

CARRIAGE SERVICES INC

Form 10-Q

August 09, 2007

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

FORM 10-Q

(Mark One)

**QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15 (d) OF THE SECURITIES
EXCHANGE ACT OF 1934**

For the quarterly period ended June 30, 2007

OR

**TRANSITION REPORT PURSUANT TO SECTION 13 OR 15 (d) OF THE SECURITIES
EXCHANGE ACT OF 1934**

For the transition period from _____ to _____

Commission file number: 1-11961

CARRIAGE SERVICES, INC.

(Exact name of registrant as specified in its charter)

DELAWARE

(State or other jurisdiction of incorporation or
organization)

76-0423828

(I.R.S. Employer Identification No.)

3040 Post Oak Boulevard, Suite 300, Houston, TX

(Address of principal executive offices)

77056

(Zip Code)

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

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No

Indicate by check mark whether the Registrant is a large accelerated filer, an accelerated filer or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Securities Exchange Act of 1934. (Check one):

Large accelerated filer Accelerated filer Non-Accelerated filer

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

The number of shares of the Registrant's Common Stock, \$.01 par value per share, outstanding as of August 1, 2007 was 19,047,339.

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

| | December 31, 2006 | June 30, 2007 (unaudited) |
|--|----------------------------------|--|
| ASSETS | | |
| Current assets: | | |
| Cash and cash equivalents | \$ 22,820 | \$ 14,342 |
| Short term investments | 10,303 | |
| Accounts receivable, net of allowance for doubtful accounts of \$925 in 2006 and \$1,519 in 2007 | 13,822 | 13,723 |
| Assets held for sale | 2,634 | |
| Inventories and other current assets | 11,883 | 11,913 |
| Total current assets | 61,462 | 39,978 |
| | | |
| Restricted cash | 2,888 | |
| Federal agency bond | 5,000 | 5,000 |
| Preneed cemetery trust investments | 55,483 | 61,743 |
| Preneed funeral trust investments | 44,851 | 66,405 |
| Preneed receivables, net of allowance for bad debts of \$492 in 2006 and \$600 in 2007 | 15,127 | 19,781 |
| Receivables from preneed funeral trusts | 15,649 | 15,297 |
| Property, plant and equipment, at cost, net of accumulated depreciation of \$47,250 in 2006 and \$50,152 in 2007 | 99,894 | 111,719 |
| Cemetery property | 57,798 | 67,627 |
| Goodwill | 148,845 | 158,854 |
| Deferred charges and other non-current assets | 25,459 | 23,934 |
| Cemetery perpetual care trust investments | 32,540 | 37,197 |
| Total assets | \$ 564,996 | \$ 607,535 |
| LIABILITIES AND STOCKHOLDERS EQUITY | | |
| Current liabilities: | | |
| Current portion of senior long-term debt and capital leases obligations | \$ 1,610 | \$ 1,664 |
| Accounts payable | 7,148 | 8,455 |
| Accrued liabilities | 15,888 | 13,650 |
| Liabilities associated with assets held for sale | 1,061 | |
| Total current liabilities | 25,707 | 23,769 |
| Senior long-term debt, net of current portion | 133,841 | 133,285 |
| Convertible junior subordinated debenture due in 2029 to an affiliated trust | 93,750 | 93,750 |

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| | | |
|---|-------------------|-------------------|
| Obligations under capital leases, net of current portion | 4,728 | 4,700 |
| Deferred preneed cemetery revenue | 50,785 | 52,859 |
| Deferred preneed funeral revenue | 28,289 | 31,564 |
| Non-controlling interests in cemetery trust investments | 55,483 | 61,743 |
| Non-controlling interests in funeral trust investments | 44,851 | 66,405 |
| Total liabilities | 437,434 | 468,075 |
| Commitments and contingencies | | |
| Non-controlling interests in perpetual care trust investments | 31,189 | 36,593 |
| Stockholders' equity: | | |
| Common Stock, \$.01 par value; 80,000,000 shares authorized; 18,608,000 and 19,000,000 shares issued and outstanding at December 31, 2006 and June 30, 2007, respectively | 186 | 190 |
| Additional paid-in capital | 190,524 | 191,879 |
| Accumulated deficit | (94,337) | (89,202) |
| Total stockholders' equity | 96,373 | 102,867 |
| Total liabilities and stockholders' equity | \$ 564,996 | \$ 607,535 |

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

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

| | For the three months ended June 30, | | For the six months ended June 30, | |
|--|--|-----------|--------------------------------------|-----------|
| | 2006 | 2007 | 2006 | 2007 |
| Revenues: | | | | |
| Funeral | \$ 28,072 | \$ 30,419 | \$ 59,059 | \$ 62,994 |
| Cemetery | 9,182 | 11,242 | 19,236 | 21,328 |
| | 37,254 | 41,661 | 78,295 | 84,322 |
| Field costs and expenses: | | | | |
| Funeral | 18,595 | 19,320 | 37,497 | 38,795 |
| Cemetery | 6,798 | 7,463 | 13,629 | 13,762 |
| Depreciation and amortization | 2,143 | 1,952 | 4,318 | 4,074 |
| Regional and unallocated funeral and cemetery costs | 1,474 | 1,787 | 3,707 | 3,614 |
| | 29,010 | 30,522 | 59,151 | 60,245 |
| Gross profit | 8,244 | 11,139 | 19,144 | 24,077 |
| Corporate costs and expenses: | | | | |
| General, administrative and other | 2,591 | 3,507 | 5,085 | 6,984 |
| Home office depreciation and amortization | 364 | 347 | 731 | 711 |
| | 2,955 | 3,854 | 5,816 | 7,695 |
| Operating income | 5,289 | 7,285 | 13,328 | 16,382 |
| Interest expense | (4,629) | (4,588) | (9,265) | (9,208) |
| Interest income and other, net | 347 | 430 | 563 | 875 |
| Total interest and other | (4,282) | (4,158) | (8,702) | (8,333) |
| Income from continuing operations before income taxes | 1,007 | 3,127 | 4,626 | 8,049 |
| Provision for income taxes | (378) | (1,204) | (1,735) | (3,099) |
| Net income from continuing operations | 629 | 1,923 | 2,891 | 4,950 |
| Income (loss) from discontinued operations, net of tax | 74 | 32 | (3,923) | 426 |
| Net income (loss) | \$ 703 | \$ 1,955 | \$ (1,032) | \$ 5,376 |
| Basic earnings (loss) per common share: | | | | |
| Continuing operations | \$ 0.03 | \$ 0.10 | \$ 0.16 | \$ 0.26 |
| Discontinued operations | | | (0.20) | 0.02 |

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| | | | | |
|--|---------|---------|-----------|---------|
| Net income (loss) | \$ 0.04 | \$ 0.10 | \$ (0.04) | \$ 0.28 |
| Diluted earnings (loss) per common share: | | | | |
| Continuing operations | \$ 0.03 | \$ 0.10 | \$ 0.15 | \$ 0.26 |
| Discontinued operations | | | (0.20) | 0.02 |
| Net income (loss) | \$ 0.04 | \$ 0.10 | \$ (0.05) | \$ 0.28 |
| Weighted average number of common and common equivalent shares outstanding: | | | | |
| Basic | 18,545 | 18,963 | 18,514 | 18,864 |
| Diluted | 18,902 | 19,442 | 18,888 | 19,364 |

