

CARRIAGE SERVICES INC

Form 10-K

March 09, 2007

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**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 **76-0423828**
(State or other jurisdiction of incorporation or organization) **(I.R.S. Employer Identification No.)**

3040 Post Oak Blvd., Suite 300, Houston, TX **77056**
(Address of principal executive offices) **(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 | New York Stock Exchange |
| Series G Preferred Stock Purchase Rights | New York Stock Exchange |
| (Title Of Class) | (Name of Exchange on which registered) |

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;

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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.

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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.

Proneed 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.

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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.

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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.

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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. 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.

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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.

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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.

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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 .

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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.

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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:

| | High | Low |
|----------------|-------------|------------|
| 2006 | | |
| First Quarter | \$5.25 | \$4.60 |
| Second Quarter | \$5.16 | \$4.40 |
| Third Quarter | \$4.94 | \$4.12 |
| Fourth Quarter | \$5.19 | \$4.61 |
| 2005 | | |
| 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

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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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| | Year ended December 31, | | | | |
|--|---|------------|------------|-------------|------------|
| | 2002 | 2003 | 2004 | 2005 | 2006 |
| | (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 |

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| | | | | | |
|---|------|------|--------|--------|--------|
| 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.

Table of Contents**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.

Table of Contents*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

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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.

Table of Contents**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.

Table of Contents**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 | 135 | 133 | 131 |
| Cemeteries at beginning of period | 30 | 30 | 29 |
| Acquisitions | | | |
| Divestitures | | 1 | 1 |
| Cemeteries at end of period | 30 | 29 | 28 |

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 |

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| | (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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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*, *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.

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**ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA
CARRIAGE SERVICES, INC.
INDEX TO CONSOLIDATED FINANCIAL STATEMENTS**

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| Report of Independent Registered Public Accounting Firm | 32 |
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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

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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

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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

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

| | December 31, | |
|---|---------------------|-------------------|
| | 2005 | 2006 |
| ASSETS | | |
| 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 | 51,152 | 61,462 |
| 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 | \$ 570,640 | \$ 564,996 |
| LIABILITIES AND STOCKHOLDERS EQUITY | | |
| 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 | 24,237 | 25,707 |
| 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 |

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| | | |
|--|------------|------------|
| Total liabilities | 441,154 | 437,434 |
| 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 | 96,374 | 96,373 |
| Total liabilities and stockholders' equity | \$ 570,640 | \$ 564,996 |

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

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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) |

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| | | | |
|--|---------|-----------|-----------|
| 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.

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

| | Shares | Common Stock | Additional Paid-in Capital | Accumulated Deficit | Total |
|--|--------|-----------------|----------------------------------|------------------------|------------|
| Balance December 31, 2003 | 17,545 | \$ 175 | \$ 186,045 | \$ (80,290) | \$ 105,930 |
| 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 |
| Balance December 31, 2004 | 17,910 | 179 | 187,315 | (71,056) | 116,438 |
| 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 |
| Balance December 31, 2005 | 18,458 | 185 | 189,110 | (92,921) | 96,374 |
| 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 |
| Balance December 31, 2006 | 18,608 | \$ 186 | \$ 190,524 | \$ (94,337) | \$ 96,373 |

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

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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) |

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| | | | |
|--|----------|----------|-----------|
| 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.

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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).

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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:

Table of Contents**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)****1. BASIS OF PRESENTATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)**

| | Years |
|----------------------------|--------------|
| 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:

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

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.

Table of Contents**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) |

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| | | | |
|--|-------------|---------------------------------|----------|
| 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.

Table of Contents**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.

Table of Contents**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 affect on the Consolidated Financial Statements, result of operations or liquidity of the Company.

Table of Contents**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.

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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).

