

SERVICE CORPORATION INTERNATIONAL

Form 10-Q/A

August 14, 2006

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**FORM 10-Q/A
(Amendment No. 1)
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D. C. 20549**

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

For the quarterly period ended September 30, 2005

or

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

For the transition period from _____ to _____

Commission file number 1-6402-1

SERVICE CORPORATION INTERNATIONAL
(Exact name of registrant as specified in charter)

Texas

(State or other jurisdiction of incorporation or organization)

74-1488375

(I. R. S. employer identification number)

1929 Allen Parkway, Houston, Texas
(Address of principal executive offices)

77019

(Zip code)

713-522-5141

(Registrant's telephone number, including area code)

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 and (2) has been subject to the filing requirements for the past 90 days.

YES

NO

Indicate by check mark whether the registrant is an accelerated filer (as defined in the Securities Exchange Act of 1934 Rule 12b-2).

YES

NO

Indicate by check mark whether the registrant is a shell company (as defined by Rule 12b-2 of the Exchange Act)

YES

NO

The number of shares outstanding of the registrant's common stock as of November 4, 2005 was 296,561,925 (net of treasury shares).

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Explanatory Note:

The Company is amending its Form 10-Q for the quarterly period ended September 30, 2005 to restate its condensed consolidated financial statements as of September 30, 2005 and December 31, 2004 and for the three and nine month periods ended September 30, 2005 and 2004. Included in this amended Form 10-Q are certain adjustments to correct errors related to (1) the miscalculation of the Company's actuarially determined pension benefit obligation, (2) the accounting for certain leases related to funeral home properties which were previously accounted for as operating leases but should have been accounted for as capital leases, and (3) other adjustments identified in a subsequent period but deemed to be not material, either individually or in the aggregate and corrected in that subsequent period. All applicable amounts relating to this restatement have been reflected in the condensed consolidated financial statements and disclosed in the notes to the condensed consolidated financial statements in this amended Form 10-Q. For a discussion of the individual restatement adjustments, see Item 1. Financial Statements note two. Restatement of Financial Statements. Additionally, see Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations.

SERVICE CORPORATION INTERNATIONAL

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SERVICE CORPORATION INTERNATIONAL
CONDENSED CONSOLIDATED STATEMENT OF OPERATIONS
(UNAUDITED)

(In thousands, except per share amounts)

| | Three months ended | | Nine months ended | |
|--|---------------------------|-------------|--------------------------|--------------|
| | September 30, | | September 30, | |
| | 2005 | 2004 | 2005 | 2004 |
| | (Restated) | (Restated) | (Restated) | (Restated) |
| | note 2 | note 2 | note 2 | note 2 |
| Revenues | \$ 406,369 | \$ 397,186 | \$ 1,285,653 | \$ 1,404,597 |
| Costs and expenses | (347,526) | (328,519) | (1,055,966) | (1,149,170) |
| Gross profit | 58,843 | 68,667 | 229,687 | 255,427 |
| General and administrative expenses | (19,744) | (25,295) | (61,936) | (100,338) |
| Gains and impairment (losses) on dispositions, net | (27,446) | (3,281) | (28,659) | 33,021 |
| Operating income | 11,653 | 40,091 | 139,092 | 188,110 |
| Interest expense | (26,170) | (26,955) | (77,399) | (92,147) |
| Loss on early extinguishment of debt | | | (14,258) | (16,770) |
| Other income, net | 4,443 | 4,255 | 11,756 | 13,265 |
| | (21,727) | (22,700) | (79,901) | (95,652) |
| (Loss) income from continuing operations before income taxes and cumulative effects of accounting changes | (10,074) | 17,391 | 59,191 | 92,458 |
| (Benefit) provision for income taxes | (885) | 4,526 | 26,188 | (6,830) |
| (Loss) income from continuing operations before cumulative effects of accounting changes | (9,189) | 12,865 | 33,003 | 99,288 |
| (Loss) income from discontinued operations (net of income tax provision (benefit) of \$2,606, \$623, \$4,587 and \$(47,502), respectively) | (463) | 850 | 3,825 | 34,971 |
| Cumulative effects of accounting changes (net of income tax benefit of \$117,428 and \$22,907, respectively) | | | (187,538) | (50,593) |
| Net (loss) income | \$ (9,652) | \$ 13,715 | \$ (150,710) | \$ 83,666 |
| Basic (loss) earnings per share: | | | | |