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

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

| | For the six months ended June 30, | |
|---|--|-------------|
| | 2006 | 2007 |
| Cash flows from operating activities: | | |
| Net income (loss) | \$ (1,032) | \$ 5,376 |
| Adjustments to reconcile net income (loss) to net cash provided by operating activities: | | |
| (Income) loss from discontinued operations | 3,923 | (692) |
| Depreciation and amortization | 4,504 | 4,785 |
| Loan cost amortization | 357 | 357 |
| Provision for losses on accounts receivable | 1,898 | 1,472 |
| Loss on sale or disposition of business assets | 175 | 36 |
| Stock-based compensation expense | 467 | 628 |
| Deferred income taxes | 1,735 | 2,796 |
| Other | (43) | 48 |
| Changes in operating assets and liabilities that provided (required) cash, net of effects from acquisitions and dispositions: | | |
| Accounts receivable | (847) | (418) |
| Inventories and other current assets | 508 | 245 |
| Deferred charges and other | (20) | (911) |
| Preneed funeral and cemetery trust investments | (8,262) | (9,621) |
| Accounts payable and accrued liabilities | (2,418) | (1,910) |
| Deferred preneed funeral and cemetery revenue | 11,414 | (1,836) |
| Non-controlling interests in preneed funeral and cemetery trusts | (3,112) | 6,122 |
| Net cash provided by operating activities of continuing operations | 9,247 | 10,149 |
| Net cash provided by operating activities of discontinued operations | 358 | 231 |
| Net cash provided by operating activities | 9,605 | 10,380 |
| Cash flows from investing activities: | | |
| Acquisitions | | (28,902) |
| Purchase of corporate investments | (35,625) | |
| Maturities of corporate investments | 26,554 | 10,303 |
| Capital expenditures | (2,388) | (5,598) |
| Withdrawal of restricted cash | | 2,888 |
| Net cash used in investing activities of continuing operations | (11,459) | (21,309) |
| Net cash provided by (used in) investing activities of discontinued operations | (15) | 2,523 |
| Net cash used in investing activities | (11,474) | (18,786) |
| Cash flows from financing activities: | | |
| Payments on senior long-term debt and obligations under capital leases | (1,152) | (530) |

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| | | |
|--|----------|-----------|
| Proceeds from the exercise of stock options and employee stock purchase plan | 319 | 500 |
| Tax benefit from stock-based compensation | 44 | 231 |
| Net cash used in financing activities of continuing operations | (789) | 201 |
| Net cash used in financing activities of discontinued operations | (83) | (273) |
| Net cash used in financing activities | (872) | (72) |
| Net decrease in cash and cash equivalents | (2,741) | (8,478) |
| Cash and cash equivalents at beginning of period | 7,949 | 22,820 |
| Cash and cash equivalents at end of period | \$ 5,208 | \$ 14,342 |

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

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

1. BASIS OF PRESENTATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

(a) The Company

Carriage Services, Inc. (Carriage or the Company) is a leading provider of products and services in the death care industry in the United States. As of June 30, 2007, the Company owned and operated 130 funeral homes in 27 states and 32 cemeteries in 11 states.

(b) Principles of Consolidation

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

(c) Interim Condensed Disclosures

The information for the three and six month periods months ended June 30, 2006 and 2007 is unaudited, but in the opinion of management, reflects all adjustments which are normal, recurring and necessary for a fair presentation of financial position and results of operations for the interim periods. Certain information and footnote disclosures, normally included in annual financial statements, have been condensed or omitted. The accompanying consolidated financial statements have been prepared consistent with the accounting policies described in our annual report on Form 10-K for the year ended December 31, 2006, and should be read in conjunction therewith.

(d) Cash Equivalents

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

(e) Use of Estimates

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

(f) Discontinued Operations

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

(g) Stock Plans and Stock-Based Compensation

The Company has stock-based employee compensation plans in the form of restricted stock, stock option and employee stock purchase plans, which are described in more detail in Note 16 to the consolidated financial statements in our Form 10-K for the year ended December 31, 2006. 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 and applies to all transactions involving issuance of equity by a company in exchange for goods and services, including employee services. The fair value of options or awards containing options is determined using the

Black-Scholes valuation model. The Company adopted FAS No. 123R in the first quarter of 2006, using the modified prospective application method.

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The Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting 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 affect on the Company s presentation and disclosure.

(i) 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 the beginning of the first quarter of 2007, which had no effect on the financial statements.

2. RECENTLY ISSUED ACCOUNTING STANDARDS

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements (FAS 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 FAS No. 157 will have on its consolidated financial statements.

In February 2007, the FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities Including an Amendment of FASB Statement No. 115 (FAS No. 159). This statement permits entities to choose to measure many financial assets and liabilities and certain other items at fair value. The objective is to improve financial reporting by providing entities with the opportunity to mitigate volatility in reported earnings caused by measuring related assets and liabilities differently without having to apply complex hedge accounting provisions. This statement is effective as of the beginning of the entity s first fiscal year beginning after November 15, 2007. The Company is currently evaluating the impact, if any, the adoption of FAS No. 159 will have on its consolidated financial statements.

3. CHANGE IN ACCOUNTING FOR INCOME TAX UNCERTAINTIES

In June 2006, FASB issued FASB Interpretation No. 48 Accounting for Uncertainty in Income Taxes (FIN 48). FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise s financial statements in accordance with FASB Statement No. 109, Accounting for Income Taxes. FIN 48 prescribes how tax benefits for uncertain tax positions are to be recognized, measured, and derecognized in financial statements; requires certain disclosures of uncertain tax matters; specifies how reserves for uncertain tax position should be classified on the balance sheet; and provides transition and interim period guidance, among other provisions. FIN 48 is effective for fiscal years beginning after December 15, 2006 and was adopted by the Company at the beginning of the first quarter of 2007. The Company has reviewed its income tax positions and identified certain tax deductions, primarily related to business acquisitions that are not certain. The cumulative effect of adopting FIN 48 has been recorded as a reduction to the 2007 opening balance of Retained Earnings and an increase in noncurrent liabilities in the amount of \$241,000, which includes accrued interest and penalties totaling \$86,000. The Company s policy with respect to potential penalties and interest is to record them as other expense and interest expense, respectively.

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The Company has unrecognized tax benefits for Federal and state income tax purposes totaling \$5.1 million at January 1, 2007, resulting from deductions totaling \$13.8 million on Federal returns and \$7.9 million on various state returns. The effect of applying FIN 48 for the six months ended June 30, 2007 was not material to operations. The Company has net operating loss carryforwards exceeding these deductions, and has accounted for these unrecognized tax benefits by reducing the net operating loss carryforwards by the amount of these unrecognized deductions. In certain states, the Company has previously reduced its taxes payable by deductions that are not considered more likely than not. The cumulative effect of adopting FIN 48 specifically relates to those state income tax returns.

