been expressly waived by the Purchaser in writing;

(c) the Company if a material default shall be made by the Purchaser in the observance or in the due and timely performance by the Purchaser of any of its covenants herein contained, or if there shall have been a material breach or misrepresentation by the Purchaser of any of its warranties and representations herein contained, or if the conditions of this Agreement to be complied with or performed by the Purchaser at or before the Closing shall not have been complied with or performed at the time required for such compliance or performance and such noncompliance or nonperformance shall not have been expressly waived by the Company in writing; or

(d) under the circumstances described in Section 7.4 or 7.7; or

(e) either the Company or the Purchaser, if the Closing has not occurred by the Outside Closing Date.

11.3. Liability Upon Termination. If this Agreement is terminated under paragraph (a), (d) or (e) of Section 11.2, then no party shall have any liability to any other party hereunder. If this Agreement is terminated under paragraph (b) or (c) of Section 11.2, then (i) the party so terminating this Agreement shall not have any liability to any other party hereto, provided the terminating party has not breached any representation or warranty or failed to comply with any of its covenants in this Agreement, and (ii) such termination shall not prejudice the rights and remedies of the terminating party against any other party which has breached any of its representations, warranties or covenants herein prior to such termination.

12. Change of Name. Promptly following the Closing (but in no event later than 30 days thereafter), the Company shall cause the corporate documents of the Company to be amended so as to change its name to one wholly dissimilar to "Seaside Cemetery" or its equivalent (or any of the other trade names included in the Assets), and the Company will furnish the Purchaser with written evidence of such amendment.

13. Miscellaneous.

13.1. Expenses. Regardless of whether the Closing occurs, the parties shall each pay their own expenses in connection with the negotiation, preparation and carrying out of this Agreement and the consummation of the transactions contemplated herein.

13.2. Notices. All notices, requests, consents and other communications hereunder shall be in writing and shall be deemed to have been given on the date personally delivered, three business days following the date mailed, first class, registered or certified mail, postage prepaid, or when sent by fax or telecopy and receipt is confirmed, as follows:

(i) if to the Company, to:

Seaside Cemetery, Inc.  
3318 S. Alameda  
Corpus Christi, Texas 78411  
Attn: Michael L. Mintz

with a copy to:

Welder Leshin, L.L.P.  
800 N. Shoreline, Suite 300-N  
Corpus Christi, Texas 78401  
Attn: Henry Nuss

(ii) if to the Purchaser, to:

Carriage Cemetery Services, Inc.  
3040 Post Oak Blvd., Suite 300  
Houston, Texas 77056  
Attention: President

with a copy to:

Thompson & Knight, LLP  
333 Clay, Suite 333  
Houston, Texas 77002  
Attention: Mr. W. Christopher Schaeper

or to such other address as shall be given in writing by any party to the other parties hereto.

13.3. Assignment. This Agreement may not be assigned by any party hereto without the prior written consent of the other parties, provided, however, that (i) prior to Closing, the Purchaser may assign the right to purchase the Assets associated with the Homes to the Purchaser's affiliate, Carriage Management, L.P., but without relieving the Purchaser of its obligations hereunder, and (ii) following the Closing the Purchaser (and, as to the Homes, such affiliate) may assign its rights hereunder without the consent of the Company to a successor-in-interest to the Purchaser or such affiliate (whether by merger, sale of assets or otherwise). Nothing in this Agreement, express or implied, is intended to confer upon any person, other than the parties to this Agreement and their successors and permitted assigns, any rights or remedies under or by reason of this Agreement.

13.4. Successors Bound. Subject to the provisions of Section 13.3, this Agreement shall be binding upon and inure to the benefit of the parties hereto and their respective successors, assigns, heirs and personal representatives.

13.5. Section and Paragraph Headings. The section and paragraph headings in this Agreement are for reference purposes only and shall not affect the meaning or interpretation of this Agreement.

13.6. Amendment. This Agreement may be amended only by an instrument in writing executed by both parties hereto.

13.7. Entire Agreement. This Agreement and the Exhibits, Schedules, certificates and other documents referred to herein constitute the entire agreement of the parties hereto, and supersede all prior understandings with respect to the subject matter hereof and thereof (including, without limitation, the letter of intent between the Purchaser and the Company dated October 31, 2006).