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Table of Contents**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 |
|---|-------------------------|
| Assets: | |
| Current assets | \$ 124 |
| Property, plant and equipment, net | 1,406 |
| Preneed receivables and trust investments | 634 |
| 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 |

Table of Contents**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 | \$ (719) | \$ 1,884 | \$ (5,242) |

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 anum. 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 | \$ 157,358 | \$ 148,845 |

Table of Contents**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 | \$ 52,673 | \$ 3,056 | \$ (494) | \$ 55,235 |
| Accrued investment income | \$ 248 | | | \$ 248 |
| Trust assets | | | | \$ 55,483 |
| Market value as a percentage of cost | | | | 105.3% |

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 |
| | \$ 21,610 |

Table of Contents**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 | \$ 53,102 | \$ 2,085 | \$ (669) | \$ 54,518 |
| Accrued investment income | \$ 250 | | | \$ 250 |
| Trust assets | | | | \$ 54,768 |
| Market value as a percentage of cost | | | | 103.1% |

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 |

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| | | | | |
|--------------------------------------|-----------|----------|---------|-----------|
| Mutual funds: | | | | |
| Equity | 8,598 | 1,169 | (25) | 9,742 |
| Fixed income | 3,278 | 263 | (11) | 3,530 |
| Trust investments | \$ 42,792 | \$ 2,134 | \$ (75) | \$ 44,851 |
| Market value as a percentage of cost | | | | 104.8% |

Table of Contents**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 |
| | \$ 12,823 |

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 | \$ 46,861 | \$ 1,261 | \$ (444) | \$ 47,678 |

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 |

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| | | |
|--|---------|---------|
| 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) |
| | \$ | \$ |

Table of Contents**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) |
| | \$ 16,229 | \$ 15,649 |

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 | Fair Value |
|--------------------------------|--------------------------------------|-------------------|
| | (in thousands) | |
| 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 | \$ 17,427 | \$ 17,141 |

| | Historical Cost Basis | Fair Value |
|--------------------------------|--------------------------------------|-------------------|
| | (in thousands) | |
| 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 | \$ 18,071 | \$ 17,762 |

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.

Table of Contents**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 | \$ 30,007 | \$ 2,690 | \$ (277) | \$ 32,420 |
| Accrued investment income | \$ 120 | | | \$ 120 |
| Trust assets | | | | \$ 32,540 |
| Market value as a percentage of cost | | | | 108.4% |

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 |
| | \$ 8,932 |

Table of Contents**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 | \$ 31,075 | \$ 1,605 | \$ (475) | \$ 32,205 |
| Accrued investment income | \$ 151 | | | 151 |
| Trust assets | | | | \$ 32,356 |
| 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 | \$ 33,112 | \$ 31,189 |

Table of Contents**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) |
| | \$ | \$ |

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 |
| | \$ 25,608 | \$ 30,459 |

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) |

\$ 134,572 \$ 133,841

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

Table of Contents**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.

Table of Contents**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 | \$ 10,214 | \$ 15,101 |
| | | |
| 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 | | \$ 4,728 |

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.

Table of Contents**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:

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

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:

| | 2004 | | 2005 | | 2006 | |
|---|-------------|---------|-------------|---------|-------------|---------|
| | Amount | Percent | Amount | Percent | Amount | Percent |
| 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) |
| | \$ 81 | 0.7% | \$ (456) | 31.5% | \$ 2,375 | 38.3% |

Table of Contents**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 | \$ 17,419 | \$ 18,212 |
| | | |
| Current deferred tax asset | \$ 1,525 | \$ 1,672 |
| Non-current deferred tax asset | 15,894 | 16,540 |
| Total net deferred tax assets | \$ 17,419 | \$ 18,212 |

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.

Table of Contents**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 | Wtd. Avg. Ex Price | Shares | Wtd. Avg. Ex Price | Shares | Wtd. Avg. Ex Price |
| | (000) | | (000) | Ex Price | (000) | 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 | Options Outstanding | | Options Exercisable | |
|--------------------|---------------------|------------------|---------------------|--|
| | Number | Weighted-Average | Number | |

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| Exercise Prices | Outstanding at 12/31/06 | Remaining Contractual Life | Weighted-Average Exercise Price | Exercisable at 12/31/06 | Weighted-Average Exercise Price |
|-----------------|-------------------------------|-------------------------------|------------------------------------|-------------------------------|------------------------------------|
| 150% increment | | | | | |
| \$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 |