The Company's Federal income tax returns for 2001 through 2006 are open tax years that may be examined by the Internal Revenue Service. The Company's unrecognized state tax benefits are related to state returns open from 2001 through 2006. The Company believes it will recognize the unrecognized tax benefits upon the expiration of statutes of limitations of previously deducted expenses.

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Effective April 2, 2007, the Company acquired a combination funeral home and cemetery business in California for cash in the amount of \$8.2 million. Effective June 12, 2007, the Company acquired a combination funeral home and cemetery business and a cemetery business in Idaho for cash in the amount of \$9.0 million and the assumption of liabilities totaling \$0.8 million. For these acquisitions, the Company acquired substantially all the assets and assumed certain operating liabilities including obligations associated with existing preneed contracts. The assets and liabilities were recorded at fair value and included goodwill in the amount of \$5.5 million. Also the Company acquired certain assets of a funeral home business in New Mexico for \$0.9 million which have been integrated with an existing business in the same market. The results of the acquired businesses are included in the Company's results from the date of acquisition. The proforma impact of the acquisitions on the prior period is not presented as the impact is not material to reported results.

The effect of the acquisitions on the consolidated balance sheet at June 30, 2007 was as follows (in thousands):

| | |
|--------------------------------------|-----------|
| Current Assets | \$ 387 |
| Cemetery property | 6,361 |
| Property, plant & equipment | 7,784 |
| Goodwill | 5,529 |
| Preneed Assets | 7,872 |
| Non-current assets | 903 |
| Current liabilities | (27) |
| Deferred preneed revenues | (2,027) |
| Other liabilities | (816) |
| Non-controlling interest in trusts | (7,872) |
| Cash used for acquisition | \$ 18,094 |
| Assumed debt paid off at acquisition | 816 |
| | \$ 18,910 |

5. DISCONTINUED OPERATIONS

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

In the first quarter of 2007, the Company sold two funeral home businesses for approximately \$2.4 million and recognized a gain of \$0.7 million. During 2006, the Company recorded impairment charges totaling \$6.1 million, which is related to specifically identified goodwill, for these businesses that were subsequently sold in 2006.

In the second quarter of 2007, the Company sold a funeral home business for approximately \$0.8 million and recognized a gain of \$0.1 million.

At December 31, 2006, assets and liabilities associated with the funeral home businesses held for sale in the accompanying balance sheet consisted of the following (in thousands). No businesses were held for sale at June 30, 2007.

| | |
|---|-------------------------|
| | December 31, 2006 |
| Assets: | |
| Current assets | \$ 124 |
| Property, plant and equipment, net | 1,406 |
| Preneed receivables and trust investments | 634 |

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| | | |
|---|----|-------|
| Goodwill | | 324 |
| Deferred charges and other assets | | 146 |
| Total | \$ | 2,634 |
| Liabilities: | | |
| 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 |
| Total | \$ | 1,061 |

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

| | For the three months ended June 30, | | For the six months ended June 30, 2007 | |
|--|--|-------|---|--------|
| | 2006 | 2007 | 2006 | 2007 |
| Revenues | \$ 1,457 | \$ 86 | \$ 2,789 | \$ 231 |
| Operating income | \$ 349 | \$ | \$ 571 | (36) |
| Gain (loss) on sale and (impairment) | (230) | 51 | (6,332) | 728 |
| (Provision) benefit for income taxes | (45) | (19) | 1,838 | (266) |
| Income (loss) from discontinued operations | \$ 74 | \$ 32 | \$ (3,923) | \$ 426 |

6. GOODWILL

Many of the acquired funeral homes, former owners and staff 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 the changes in goodwill in the accompanying consolidated balance sheet (in thousands):

| | June 30, 2007 |
|-------------------------------|------------------|
| Goodwill at beginning of year | \$ 148,845 |
| Acquisitions | 10,009 |
| Goodwill at end of period | \$ 158,854 |

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 investments at June 30, 2007 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 and money market accounts | \$ 5,145 | \$ | \$ | \$ 5,145 |
| Fixed income securities: | | | | |
| U.S. Agency obligations | 20,361 | | (186) | 20,175 |
| State and municipal obligations | 379 | 1 | (1) | 379 |
| Corporate | 2,000 | 11 | (24) | 1,987 |
| Other | 5 | | | 5 |

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| | | | | |
|--------------------------------------|-----------|----------|----------|-----------|
| Common stock | 11,945 | 2,003 | (149) | 13,799 |
| Mutual funds: | | | | |
| Equity | 12,205 | 2,132 | (47) | 14,290 |
| Fixed income | 5,723 | 11 | (59) | 5,675 |
| | \$ 57,763 | \$ 4,158 | \$ (466) | \$ 61,455 |
| Accrued investment income | \$ 288 | | | \$ 288 |
| Trust investments | | | | \$ 61,743 |
| Market value as a percentage of cost | | | | 106.9% |

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

| | Cost | Net Unrealized Loss | Market |
|--------------------------|-----------|---------------------------|-----------|
| Due in one year or less | \$ 2,864 | \$ (17) | \$ 2,847 |
| Due in one to five years | 15,605 | (122) | 15,483 |
| Due in five to ten years | 4,117 | (58) | 4,059 |
| Thereafter | 159 | (2) | 157 |
| | \$ 22,745 | \$ (199) | \$ 22,546 |

Preneed funeral trust investments

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

The cost and market values associated with preneed funeral trust investments at June 30, 2007 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 and money market accounts | \$ 26,648 | \$ | \$ | \$ 26,648 |
| Fixed income securities: | | | | |
| U.S. Treasury | 9,108 | 5 | (55) | 9,058 |
| State and municipal obligations | 1,578 | 28 | | 1,606 |
| Corporate | 2,075 | 8 | (31) | 2,052 |
| Mortgage Backed Securities | 2,023 | 3 | (20) | 2,006 |
| Common stock | 7,219 | 2,097 | (1) | 9,315 |
| Mutual funds: | | | | |
| Equity | 10,214 | 1,700 | (25) | 11,889 |
| Fixed income | 3,462 | 417 | (48) | 3,831 |
| | \$ 62,327 | \$ 4,258 | \$ (180) | \$ 66,405 |
| Trust investments | | | | \$ 66,405 |
| Market value as a percentage of cost | | | | 106.5% |

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

| Cost | Net Unrealized Gain (Loss) | Market |
|------|-------------------------------------|--------|
|------|-------------------------------------|--------|

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| | | | |
|--------------------------|-----------|----------|-----------|
| Due in one year or less | \$ 2,070 | \$ (157) | \$ 1,913 |
| Due in one to five years | 11,794 | 55 | 11,849 |
| Due in five to ten years | 794 | 39 | 833 |
| Thereafter | 126 | 1 | 127 |
| | \$ 14,784 | \$ (62) | \$ 14,722 |

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.