13.8. Governing Law; Dispute Resolution.

(a) This Agreement shall be construed and enforced under and in accordance with and governed by the law of the State of Texas.

(b) UPON THE WRITTEN REQUEST OF THE COMPANY OR THE PURCHASER, ANY DISPUTE, CONTROVERSY OR CLAIM ("CONTROVERSY") CONCERNING THIS AGREEMENT AND ANY OTHER CONTROVERSY BETWEEN ANY OF THE PARTIES (INCLUDING ANY CLAIM BASED ON OR ARISING FROM NEGLIGENCE AND/OR AN ALLEGED TORT) ARISING OUT OF THE TRANSACTIONS CONTEMPLATED HEREBY, WILL BE DETERMINED BY ARBITRATION. THERE SHALL BE A SINGLE ARBITRATOR WHO SHALL BE MUTUALLY SELECTED BY THE PARTIES FROM A PANEL OF NEUTRALS PROVIDED BY JAMS, UNLESS THE AMOUNT IN CONTROVERSY IS \$1 MILLION OR MORE, IN WHICH CASE THE ARBITRATION PANEL SHALL CONSIST OF THREE ARBITRATORS. IF A SINGLE ARBITRATOR IS TO BE DESIGNATED, THE ARBITRATOR SHALL BE JOINTLY SELECTED BY THE PARTIES ACCORDING TO A LIST PROVIDED BY JAMS, BUT IF THE PARTIES ARE UNABLE TO AGREE, THEN JAMS SHALL DESIGNATE THE ARBITRATOR. IF A PANEL OF THREE ARBITRATORS IS TO BE USED, EACH PARTY MAY DESIGNATE ONE ARBITRATOR FROM JAMS' LIST AND THE TWO SO SELECTED SHALL SELECT THE THIRD. THE ONLY JUDICIAL ACTION TAKEN CONCERNING A CONTROVERSY SHALL BE TO COMPEL ARBITRATION AND TO ENFORCE THE ARBITRATOR'S DECISION, EXCEPT AS SET FORTH IN PARAGRAPH (C) BELOW. ARBITRATION HEREUNDER SHALL BE CONDUCTED IN NUECES COUNTY, TEXAS IN ACCORDANCE WITH THE JAMS COMPREHENSIVE ARBITRATION RULES AND PROCEDURES, EXCEPT TO THE EXTENT MODIFIED HEREBY. THE ARBITRATOR SHALL DETERMINE THE AMOUNT AND RESPONSIBILITY FOR ATTORNEYS' FEES AND COSTS TO BE AWARDED IN CONNECTION WITH THE ARBITRATION. NO ACTION OR INACTION OF EITHER PARTY INCLUDING BUT NOT LIMITED TO THE PROSECUTION OF A LAWSUIT, SHALL EVER BE CONSTRUED TO CONSTITUTE WAIVER OF SUCH PARTY'S RIGHT TO REQUIRE THAT THE DISPUTE BE RESOLVED BY ARBITRATION. NOTHING HEREIN SHALL BE CONSTRUED TO PREVENT THE PARTIES FROM MEDIATING ANY CONTROVERSY.

(c) Notwithstanding the foregoing, the Purchaser retains the right to seek injunctive relief in a court of applicable jurisdiction in the case of any breach or threatened breach of the Non-Competition Agreement.

13.9. The Company's "Knowledge". When used in this Agreement, the words "the Company's knowledge" or "the knowledge of the Company" and similar words shall mean that no information with respect to the statements to which those words refer has come to the actual, conscious attention of either of the Directors or the Manager of the Businesses, Debbie Newman, which, after reasonable inquiry, would lead Ms. Newman or either such Director to reasonably conclude that any such statement is untrue or incomplete.

13.10. Construction. As the context requires or permits: pronouns used herein shall include the masculine, the feminine and neuter; terms used in plural shall include the singular, and singular terms shall include the plural; "hereof", "herein", "hereunder" and "hereto" shall refer to this Agreement; and section and paragraph references, when not expressly referring to another agreement or document, shall mean sections or paragraphs in this Agreement.