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Table of Contents**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:

| | Stock Options | ESPP |
|-------------------------|----------------------|---------------|
| 2006 Assumptions: | | |
| 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 |

| | Stock Options | ESPP |
|-------------------------|----------------------|---------------|
| 2005 Assumptions: | | |
| 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 |

| | Stock Options | ESPP |
|-------------------------|----------------------|---------------|
| 2004 Assumptions: | | |
| 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:

| | Shares (in thousands) | Weighted Average Grant Date Fair Value |
|------------------------------|--------------------------------------|---|
| Unvested stock awards | | |
| 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 | 248,750 | 4.76 |
|-------------------------------|---------|------|

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

Table of Contents**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) | \$ 9,234 | \$ (21,865) | \$ (1,416) |
| 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 | 18,260 | 18,334 | 18,912 |
| Basic earnings (loss) per share: | | | |
| Continuing operations | \$ 0.56 | \$ (0.05) | \$ 0.21 |
| Discontinued operations | (0.04) | 0.10 | (0.29) |

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| | | | |
|--|---------|-----------|-----------|
| 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) |

Table of Contents**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.

| | Funeral | Cemetery | Corporate | Consolidated |
|---|---|-----------------|------------------|---------------------|
| | (in thousands, except number of operating locations) | | | |
| 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 |

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| | | | | |
|--|-----------|----------|------------|-----------|
| 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 |
| | | | 60 | |

Table of Contents**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)****21. SUPPLEMENTAL DISCLOSURE OF STATEMENT OF OPERATIONS INFORMATION**

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

Table of Contents**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.

| | First Quarter | Second Quarter | Third Quarter | Fourth Quarter |
|--|--------------------------|---------------------------|--------------------------|---------------------------|
| 2006 | | | | |
| 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) | \$ (1,735) | \$ 703 | \$ (565) | \$ 181 |
| 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 | \$ (0.09) | \$ 0.04 | \$ (0.03) | \$ 0.01 |
| 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 | \$ (0.09) | \$ 0.04 | \$ (0.03) | \$ 0.01 |
| 2005 | | | | |
| 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) | \$ (23,560) | \$ 232 | \$ 670 | \$ 793 |
| 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 | \$ (1.29) | \$ 0.01 | \$ 0.04 | \$ 0.04 |
| 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 | \$ (1.29) | \$ 0.01 | \$ 0.04 | \$ 0.04 |

- (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.

Table of Contents**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 | \$ 3,919 | \$ (379) | \$ 716 |

(decreasing) noncontrolling interests

| | | | |
|---|-------|--------|----------|
| 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) |
|---|----------|------------|-------------|

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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.

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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

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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 |
|---|-------------------|----------------------------------|-----------|---------------------|
| Year ended December 31, 2004: | | | | |
| 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 |
| Year ended December 31, 2005: | | | | |
| 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 |
| Year ended December 31, 2006: | | | | |
| Allowance for bad debts, current | \$ 937 | \$ 1,932 | \$ 1,944 | \$ 925 |

| | | | | |
|---|--------|----------|----------|--------|
| portion | | | | |
| 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 | \$ |
| | | 66 | | |

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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.

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PART III

ITEM 10. DIRECTORS, 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.

Table of Contents**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:

| | Page |
|---|-------------|
| 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:

| | Page |
|---|-------------|
| 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.