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Table of Contents*Trust Investment Security Transactions*

Cemetery and funeral trust investment security transactions recorded in Other income in the Consolidated Statement of Operations for the three and six months ended June 30, 2006 and 2007 are as follows (in thousands).

| | For the three months ended June 30, | | For the six months ended June 30, | |
|--|--|---------|--------------------------------------|----------|
| | 2006 | 2007 | 2006 | 2007 |
| Investment income (loss) | \$ (304) | \$ 959 | \$ 473 | \$ 1,824 |
| Realized gains | 658 | 1,102 | 2,014 | 1,480 |
| Realized losses | (284) | (44) | (840) | (130) |
| Expenses | (343) | (379) | (637) | (551) |
| Increase in non-controlling interests in trust investments | 273 | (1,638) | (1,010) | (2,623) |
| | \$ | \$ | \$ | \$ |

8. RECEIVABLES FROM PRENEED FUNERAL TRUSTS

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

9. CONTRACTS SECURED BY INSURANCE

Certain preneed funeral contracts are secured by life insurance contracts. Generally, the proceeds of the life insurance policies have been assigned to the Company and will be paid upon the death of the insured. The proceeds will be used to satisfy the beneficiary's obligations under the preneed contract for services and merchandise. The preneed funeral contracts secured by insurance totaled \$176 million at June 30, 2007, and are not included in the Company's consolidated balance sheet.

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. The cost and market values associated with the trust investments held in perpetual care trust funds at June 30, 2007 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 and money market accounts | \$ 3,101 | \$ | \$ | \$ 3,101 |
| Fixed income securities: | | | | |
| U.S. Treasury | 102 | | (1) | 101 |
| U.S. Agency obligation | 5,265 | 2 | (49) | 5,218 |
| State and municipal obligations | 609 | 2 | (2) | 609 |
| Corporate | 901 | 16 | (2) | 915 |
| Other | 348 | | (10) | 338 |
| Common stock | 10,534 | 1,824 | (154) | 12,204 |
| Mutual funds: | | | | |
| Equity | 6,466 | 1,362 | (43) | 7,785 |
| Fixed income | 6,850 | 59 | (62) | 6,847 |
| | \$ 34,176 | \$ 3,265 | \$ (323) | \$ 37,118 |

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| | | |
|--------------------------------------|-------|-----------|
| Accrued net investment income | \$ 79 | \$ 79 |
| Trust investments | | \$ 37,197 |
| Market value as a percentage of cost | | 108.8% |

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

| | Cost | Net Unrealized Loss | Market |
|--------------------------|----------|---------------------------|----------|
| Due in one year or less | \$ 1,049 | \$ (5) | \$ 1,044 |
| Due in one to five years | 4,582 | (29) | 4,553 |
| Due in five to ten years | 1,347 | (9) | 1,338 |
| Thereafter | 247 | (1) | 246 |
| | \$ 7,225 | \$ (44) | \$ 7,181 |

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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, 2006 and June 30, 2007 are as follows:

| | December 31, 2006 | June 30, 2007 |
|-------------------------------|-------------------------|------------------|
| Trust assets, at market value | \$ 32,540 | \$ 37,197 |
| Pending withdrawals of income | (1,351) | (604) |
| Non-controlling interests | \$ 31,189 | \$ 36,593 |

Trust Investment Security Transactions

Perpetual care trust investment security transactions recorded in Other income in the Consolidated Statement of Operations for the three and six months ended June 30, 2006 and 2007 are as follows (in thousands).

| | For the three months ended June 30, | | For the six months ended June 30, | |
|--|--|--------|--------------------------------------|--------|
| | 2006 | 2007 | 2006 | 2007 |
| Investment income (loss) | \$ (94) | \$ 291 | \$ 366 | \$ 621 |
| Realized gains | 282 | 603 | 1,078 | 976 |
| Realized losses | (77) | (30) | (381) | (57) |
| Expenses | (165) | (600) | (175) | (558) |
| Increase in non-controlling interests in trust investments | 54 | (264) | (888) | (982) |
| | \$ | \$ | \$ | \$ |

11. MAJOR SEGMENTS OF BUSINESS

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

| | Funeral | Cemetery | Corporate | Consolidated |
|---|-----------|-----------|------------|--------------|
| Revenues from continuing operations: | | | | |
| Six months ended June 30, 2007 | \$ 62,994 | \$ 21,328 | \$ | \$ 84,322 |
| Six months ended June 30, 2006 | \$ 59,059 | \$ 19,236 | \$ | \$ 78,295 |
| Income (loss) from continuing operations before income taxes: | | | | |
| Six months ended June 30, 2007 | \$ 19,143 | \$ 4,606 | \$(15,700) | \$ 8,049 |
| Six months ended June 30, 2006 | \$ 16,413 | \$ 2,731 | \$(14,518) | \$ 4,626 |
| Total assets: | | | | |
| June 30, 2007 | \$357,026 | \$200,857 | \$ 49,652 | \$607,535 |
| December 31, 2006 | \$309,140 | \$181,225 | \$ 74,631 | \$564,996 |

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Table of Contents**12. SUPPLEMENTAL DISCLOSURE OF STATEMENT OF OPERATIONS INFORMATION**

| | For the three months ended June 30, | | For the six months ended June 30, | |
|------------------------|--|-----------|--------------------------------------|-----------|
| | 2006 | 2007 | 2006 | 2007 |
| Revenues | | | | |
| Goods | | | | |
| Funeral | \$ 12,085 | \$ 12,878 | \$ 25,391 | \$ 26,527 |
| Cemetery | 6,407 | 8,070 | 13,412 | 15,091 |
| Total goods | \$ 18,492 | \$ 20,948 | \$ 38,803 | \$ 41,618 |
| Services | | | | |
| Funeral | \$ 15,986 | \$ 17,541 | \$ 33,668 | \$ 36,467 |
| Cemetery | 2,776 | 3,172 | 5,824 | 6,237 |
| Total services | \$ 18,762 | \$ 20,713 | \$ 39,492 | \$ 42,704 |
| Total revenues | \$ 37,254 | \$ 41,661 | \$ 78,295 | \$ 84,322 |
| Cost of revenues | | | | |
| Goods | | | | |
| Funeral | \$ 10,585 | \$ 10,804 | \$ 21,268 | \$ 21,745 |
| Cemetery | 5,044 | 5,654 | 10,111 | 10,231 |
| Total goods | \$ 15,629 | \$ 16,458 | \$ 31,379 | \$ 31,976 |
| Services | | | | |
| Funeral | \$ 8,010 | \$ 8,515 | \$ 16,229 | \$ 17,049 |
| Cemetery | 1,754 | 1,810 | 3,518 | 3,532 |
| Total services | \$ 9,764 | \$ 10,325 | \$ 19,747 | \$ 20,581 |
| Total cost of revenues | \$ 25,393 | \$ 26,783 | \$ 51,126 | \$ 52,557 |

Table of Contents**13. SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION**