13.11. Counterparts. This Agreement may be executed in counterparts, each of which shall be deemed an original, but all of which shall constitute the same instrument.

[the remainder of this page has intentionally been left blank]

IN WITNESS WHEREOF, this Agreement has been executed and delivered as of the date first above written.

THE PURCHASER:

CARRIAGE CEMETERY SERVICES, INC.

By: /s/ Melvin C. Payne  
MELVIN C. PAYNE, President and  
Chief Executive Officer

THE COMPANY:

SEASIDE CEMETERY, INC.

By: /s/ Michael L. Mintz  
MICHAEL L. MINTZ, President

<u>Exhibit</u>	<u>Description</u>
2.2	Non-Competition Agreement
7.2	Opinion of Counsel for the Company
8.2	Opinion of Counsel for the Purchaser
10.4	Escrow Agreement

<u>Schedules</u>	<u>Description</u>
1.5(iii)	Preconstruction Mausoleum Contracts
3.2	Financial Information
3.3	Liens and Permitted Exceptions
3.5	Real Property
3.8	Fixed Assets
3.9	Contracts and Commitments
3.10	Preneed Contracts and Trust Accounts
3.11	IP Rights
3.13	Licenses, Permits, Etc.
3.14	Litigation
3.17	Employees
7.9	Lake Placid Estates Property

First Amendment to Contingent Asset Sale Agreement

This First Amendment to Contingent Asset Sale Agreement is made effective January 22, 2007 by and between Alderwoods Group (California), Inc. ("Seller") and Carriage Cemetery Services, Inc., a Texas corporation ("Buyer");

WHEREAS, SCI Funeral Services, Inc. ("SCI Funeral Services") and the Buyer entered into an Contingent Asset Sale Agreement dated November 22, 2006 (the "Agreement");

WHEREAS, the Seller executed a Seller Joinder assuming all obligations of the Seller under the Agreement, whereupon SCI Funeral Services was released therefrom; and

WHEREAS, Seller and Buyer wish to amend that Agreement in the manner set forth below.

NOW THEREFORE, in consideration of the premises and agreements herein contained, the Parties intending to be legally bound hereby agree to amend certain sections of the Agreement as follows:

1. Section 5.16(b) of the Agreement is hereby amended in its entirety so that, as amended, said Section 5.16(b) shall read as follows:

"(b) [INTENTIONALLY DELETED]."

2. Section 5.16(c) of the Agreement is hereby amended in its entirety to read as follows:

"Seller agrees that upon the breach or threatened breach of the provisions of this Section, the remedies at law of Buyer will be inadequate, and Buyer shall be entitled to an injunction or injunctions to prevent such breach and to enforce specifically the provisions hereof in addition to any other remedy to which the Buyer may be entitled at law or equity. "

3. Section 5.18 of the Agreement is hereby amended in its entirety so that, as amended, said Section 5.18 shall read as follows:

"5.18 [INTENTIONALLY DELETED]."

4. Except as hereinabove specifically amended, the Agreement is and shall remain in full force and effect according to its terms and conditions, all of which are hereby ratified and confirmed by the parties.

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IN WITNESS WHEREOF, the undersigned have executed and delivered this First Amendment to Contingent Asset Sale Agreement on the date and year first above mentioned.

BUYER:

Carriage Cemetery Services, Inc.

By:       /s/ W. Clark Harlow        
W. Clark Harlow, Vice President

SELLER:

Alderwoods Group (California), Inc.

By:       /s/ Lori E. Spilde        
Lori E. Spilde, Vice President

SCI California Funeral Services, Inc., Guarantor of Seller's obligations under the Agreement, hereby joins in the execution of this First Amendment to acknowledge the amendments to the Agreement made hereby.

SCI California Funeral Services, Inc.