| Exhibit No. | Description |
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| 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
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| Exhibit No. | Description |
|--------------------|---|
| | 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. |
| 4.3 | Indenture for the Convertible Junior Subordinated Debentures due 2029 dated June 3, 1999 between the Company and Wilmington Trust Company. Incorporated by reference to Exhibit 4.8 to the Company's Form S-3 Registration Statement No. 333-84141. |
| 4.4 | Form of Carriage Services Capital Trust 7% Convertible Preferred Securities. Incorporated by reference to Exhibit 4.10 to the Company's Form S-3 Registration Statement No. 333-84141. |
| 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. |
| 4.6 | Preferred Securities Guarantee dated June 3, 1999 between the Company and Wilmington Trust Company. Incorporated by reference to Exhibit 4.12 to the Company's Form S-3 Registration Statement No. 333-84141. |
| 4.7 | Common Securities Guarantee, dated June 3, 1999 by Carriage Services, Inc. as Guarantor. Incorporated by reference to Exhibit 4.13 to the Company's Form S-3 Registration Statement No. 333-84141. |
| 4.8 | Amendment No. 1 to Amended and Restated Declaration of Trust of Carriage Services Capital Trust. Incorporated by reference to Exhibit 4.14 to the Company's Form S-3 Registration Statement No. 333-84141. |
| 4.9 | Rights Agreement with American Stock Transfer & Trust Company dated December 18, 2000. Incorporated by reference to Exhibit 1 to the Company's Form 8-A filed December 29, 2000. |
| 4.10 | Indenture dated as of January 27, 2005 between Carriage Services, Inc., the Guarantors named therein, as Guarantors, and Wells Fargo Bank, National Association, as trustee. Incorporated herein by reference to Exhibit 4.1 to the Company's current report on Form 8-K dated January 27, 2005. |
| 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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| Exhibit No. | Description |
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| 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. |
| 10.4 | Second Amended and Restated 1996 Director's Stock Option Plan. Incorporated by reference to Exhibit 99.1 to the Company's 2000 Schedule 14A. |
| 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. |
| 10.8 | Indemnity Agreement with Melvin C. Payne dated December 18, 2000. Incorporated by reference to Exhibit 10.20 to the Company's Annual Report on Form 10-K for its fiscal year ended December 31, 2000. |
| 10.9 | Indemnity Agreement with Mark F. Wilson dated December 18, 2000. Incorporated by reference to Exhibit 10.24 to the Company's Annual Report on Form 10-K for its fiscal year ended December 31, 2000. |
| 10.10 | Indemnity Agreement with Ronald A. Erickson dated December 18, 2000. Incorporated by reference to Exhibit 10.27 to the Company's Annual Report on Form 10-K for its fiscal year ended December 31, 2000. |
| 10.11 | Indemnity Agreement with Vincent D. Foster dated December 18, 2000. Incorporated by reference to Exhibit 10.28 to the Company's Annual Report on Form 10-K for its fiscal year ended December 31, 2000. |
| 10.12 | Employment Agreement with George J. Klug dated May 7, 2002. Incorporated by reference to Exhibit 10.1 to the Company's Quarterly Report on Form 10-Q for its quarter ended June 30, 2002. |

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- 10.13 Indemnity Agreement with Joe R. Davis dated May 13, 2003. Incorporated by reference to Exhibit 10.1 to the Company's Quarterly Report on Form 10-Q for its quarter ended June 30, 2003.
- 10.14 Indemnity Agreement with Joseph Saporito dated May 13, 2003. Incorporated by reference to Exhibit 10.2 to the Company's Quarterly Report on Form 10-Q for its quarter ended June 30, 2003.

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| Exhibit No. | Description |
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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. |
| *10.18 | Termination Agreement with James J. Benard dated July 17, 2006. |
| *10.19 | Employment Agreement with J. Bradley Green dated September 11, 2006. |
| *10.20 | Contingent Asset Sale Agreement dated November 22, 2006 among Carriage Cemetery Services, Inc. and SCI Funeral Services, Inc. |
| *10.21 | Asset Purchase Agreement dated December 15, 2006 among Carriage Cemetery Services, Inc. and Seaside Cemetery, Inc. |
| *10.22 | Amendment No. 1 to the Contingent Asset Sale Agreement dated January 22, 2007 among Carriage Cemetery Services, Inc. and Alderwoods Group (California), Inc. |
| *10.23 | Amendment No. 2 to the Contingent Asset Sale Agreement dated February 26, 2007 among Carriage Cemetery Services, Inc. and Alderwoods Group (California), Inc. |
| *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 www.carriageservices.com . |
| 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. |
| *21.1 | Subsidiaries of the Company. |
| *23.1 | Consent of KPMG LLP. |
| *31.1 | Certification of Periodic Financial Reports by Melvin C. Payne in satisfaction of Section 302 of the Sarbanes-Oxley Act of 2002. |
| *31.2 | Certification of Periodic Financial Reports by 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. |

(*) Filed herewith.

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

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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.

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

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Index to Exhibits

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| 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). |
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| 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. |

- *21.1 Subsidiaries of the Company.
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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.

(*) Filed herewith.

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