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

| | For the six months ended June 30, | |
|---|--------------------------------------|---------|
| | 2006 | 2007 |
| Cash paid for interest and financing costs | 9,090 | 9,009 |
| Cash paid for income taxes (state) | 159 | 178 |
| Restricted common stock issued to officers and directors | | 1,234 |
| Net deposits (withdrawals) in preneed funeral trust investments | (3,634) | (1,173) |
| Net deposits in preneed cemetery trust investments | (2,899) | (3,115) |
| Net deposits into perpetual care trusts | (2,556) | (1,030) |
| Net (deposits) withdrawals from preneed funeral trust receivables | 431 | (3,898) |
| Net (deposits) withdrawals in cemetery trust receivables | 260 | (756) |
| Net withdrawals in preneed funeral receivables | 136 | 351 |
| Net deposits (withdrawals) in preneed funeral trust accounts increasing deferred revenue | 5,438 | (3,279) |
| Net deposits (withdrawals) in cemetery trust accounts increasing (decreasing) deferred revenue | 5,976 | (1,443) |
| Net deposits (withdrawals) in preneed funeral trust accounts increasing (decreasing) noncontrolling interests | (2,422) | 1,173 |
| Net deposits (withdrawals) in cemetery trust accounts increasing (decreasing) noncontrolling interests | (2,128) | 3,115 |
| Deposits in perpetual care trust accounts increasing noncontrolling interests | 1,438 | 1,834 |
| Restricted cash investing and financing activities: | | |
| Proceeds from the sale of available for sale securities of the funeral and cemetery trusts | 29,967 | 17,706 |
| Purchase of available for sale securities of the funeral and cemetery trusts | 28,216 | 32,873 |
| Net deposits (withdrawals) in trust accounts increasing (decreasing) noncontrolling interests | (7,875) | 9,956 |

14. DEBT

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

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

15. STOCK-BASED COMPENSATION*Stock options and employee stock purchase plan*

No stock options were awarded during the first six months of 2007. During the second quarter of 2007, employees purchased a total of 19,976 shares of common stock through the employee stock purchase plan (ESPP) at a weighted average price of \$4.73 per share. The Company recorded pre-tax stock-based compensation expense for the stock options and the ESPP totaling \$101,000 and \$31,000 for the three months ended June 30, 2006 and 2007 and

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\$153,000 and \$70,000 for the six months ended June 30, 2006 and 2007. As of June 30, 2007, there was \$9,000 of total unrecognized compensation costs, net of estimated forfeitures, related to nonvested stock options that are expected to be recognized over a weighted-average period of approximately one year.

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The fair value of the right (option) to purchase shares under the ESPP during 2006 and 2007, respectively, is estimated on the date of grant using the Black-Sholes option-pricing model with the following weighted average assumptions:

| | Six Months Ended June 30, 2006 | Six Months Ended June 30, 2007 |
|-------------------------------------|---|---|
| Employee Stock Purchase Plan | | |
| Dividend yield | None | None |
| Expected volatility | 58.0% | 23.7% |
| Risk-free interest rate | 4.25% | 4.96% |
| Expected life (in years) | 0.25 | 0.25 |

Expected volatilities are based on the historical volatility for the last twelve months of our stock. The risk-free rate for periods within the contractual life of the option is based on the U.S. Treasury yields in effect at the time of grant.

Common stock grants

The Company granted 180,500 shares of restricted stock to certain officers and employees during the first quarter of 2007, with a four-year vesting period. The Company granted 20,000 shares of restricted stock to a new director in which 10,000 vest immediately and 10,000 vest over four years. Additionally, the other outside directors each received 3,000 shares of restricted stock (total of 9,000) with immediate vesting. The Company recorded \$297,000 and \$317,000 in pre-tax compensation expense for the six months ended June 30, 2006 and 2007, respectively, related to the vesting of restricted stock awards. As of June 30, 2007, there was \$1,651,000 of total unrecognized compensation costs related to unvested restricted stock awards, which is expected to be recognized over a weighted average period of approximately two years.

Directors may elect to receive all or a portion of their fees in stock. During the three months ended June 30, 2006 and 2007, the Company issued unrestricted common stock to directors totaling 3,003 and 2,542 shares respectively, in lieu of payment in cash for their fees, the value of which totaled \$28,000 and \$36,000, respectively. During the six months ended June 30, 2006 and 2007, the Company issued unrestricted stock to directors totaling 9,912 and 10,364 shares respectively, in lieu of payment in cash for their fees, the value of which totaled \$63,000 and \$76,000, respectively.

16. SUBSEQUENT ACQUISITION

The Company acquired substantially all the assets and assumed liabilities of six funeral home businesses in Springfield, Massachusetts on August 3, 2007 in exchange for a cash payment at closing in the amount of \$3.5 million. Management currently plans to sell one of the locations for use other than a funeral home.

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Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

Forward-Looking Statements

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

Cautionary Statements

We caution readers that the following important factors, among others, in some cases have affected, and in the future could affect, our actual consolidated results and could cause our actual consolidated results in the future to differ materially from the goals and expectations expressed herein and in any other forward-looking statements made by or on behalf of us. For further information regarding risks associated with our business and the death care industry, see Item 1A Risk Factors in our annual report filed on Form 10-K for the year ended December 31, 2006.

Risks related to our business

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

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

(3) Price competition could also reduce our market share or cause us to reduce prices to retain or recapture market share, either of which could reduce revenues and margins.

(4) Our ability to execute our growth strategy is highly dependent upon our ability to successfully identify suitable acquisition candidates and negotiate transactions on favorable terms.

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

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

(7) Our smaller businesses are typically dependent upon one or a few key employees for success.

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

(9) Covenant restrictions under our debt instruments may limit our flexibility in operating our business.

Risks related to the death care industry

(1) Declines in the number of deaths in our markets can cause a decrease in revenues. Changes in the number of deaths are not predictable from market to market or over the short term.

(2) The increasing number of cremations in the United States could cause revenues to decline because we could lose market share to firms specializing in cremations. In addition, direct cremations produce minimal revenues for cemetery operations and lower funeral revenues.

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

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

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

Table of Contents**OVERVIEW***General*

We operate two types of businesses: funeral homes, which account for approximately 75% of our revenues, and cemeteries, which account for approximately 25% of our revenues. Funeral homes are principally 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 outer burial containers. As of June 30, 2007, we operated 130 funeral homes in 27 states and 32 cemeteries in 11 states within the United States. Substantially all administrative activities are conducted or coordinated in our home office in Houston, Texas.

We have implemented long-term models in our operations which are designed to improve operating and financial results. We introduced a more decentralized, entrepreneurial and local operating model that we refer to as our

Standard Operating Model . This model includes 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 and, focuses on key drivers of a successful operation market share, people and operating and financial metrics. The model requires strong leadership to grow an entrepreneurial, high value, personal service and sales business at sustainable profit margins. We believe a primary driver of higher margins in the future will be the execution of our Strategic Portfolio Optimization Model that helps us to assess acquisition and divestiture candidates. Using this model, we believe 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.