By:       /s/ Lori E. Spilde        
Lori E. Spilde, Vice President



Second Amendment to Contingent Asset Sale Agreement

This Second Amendment to Contingent Asset Sale Agreement is made effective February 26, 2007 by and between Alderwoods Group (California), Inc., a California corporation ("Seller"), and Carriage Cemetery Services, Inc., a Texas corporation ("Buyer");

WHEREAS, SCI Funeral Services, Inc. ("SCI Funeral Services") and the Buyer entered into an Contingent Asset Sale Agreement dated November 22, 2006 (the "Agreement"); and

WHEREAS, the Seller executed a Seller Joinder assuming all obligations of the Seller under the Agreement, whereupon SCI Funeral Services was released therefrom; and

WHEREAS, the parties amended the Agreement pursuant to the First Amendment dated January 22, 2007; and

WHEREAS, Seller and Buyer wish to further amend the Agreement in the manner set forth below;

NOW THEREFORE, in consideration of the premises and agreements herein contained, the Parties, intending to be legally bound, hereby agree to amend certain sections of the Agreement as follows:

1. The references to "March 15, 2007" in Sections 2.1 and 9.1(b)(vii) of the Agreement are hereby amended to read "March 30, 2007."
2. The references to "February 28, 2007" in Sections 9.1(b)(iii) and 9.1(c)(iii) of the Agreement are hereby amended to read "March 21, 2007."
3. Except as hereinabove specifically amended, the Agreement is and shall remain in full force and effect according to its terms and conditions, all of which are hereby ratified and confirmed by the parties.

IN WITNESS WHEREOF, the undersigned have executed and delivered this Second Amendment to Contingent Asset Sale Agreement on the date and year first above mentioned.

BUYER:

Carriage Cemetery Services, Inc.

By: /s/ W. Clark Harlow  
W. Clark Harlow, Vice President

SELLER:

Alderwoods Group (California), Inc.

By: /s/ Lori E. Spilde  
Lori E. Spilde, Vice President

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SCI California Funeral Services, Inc., Guarantor of Seller's obligations under the Agreement, hereby joins in the execution of this Second Amendment to acknowledge the amendments to the Agreement made hereby.

SCI California Funeral Services, Inc.

By: /s/ Lori E. Spilde  
Lori E. Spilde, Vice President

**CARRIAGE SERVICES, INC.**  
**COMPUTATION OF RATIO OF EARNINGS TO FIXED CHARGES**  
**(unaudited and in thousands)**

	<u>2002</u>	<u>2003</u>	<u>2004</u>	<u>2005</u>	<u>2006</u>
Fixed charges:					
Interest expense	\$ 18,200	\$ 16,819	\$ 15,984	\$ 24,778	\$ 17,800
Amortization of capitalized expenses related to debt	1,343	954	924	754	714
Rental expense factor	1,529	1,221	1,208	1,268	1,245
Total fixed charges before capitalized interest	21,072	18,994	18,116	26,800	19,759
Capitalized interest	184	131	24	46	50
Total fixed charges	<u>\$ 21,256</u>	<u>\$ 19,125</u>	<u>\$ 18,140</u>	<u>\$ 26,846</u>	<u>\$ 19,809</u>
Earnings available for fixed charges:					
Earnings (loss) before income taxes and cumulative effect of change in accounting principle	\$ 9,710	\$ 8,125	\$ 10,034	\$ (1,449)	\$ 6,201
Add fixed charges before capitalized interest	21,072	18,994	18,116	26,800	\$ 19,759
Total earnings available for fixed charges	<u>\$ 30,782</u>	<u>\$ 27,119</u>	<u>\$ 28,150</u>	<u>\$ 25,351</u>	<u>\$ 25,960</u>
Ratio of earnings to fixed charges (1)	<u>1.45</u>	<u>1.42</u>	<u>1.55</u>	<u>.94</u>	<u>1.31</u>

- (1) For purposes of computing the ratios of earnings to fixed charges and earnings to fixed charges plus dividends: (i) earnings consist of income from continuing operations before provision for income taxes plus fixed charges (excluding capitalized interest) and (ii) "fixed charges" consist of interest expensed and capitalized, amortization of debt discount and expense relating to indebtedness and the portion of rental expense representative of the interest factor attributable to leases for rental property. There were no dividends paid or accrued on the Company's Common Stock during the periods presented above.