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| | | | | | | | | |
|--|----|---------|----|---------|----|---------|----|---------|
| (Loss) income from continuing operations before cumulative effects of accounting changes | \$ | (.03) | \$ | .04 | \$ | .11 | \$ | .32 |
| Income from discontinued operations, net of tax | | | | | | .01 | | .11 |
| Cumulative effects of accounting changes, net of tax | | | | | | (.62) | | (.16) |
| Net (loss) income | \$ | (.03) | \$ | .04 | \$ | (.50) | \$ | .27 |
| Diluted (loss) earnings per share: | | | | | | | | |
| (Loss) income from continuing operations before cumulative effects of accounting changes | \$ | (.03) | \$ | .04 | \$ | .11 | \$ | .30 |
| Income from discontinued operations, net of tax | | | | | | .01 | | .10 |
| Cumulative effects of accounting changes, net of tax | | | | | | (.61) | | (.14) |
| Net (loss) income | \$ | (.03) | \$ | .04 | \$ | (.49) | \$ | .26 |
| Basic weighted average number of shares | | 297,421 | | 336,590 | | 304,366 | | 315,656 |
| Diluted weighted average number of shares | | 297,421 | | 340,215 | | 308,807 | | 348,894 |
| Dividends declared per share | \$ | .025 | | | \$ | .075 | | |

(See notes to unaudited condensed consolidated financial statements)

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SERVICE CORPORATION INTERNATIONAL
CONDENSED CONSOLIDATED BALANCE SHEET
(In thousands, except share amounts)

| | September 30, 2005 (Unaudited) (Restated) note 2 | December 31, 2004 (Restated) note 2 |
|--|---|---|
| Assets | | |
| Current assets: | | |
| Cash and cash equivalents | \$ 492,059 | \$ 287,785 |
| Receivables, net | 82,306 | 102,622 |
| Inventories | 66,158 | 81,526 |
| Current assets held for sale | 12,959 | |
| Current assets of discontinued operations | | 11,085 |
| Other | 55,069 | 53,820 |
| Total current assets | 708,551 | 536,838 |
| Preneed funeral receivables and trust investments | 1,238,123 | 1,267,784 |
| Preneed cemetery receivables and trust investments | 1,295,352 | 1,399,778 |
| Cemetery property, at cost | 1,376,817 | 1,509,599 |
| Property and equipment, at cost, net | 955,078 | 978,861 |
| Non-current assets held for sale | 49,774 | |
| Non-current assets of discontinued operations | | 4,367 |
| Deferred charges and other assets | 259,375 | 631,839 |
| Goodwill | 1,140,509 | 1,169,040 |
| Cemetery perpetual care trust investments | 701,382 | 729,048 |
| | \$ 7,724,961 | \$ 8,227,154 |
| Liabilities & Stockholders Equity | | |
| Current liabilities: | | |
| Accounts payable and accrued liabilities | \$ 233,634 | \$ 221,235 |
| Current maturities of long-term debt | 91,379 | 78,164 |
| Current liabilities of discontinued operations | | 7,111 |
| Income taxes | 690 | 7,850 |
| Total current liabilities | 325,703 | 314,360 |
| Long-term debt | 1,195,535 | 1,200,353 |
| Deferred preneed funeral revenues | 558,381 | 540,794 |
| Deferred preneed cemetery revenues | 789,143 | 803,144 |
| Deferred income taxes | 172,601 | 274,463 |
| Non-current liabilities held for sale | 49,985 | |
| Non-current liabilities of discontinued operations | | 58,225 |

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| | | |
|--|--------------|--------------|
| Other liabilities | 385,866 | 437,298 |
| Non-controlling interest in funeral and cemetery trusts | 1,973,091 | 2,050,658 |
| Commitments and contingencies (note 9) | | |
| Non-controlling interest in perpetual care trusts | 680,088 | 704,912 |
| Stockholders' equity: | | |
| Common stock, \$1 per share par value, 500,000,000 shares authorized, 298,148,297 and 323,225,352, issued and outstanding (net of 44,917,591 and 18,502,478 treasury shares, at par) | 298,148 | 323,225 |
| Capital in excess of par value | 2,216,952 | 2,395,057 |
| Unearned compensation | (4,153) | (2,022) |
| Accumulated deficit | (985,674) | (834,964) |
| Accumulated other comprehensive income (loss) | 69,295 | (38,349) |
| Total stockholders' equity | 1,594,568 | 1,842,947 |
| | \$ 7,724,961 | \$ 8,227,154 |

(See notes to unaudited condensed consolidated financial statements)