Funeral Operations

Factors affecting our funeral operating results include: demographic trends in terms of population growth and average age, which impact death rates and number of deaths; establishing and maintaining leading market share positions supported by strong local heritage and relationships; effectively responding to increasing cremation trends by packaging complementary services and merchandise; controlling salary and merchandise costs; and exercising pricing leverage related to our at-need business to increase average revenues per contract. In simple terms, volume and price are the two variables that affect funeral revenues. The average revenue per contract is influenced by the mix of traditional and cremation services because our average cremation service revenue is approximately 38% of the average revenue earned from a traditional burial service. Funeral homes have a relatively fixed cost structure. Thus, small changes in revenues, up or down, normally cause significant changes to our profitability.

Our same store volumes have declined gradually each year from 22,514 in 2003 to 21,555 in 2006 (compound annual decline of 1.4%) consistent with a period of weak death rates nationally and the loss of market share primarily in our Central Region funeral operations. We have continued to experience lower volumes in 2007, primarily in our eastern and Western Regions, while the Central Region has reversed its previous trend by reporting slightly higher volumes. Our same store funeral operations have increased revenue steadily from \$107.9 million in 2003 to \$113.7 million in 2006 (compound annual increase of 1.8%). We expect same store portfolio volumes to stabilize and our average revenue per funeral to increase over time as we seek to provide increased services to our client families in order to offset potential weak death rates and higher cremation rates.

Cemetery Operations

The cemetery operating results are affected by the size and success of our sales organization. Approximately 55% of our cemetery revenues relate to preneed sales of interment rights and mausoleums and related merchandise and services. We believe that changes in the level of consumer confidence (a measure of whether consumers will spend for discretionary items) also affect the amount of cemetery revenues. Approximately 10% of our cemetery revenues are attributable to investment earnings on trust funds and finance charges on installment contracts. Changes in the capital markets and interest rates affect this component of our cemetery revenues.

Our same store cemetery financial performance from 2003 through 2005 was characterized by increasing revenues but slightly declining Field level profit margins. Our goal is to build broader and deeper teams of sales leaders and counselors in our larger and more strategically located cemeteries that can sustain consistent, modest growth in

preneed property sales over time and to diversify and substantially increase our cemetery operating and financial results.

Financial Highlights

Net income from continuing operations for the three months ended June 30, 2007 totaled \$1.9 million, equal to \$0.10 per diluted share as compared to net income from continuing operations of \$0.6 million for the second quarter of 2006, or \$0.03 per diluted share. Net income from continuing operations for the six months ended June 30, 2007 totaled \$4.9 million, equal to \$0.26 per diluted share as compared to net income from continuing operations of \$2.9 million for the first six months of 2006, or \$0.15 per diluted share.

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The year to date improvement in earnings is due in large part to the success of three initiatives in which we have focused our attention to improve operating results for 2007: (1) the significant improvement of existing Central Region funeral homes, (2) new leadership and sales growth at Rolling Hills Memorial Park and (3) operating results from 2007 acquisitions. The existing Central Region funeral homes generated 7.8% higher revenues and \$1.2 million in additional net income, equal to \$0.06 per diluted share in the first six months of 2007 when compared to the same period in 2006. A new Managing Partner was hired at the beginning of 2007 at Rolling Hills Memorial Park, and with the influence of that new leadership and other improvements, revenues at Rolling Hills Memorial Park increased 30.4% which helped generate \$0.7 million in additional net income, equal to \$0.03 per diluted share. During the second quarter of 2007 we acquired a combination funeral home and cemetery in California and a combination funeral home and cemetery and a stand-alone cemetery in Idaho. Those acquired businesses, along with the Texas businesses acquired in the first quarter generated revenues totaling \$4.0 million and net income of \$0.7 million, equal to \$0.04 per diluted share. We expect a continued positive trend in net income during the balance of 2007 and into 2008 from these three areas.

Income from discontinued operations for the six months ended June 30, 2007 totaled \$0.4 million, equal to \$0.02 per diluted share. During the first six months of 2007, the Company completed the sale of three funeral home businesses, resulting in a pre-tax gain of \$0.7 million. Loss from discontinued operations for the six months ended June 30, 2006 totaled \$(3.9) million, equal to \$(0.20) per diluted share. During the 2006 period we recorded pre-tax impairment charges of approximately \$6.3 million to write down the book value of non-strategic businesses in Indiana to the estimated net sales proceeds.

CRITICAL ACCOUNTING POLICIES AND ESTIMATES

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

Management's discussion and analysis of financial condition and results of operations are based upon our consolidated financial statements presented herewith, which have been prepared in accordance with accounting principles generally accepted in the United States excluding certain year end adjustments because of the interim nature of the consolidated financial statements. Our significant accounting policies are more fully described in Note 1 to the Consolidated Financial Statements included in our annual report on Form 10-K for the year ended December 31, 2006. 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 are provided at the date that the sale is recognized as revenue. In addition, we monitor changes in delinquency rates and provide additional bad debt and cancellation reserves when

warranted.

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

Goodwill

The excess of the purchase price over the fair value of net identifiable assets acquired, as determined by management in transactions accounted for as purchases, is recorded as goodwill. Many of the acquired funeral homes have provided high quality service to families for generations. The resulting loyalty often represents a substantial portion of the value of a funeral business. Goodwill is typically not associated with or recorded for the cemetery businesses. In accordance with SFAS No. 142, 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.

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The calculation of fair value can vary dramatically with changes in estimates of the number of future services performed, inflation in costs, and the Company's cost of capital, which is impacted by long-term interest rates. If impairment is indicated, then an adjustment will be made to reduce the carrying amount of goodwill to fair value.

Income Taxes

The Company and its subsidiaries file a consolidated U.S. Federal income tax return and separate income tax returns in the states in which we operate. We record deferred taxes for temporary differences between the tax basis and financial reporting basis of assets and liabilities, in accordance with SFAS 109, Accounting for Income Taxes and account for uncertain tax positions in accordance with FASB Interpretation No. 48 Accounting for Uncertainty in Income Taxes. 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. 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.

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.

Discontinued Operations

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

RESULTS OF OPERATIONS

The following is a discussion of the Company's results of operations for the three and six month periods ended June 30, 2006 and 2007. Funeral homes and cemeteries owned and operated for the entirety of each period being compared are referred to as same-store or existing operations. Funeral homes and cemeteries purchased after January 2005 (date of refinancing our Senior Debt) are referred to as acquired.

Funeral Home Segment. The following table sets forth certain information regarding the revenues and gross profit of the Company from the funeral home operations for the three and six months ended June 30, 2006 compared to the three and six months ended June 30, 2007 (dollars in thousands).