**CARRIAGE SERVICES, INC.**  
**SUBSIDIARIES AS OF DECEMBER 31, 2006**

NAME	JURISDICTION OF INCORPORATION
Carriage Funeral Holdings, Inc.	Delaware
CFS Funeral Services, Inc.	Delaware
Carriage Holding Company, Inc.	Delaware
Carriage Funeral Services of Michigan, Inc.	Michigan
Carriage Funeral Services of Kentucky, Inc.	Kentucky
Carriage Funeral Services of California, Inc.	California
Carriage Funeral Services of Idaho, Inc.	Idaho
Wilson & Kratzer Mortuaries	California
Rolling Hills Memorial Park	California
Carriage Services of Connecticut, Inc.	Connecticut
CSI Funeral Services of Massachusetts, Inc.	Massachusetts
CHC Insurance Agency of Ohio, Inc.	Ohio
Barnett, Demrow & Ernst, Inc.	Kentucky
Carriage Services of New Mexico, Inc.	New Mexico
Forastiere Family Funeral Services, Inc.	Massachusetts
Carriage Cemetery Services, Inc.	Texas
Carriage Services of Oklahoma, L.L.C.	Oklahoma
Carriage Services of Nevada, Inc.	Nevada
Hubbard Funeral Home, Inc.	Maryland
Carriage Services Capital Trust	Delaware
Carriage Team California (Cemetery), LLC	Delaware
Carriage Team California (Funeral), LLC	Delaware
Carriage Team Florida (Cemetery), LLC	Delaware
Carriage Team Florida (Funeral), LLC	Delaware
Carriage Services of Ohio, LLC	Delaware
Carriage Team Kansas, LLC	Delaware
Carriage Municipal Cemetery Services of Nevada, Inc.	Nevada
Carriage Cemetery Services of California, Inc.	California
Carriage Insurance Agency of Massachusetts, Inc.	Massachusetts
Carriage Internet Strategies, Inc.	Delaware
Carriage Investments, Inc.	Delaware
Carriage Management, L.P.	Texas
Cochrane's Chapel of the Roses, Inc.	California
Horizon Cremation Society, Inc.	California
Carriage Life Events, Inc.	Delaware
Carriage Merger I, Inc.	Delaware
Carriage Merger II, Inc.	Delaware
Carriage Merger III, Inc.	Delaware
Aria Cremation Services, LLC	Delaware

**CONSENT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

The Board of Directors and Stockholders  
Carriage Services, Inc.:

We consent to the incorporation by reference in the previously filed registration statements (No. 333-11435, 333-49053, 333-62593, and 333-136313) on Form S-8 and in the registration statement (No. 333-71902) on Form S-3 of Carriage Services, Inc. (the Company) of our reports dated March 9, 2007, with respect to the consolidated balance sheets of the Company as of December 31, 2006 and 2005, and the related consolidated statements of operations, stockholders' equity, and cash flows, and the related financial statement schedule for the years ended December 31, 2006, 2005 and 2004, and management's assessment of the effectiveness of internal control over financial reporting as of December 31, 2006 and the effectiveness of internal control over financial reporting as of December 31, 2006, which reports appear in the December 31, 2006 annual report on Form 10-K of the Company. Our reports refer to a change in the method of accounting for preneed selling costs in 2005 and to the Company's adoption of the provisions of Statements of Financial Accounting Standards No. 123R, Share-Based Payment.

/s/ KPMG LLP

Houston, Texas  
March 9, 2007

I, Melvin C. Payne, certify that:

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

Dated: March 9, 2007

/s/ Melvin C. Payne

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Melvin C. Payne  
Chairman of the Board, President and  
Chief Executive Officer

I, Joseph Saporito, certify that:

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

Dated: March 9, 2007

/s/ Joseph Saporito  
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Joseph Saporito  
Executive Vice President and  
Chief Financial Officer

In connection with the Annual Report of Carriage Services, Inc. ("the Company") on Form 10-K for the year ended December 31, 2006 ("Form 10-K"), each of the undersigned officers of the Company certifies pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, 18 U.S.C. Section 1350, that to the best of such officer's knowledge: (i) the Form 10-K fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934, as amended; and (ii) the information contained in the Form 10-K fairly presents, in all material respects, the financial condition and results of operations of Carriage Services, Inc.

March 9, 2007

/s/ Melvin C. Payne

Melvin C. Payne  
Chairman of the Board,  
President and  
Chief Executive Officer

/s/ Joseph Saporito

Joseph Saporito  
Executive Vice President and  
Chief Financial Officer