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SERVICE CORPORATION INTERNATIONAL
CONDENSED CONSOLIDATED STATEMENT OF CASH FLOWS
(UNAUDITED)
(In thousands)

| | Nine months ended | |
|--|--------------------------|-------------|
| | September 30, | |
| | 2005 | 2004 |
| | (Restated) | (Restated) |
| | note 2 | note 2 |
| Cash flows from operating activities: | | |
| Net (loss) income | \$ (150,710) | \$ 83,666 |
| Adjustments to reconcile net (loss) income to net cash provided by operating activities: | | |
| Net income from discontinued operations | (3,825) | (34,971) |
| Loss on early extinguishment of debt | 14,258 | 16,770 |
| Premiums paid on early extinguishment of debt | (12,186) | (13,817) |
| Cumulative effects of accounting changes, net of tax | 187,538 | 50,593 |
| Depreciation and amortization | 65,122 | 104,199 |
| Provision (benefit) for deferred income taxes | 24,528 | (8,883) |
| (Gains) and impairment losses on dispositions, net | 28,659 | (33,021) |
| Other non-cash adjustments | | 667 |
| Change in assets and liabilities, net of effects from acquisitions and dispositions: | | |
| Decrease in receivables | 24,912 | 25,464 |
| Decrease in other assets | 33,212 | 2,106 |
| Increase in payables and other liabilities | 8,901 | 20,772 |
| Net effect of preneed funeral production and maturities | (3,797) | (20,838) |
| Net effect of cemetery production and deliveries | 46,932 | (18,112) |
| Other | 337 | 318 |
| Net cash provided by operating activities from continuing operations | 263,881 | 174,913 |
| Net cash used in operating activities from discontinued operations | (5,344) | (5,378) |
| Net cash provided by operating activities | 258,537 | 169,535 |
| Cash flows from investing activities: | | |
| Capital expenditures | (72,241) | (67,495) |
| Proceeds from divestitures and sales of property and equipment | 58,122 | 30,326 |
| Proceeds and distributions from dispositions of businesses, net of cash retained | 112,018 | 330,789 |
| Proceeds from equity investments | 39,674 | |
| Payment of purchase obligations to former owners of acquired business | | (51,749) |
| Indemnity payments related to the joint venture of French operations | (1,834) | |
| Net withdrawals (deposits) of restricted funds and other | 13,944 | (120,903) |
| Net cash provided by investing activities from continuing operations | 149,683 | 120,968 |
| Net cash used in investing activities from discontinued operations | (212) | (132) |
| Net cash provided by investing activities | 149,471 | 120,836 |

Cash flows from financing activities:

| | | |
|--|------------|------------|
| Proceeds from issuance of long-term debt | 291,472 | 241,237 |
| Payments of debt | (8,209) | (124,878) |
| Early extinguishments of debt | (286,215) | (299,961) |
| Proceeds from exercise of stock options | 5,145 | 6,040 |
| Purchase of Company common stock | (191,221) | (34,812) |
| Payments of dividends | (15,184) | |
| Purchase of subsidiary stock | (844) | |
| Net cash used in financing activities | (205,056) | (212,374) |
| Effect of foreign currency | 1,322 | 617 |
| Net increase in cash and cash equivalents | 204,274 | 78,614 |
| Cash and cash equivalents at beginning of period | 287,785 | 239,431 |
| Cash and cash equivalents at end of period | \$ 492,059 | \$ 318,045 |

(See notes to unaudited condensed consolidated financial statements)

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SERVICE CORPORATION INTERNATIONAL
CONDENSED CONSOLIDATED STATEMENT OF STOCKHOLDERS EQUITY
(UNAUDITED)

(In thousands, except per share amounts)

| | Outstanding | Common | Treasury stock, par value | Capital in excess of par value | Unearned Compensation | Accumulated deficit (Restated) note 2 | Accumulated other comprehensive (loss) income | Total |
|---|-------------|------------|------------------------------------|--------------------------------------|--------------------------|--|---|--------------|
| Balance at December 31, 2004 | 323,225 | \$ 341,727 | \$ (18,502) | \$ 2,395,057 | \$ (2,022) | \$ (834,964) | \$ (38,349) | \$ 1,842,947 |
| Net loss | | | | | | (150,710) | | (150,710) |
| Dividends on common stock (\$0.075 per share) | | | | (22,641) | | | | (22,641) |
| Other comprehensive income: | | | | | | | | |
| Foreign currency translation | | | | | | | 6,056 | 6,056 |
| Reclassification for translation adjustments realized in net loss | | | | | | | 101,588 | 101,588 |
| Total other comprehensive income | | | | | | | | 107,644 |
| Stock option exercises | 1,338 | 1,338 | | 4,157 | | | | 5,495 |
| Tax benefit from stock option exercises | | | | 1,509 | | | | 1,509 |
| Restricted stock award | 499 | | 499 | 3,177 | (3,676) | | | |
| Restricted stock amortization | | | | | 1,545 | | | 1,545 |
| Purchase of Company common stock | (26,914) | | (26,914) | (164,307) | | | | (191,221) |
| | 298,148 | \$ 343,065 | \$ (44,917) | \$ 2,216,952 | \$ (4,153) | \$ (985,674) | \$ 69,295 | \$ 1,594,568 |