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Three months ended June 30, 2006 compared to three months ended June 30, 2007 (dollars in thousands):

| | Three Months Ended | | Change | % |
|---|---------------------------|-------------|---------------|----------|
| | June 30, | | | |
| | 2006 | 2007 | Amount | |
| Total same-store revenue | \$ 27,197 | \$ 27,850 | \$ 653 | 2.4% |
| Acquired | 279 | 1,944 | 1,665 | * |
| Preneed insurance commissions revenue | 596 | 625 | 29 | 4.9% |
| Revenues from continuing operations | \$ 28,072 | \$ 30,419 | \$ 2,347 | 8.4% |
| Revenues from discontinued operations | \$ 984 | \$ 86 | \$ (898) | * |
| Total same-store gross profit | \$ 6,486 | \$ 7,503 | \$ 1,017 | 15.7% |
| Acquired | 78 | 542 | 464 | * |
| Preneed insurance commissions revenue | 596 | 625 | 29 | 4.9% |
| Gross profit from continuing operations | \$ 7,160 | \$ 8,670 | \$ 1,510 | 21.1% |
| Gross profit from discontinued operations | \$ 198 | \$ | \$ (198) | * |

* not meaningful

Six months ended June 30, 2006 compared to six months ended June 30, 2007 (dollars in thousands):

| | Six Months Ended | | Change | % |
|---|-------------------------|-------------|---------------|----------|
| | June 30, | | | |
| | 2006 | 2007 | Amount | |
| Total same-store revenue | \$ 57,330 | \$ 58,422 | \$ 1,092 | 1.9% |
| Acquired | 547 | 3,319 | 2,772 | * |
| Preneed insurance commissions revenue | 1,182 | 1,253 | 71 | 6.0% |
| Revenues from continuing operations | \$ 59,059 | \$ 62,994 | \$ 3,935 | 6.7% |
| Revenues from discontinued operations | \$ 2,126 | \$ 231 | \$ (1,895) | * |
| Total same-store gross profit | \$ 15,076 | \$ 17,199 | \$ 2,123 | 14.1% |
| Acquired | 155 | 955 | 800 | * |
| Preneed insurance commissions revenue | 1,182 | 1,253 | 71 | 6.0% |
| Gross profit from continuing operations | \$ 16,413 | \$ 19,407 | \$ 2,994 | 18.2% |
| Gross profit from discontinued operations | \$ 513 | \$ (36) | \$ (549) | * |

* not meaningful

Funeral same-store revenues for the three months ended June 30, 2007 increased \$0.7 million, or 2.4%, when compared to the three months ended June 30, 2006 as we experienced a decrease of 2.1% in the number of contracts and an increase of 4.6% to \$5,406 in the average revenue per contract for those existing operations. Total funeral same-store gross profit for the three months ended June 30, 2007 increased \$1.0 million from the comparable three months of 2006, and as a percentage of funeral same-store revenue, increased from 23.9% to 26.9%. The Central Region generated an increase of \$0.9 million in same-store revenues, equal to 11.6% for the region, and provided most of the increase in same-store profits. The improvement in the Central Region was due to the ability to realize a 5.9% increase in the average revenue per contract, a 5.5% increase in number of contracts and aggressive expense management.

Acquired revenue and gross profit is related primarily to the funeral home businesses in Corpus Christi, Texas acquired in January 2007.

Cremation services represented 34.2 % of the number of funeral services during the second quarter of 2007, a slight decrease from 34.4% in the second quarter of 2006. The average revenue for burial contracts increased 4.5% to \$7,335, and the average revenue for cremation contracts increased 0.7% to \$2,708. 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. The average revenue for other contracts, which make up approximately nine percent of the number of contracts, declined \$480 to \$2,026. Other contracts consist of charges for merchandise or services for which we do not perform a funeral service for the deceased during the period.

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Cemetery Segment. The following table sets forth certain information regarding the revenues and gross profit of the Company from the cemetery operations for the three and six months ended June 30, 2006 compared to the three and six months ended June 30, 2007 (dollars in thousands).

Three months ended June 30, 2006 compared to three months ended June 30, 2007 (dollars in thousands):

| | Three Months Ended | | Change | % |
|---|---------------------------|-------------|---------------|----------|
| | June 30, | | | |
| | 2006 | 2007 | Amount | |
| Total same-store revenue | \$ 9,182 | \$ 10,141 | \$ 959 | 10.4% |
| Acquired | | 1,101 | 1,101 | * |
| Revenues from continuing operations | \$ 9,182 | \$ 11,242 | \$ 2,060 | 22.4% |
| Revenues from discontinued operations | \$ 473 | \$ | \$ (473) | * |
| Total same-store gross profit | \$ 1,084 | \$ 2,200 | \$ 1,116 | 103.0% |
| Acquired | | 269 | 269 | * |
| Gross profit from continuing operations | \$ 1,084 | \$ 2,469 | \$ 1,385 | 127.8% |
| Gross profit from discontinued operations | \$ 151 | \$ | \$ (151) | * |

* not meaningful

Six months ended June 30, 2006 compared to six months ended June 30, 2007 (dollars in thousands):

| | Six Months Ended | | Change | % |
|---|-------------------------|-------------|---------------|----------|
| | June 30, | | | |
| | 2006 | 2007 | Amount | |
| Total same-store revenue | \$ 19,236 | \$ 19,838 | \$ 602 | 3.1% |
| Acquired | | 1,490 | 1,490 | * |
| Revenues from continuing operations | \$ 19,236 | \$ 21,328 | \$ 2,092 | 10.9% |
| Revenues from discontinued operations | \$ 663 | \$ | \$ (663) | * |
| Total same-store gross profit | \$ 2,731 | \$ 4,357 | \$ 1,626 | 59.5% |
| Acquired | | 313 | 313 | * |
| Gross profit from continuing operations | \$ 2,731 | \$ 4,670 | \$ 1,939 | 71.0% |
| Gross profit from discontinued operations | \$ 58 | \$ | \$ (58) | * |

* not meaningful

Cemetery same-store revenues for the three months ended June 30, 2007 increased \$1.0 million, or 10.4% compared to the three months ended June 30, 2006, the majority (\$0.6 million) of which was due to higher revenues at

our largest business, Rolling Hills Memorial Park and secondarily to broadly higher performance in our Eastern Region cemeteries. Total atneed revenues increased from \$3.5 million to \$4.0 million. Total revenue from property sales increased \$1.4 million and revenues from merchandise and service deliveries increased \$0.2 million.

Cemetery same-store gross profit for the three months ended June 30, 2007 increased \$1.1 million, approximately twice the amount for the comparable three months of 2006. As a percentage of revenues, cemetery same store gross profit increased from 11.8% to 21.7%, the primary reason was the additional margin on the higher level of revenues. Secondarily, improvements in collection efforts resulted in \$0.4 million less bad debt expense.

Acquired revenue and gross profit for the three months ended June 30, 2007 represents the results of Seaside Memorial Park in Corpus Christi, Texas which was acquired in January 2007 and Conejo Mountain Memorial Park in Camarillo, California, which was acquired in April 2007. Because the acquisition of Cloverdale Park, Inc. occurred in mid June 2007, it had little impact on revenues or gross profit.

Other. General, administrative and other expenses totaled \$3.5 million and \$7.0 for the three and six months ended June 30, 2007 and \$2.6 and \$5.1 for the three and six months ended June 30, 2006. Included in this category for the 2007 periods are the costs to integrate the acquired businesses.

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Table of Contents*Income Taxes*

The Company recorded income taxes on earnings from continuing operations at the effective rate of 38.5% during 2007. For Federal income tax reporting purposes, Carriage has net operating loss carryforwards totaling \$6.1 million net of unrecognized tax benefits available at June 30, 2007 to offset future Federal taxable income, which expire between 2021 and 2025 if not utilized. Carriage also has approximately \$81.0 million of state net operating loss carryforwards that will expire between 2007 and 2025, if not utilized. Based on management's assessment of the various state net operating losses, it was determined that it is more likely than not that the Company will not be able to realize tax benefits on a substantial amount of the state losses. Accordingly, the Company established a valuation allowance against a substantial portion of the deferred tax asset related to the state operating losses.

LIQUIDITY AND CAPITAL RESOURCES

Cash and corporate investments at June 30, 2007 totaled \$19.3 million and consisted of \$14.3 million in cash, and \$5.0 million in a Federal agency bond. Cash and corporate investments totaled \$41.0 million at December 31, 2006. The decrease of \$21.7 million since year end 2006 is primarily attributable to the \$28.9 million used for the acquisitions in 2007. For the six months ended June 30, 2007, cash provided by operating activities of continuing operations was \$10.1 million as compared to \$9.2 million for the six months ended June 30, 2006. Additionally, capital expenditures totaled \$5.6 million compared to \$2.4 million in the prior year.

The Company's senior debt at June 30, 2007 totaled \$139.6 million and consisted of \$130.0 million in Senior Notes, described below, and \$9.6 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 June 30, 2007.

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

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

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

The Company intends to use its cash and short-term investments, cash flow and proceeds from the sale of businesses, to acquire funeral home and cemetery businesses. The Company also has the ability to draw on its revolving credit facility, subject to customary terms and conditions of the credit agreement, to finance acquisitions.

SEASONALITY

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

INFLATION

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

Item 3. Quantitative and Qualitative Disclosures about Market Risk

Carriage is currently exposed to market risk primarily related to changes in interest rates related to the Company's debt, decreases in interest rates related to the Company's short-term investments and changes in the values of securities associated with the preneed and perpetual care trusts. For information regarding the Company's exposure to certain market risks, see Item 7A. Quantitative and Qualitative Market Risk Disclosure in the Company's annual report filed on Form 10-K for the year ended December 31, 2006. There have been no significant changes in the Company's

market risk from that disclosed in the Form 10-K for the year ended December 31, 2006.

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Item 4. Controls and Procedures

In accordance with the Securities Exchange Act of 1934 Rules 13a-15 and 15d-15, we carried out an evaluation under the supervision and with the participation of management, including our Chief Executive Officer and Chief Financial Officer, of the effectiveness of our disclosure controls and procedures as of the end of the period covered by this report. Based on that evaluation, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures were effective as of June 30, 2007 to provide reasonable assurance that information required to be disclosed in our reports filed or submitted under the Exchange Act is recorded, processed, summarized, and reported within the time periods specified in the Securities and Exchange Commission's rules and forms. Our disclosure controls and procedures include controls and procedures designed to ensure that information required to be disclosed in reports filed or submitted under the Exchange Act is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure.

There has been no change in our internal control over financial reporting that occurred during the six months ended June 30, 2007 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

PART II OTHER INFORMATION

Item 1. Legal Proceedings

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 consistent with our assessment of risks in our business and of an acceptable level of financial exposure. Although there can be no assurance that self-insurance reserves and insurance will be sufficient to mitigate all damages, claims or contingencies, we believe that our reserves and insurance provide reasonable coverage for known asserted or unasserted claims. In the event the Company 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 1A. Risk Factors

There have been no material changes in our risk factors from those disclosed in Item 1A of our Annual Report on Form 10-K for the year ended December 31, 2006.

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

Purchases of Equity Securities by the Issuer and Affiliated Purchasers

None

Issuance of Unregistered Securities

None

Item 3. Defaults Upon Senior Securities

None

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

The Company's 2007 annual meeting was held on May 22, 2007. The director nominees were elected, the 2007 Employee Stock Purchase Plan was approved and the selection of KPMG LLP as Carriage's independent public accountants for the year ending December 31, 2007 was ratified. The voting tabulation was as follows:

| Name of Nominee/Plan | Number of Votes For | Number of Votes Against | Number of Votes Withheld |
|---|---------------------------|-------------------------------|--------------------------------|
| Vincent D. Foster | 15,964,402 | | 240,687 |
| Gary L. Forbes | 15,963,863 | | 241,226 |
| Approval of the 2007 Employee Stock Purchase Plan | 9,947,484 | 314,898 | 5,942,707 |
| Ratification of the selection of KPMG LLP | 15,943,968 | 196,396 | 64,725 |

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

| Director | Expiration of Term at Annual Shareholder's Meeting |
|--------------------|--|
| Ronald A. Erickson | 2008 |
| Melvin C. Payne | 2009 |
| Joe R. Davis | 2009 |

The term of Mark F. Wilson expired at the 2007 annual meeting and he did not stand for re-election.

Item 5. Other Information

In connection with the Company's annual meeting on May 22, 2007, the shareholders approved the 2007 Employee Stock Purchase Plan (the "Plan"). The Plan provides a total of 1,000,000 shares of Carriage Services, Inc. Common Stock available for sale to all employees through payroll deductions. The Board of Directors has exclusive responsibility and authority over the Plan. A copy of the Plan was filed as Appendix A to the Company's 2007 Notice of Annual Meeting and Proxy Statement.

Except the preceding notice of the 2007 Employee Stock Purchase Plan, for which notice is alternately permitted in this the next Form 10-Q, the Company reported on Form 8-K during the quarter covered by this report all information required to be reported on such form.

Item 6. Exhibits

- 4.1 Amendment No. 2 to the Credit Agreement dated May 4, 2007 among Carriage Services, Inc., as the Borrower, Bank of America, N.A. as the Administrative Agent, Swing Line Lender and L/C Issuer and Wells Fargo Bank of Texas National Association, as Syndication Agent.
- 10.1 Amendment No. 1 to the 2006 Long Term Incentive Plan.
- 10.2 Stock Purchase Agreement as of June 12, 2007 among Carriage Cemetery Services of Idaho, Inc., buyer, and Timothy T. Gibson, seller, for 100 percent of the issued and outstanding capital stock of Cloverdale Park, Inc.
- 11.1 Computation of Per Share Earnings
- 31.1

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

31.2 Certification of Periodic Financial Reports by Joseph Saporito in satisfaction of Section 302 of the Sarbanes-Oxley Act of 2002

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 and 18 U.S.C. Section 1350

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SIGNATURES

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

CARRIAGE SERVICES, INC.

August 9, 2007
Date

/s/ Joseph Saporito
Joseph Saporito,
Executive Vice President, Chief Financial
Officer and Secretary (Authorized Officer
and Principal Financial Officer)

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