Balance at
September 30,
2005

(See notes to unaudited condensed consolidated financial statements)

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SERVICE CORPORATION INTERNATIONAL
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Dollars in thousands, except per share amounts)

1. Nature of Operations

Service Corporation International (SCI or the Company) owns and operates funeral service locations and cemeteries worldwide. The Company also has a minority interest equity investment in funeral operations in France. The Company owns and operates Kenyon International Emergency Services, a disaster response team that engages in mass fatality and emergency response services, which is included in the Company's funeral operations segment.

The funeral service and cemetery operations consist of funeral service locations, cemeteries, crematoria and related businesses. Personnel at the funeral service locations provide all professional services relating to atneed funerals, including the use of funeral facilities and motor vehicles, and preparation and embalming services. Funeral related merchandise (including caskets, burial vaults, cremation receptacles, flowers and other ancillary products and services) is sold at funeral service locations. Certain funeral service locations contain crematoria. The Company sells preneed funeral services whereby a customer contractually agrees to the terms of a funeral to be performed in the future. The Company's cemeteries provide cemetery property interment rights (including mausoleum spaces, lots and lawn crypts) and sell cemetery related merchandise (including stone and bronze memorials, burial vaults, casket and cremation memorialization products) and services (primarily merchandise installations and burial openings and closings). Cemetery items are sold on an atneed or preneed basis. Personnel at cemeteries perform interment services and provide management and maintenance of cemetery grounds. Certain cemeteries operate crematoria, and certain cemeteries contain gardens specifically for the purpose of cremation memorialization.

2. Restatement of Financial Statements

Overview 2006 Restatement

The Company has restated herein its previously issued condensed consolidated statement of operations for the three and nine months ended September 30, 2005 and 2004, its condensed consolidated statement of cash flows for the nine months ended September 30, 2005 and 2004, and its condensed consolidated balance sheet as of September 30, 2005 and December 31, 2004. This restatement corrects errors related to (1) the miscalculation of the Company's actuarially determined pension benefit obligation, (2) the accounting for certain leases related to funeral home properties which were previously accounted for as operating leases, but should have been accounted for as capital leases, and (3) other adjustments identified in a subsequent period but deemed to be not material either individually or in the aggregate. All applicable amounts related to this restatement have been reflected in the Company's condensed consolidated financial statements and disclosed in the notes to the condensed consolidated financial statements in this amended Form 10-Q.

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Pension Benefit Obligation

As previously disclosed in the Company's 2004 Form 10-K, effective January 1, 2004, the Company adopted a new accounting policy related to the accounting for actuarial gains and losses in its pension plan. Under the new accounting policy, the Company began to recognize such actuarial gains and losses in its consolidated statement of operations as they occurred. Previously, the Company amortized the difference between actual and expected investment returns and other actuarial gains and losses over seven years (except to the extent that settlements with employees required earlier recognition). As a result of this accounting change, the Company initially recognized an after tax charge in its 2004 financial statements, representing the cumulative effect of this accounting change, of \$33,599 (\$54,873 before tax). This amount represented the accumulated unrecognized net losses related to the pension plan assets and liabilities as of January 1, 2004.

During the second quarter of 2006, the Company discovered that its actuarially determined pension benefit obligation (PBO) had been incorrectly calculated for the years ended December 31, 2005, 2004, 2003, and 2002 as the impact of pending lump sum cash settlements in the PBO calculation at the end of each respective year had been inadvertently omitted. The net aggregate pre-tax impact of this error over the four-year period ended December 31, 2005 was \$4,233. Had this PBO calculation been correct at the time the Company adopted its new accounting policy effective January 1, 2004, the Company would have recognized an additional cumulative effect of accounting change of \$4,961 (\$3,037 after tax) in its December 31, 2004 consolidated statement of operations, as the vast majority of the impact of previously unrecognized pending lump sum settlements for 2002 and 2003 would have been recognized in connection with the accounting policy change.

Lease Accounting

During the first quarter of 2006, the Company determined that certain of its leases related to funeral home properties that were previously accounted for as operating leases should have been accounted for as capital leases. The aggregate pre-tax adjustment to the Company's previously issued consolidated financial statements is \$2,677, of which \$657 relates to the three-year period ended December 31, 2005. The remaining \$2,020 relates to periods prior to January 1, 2003.

Other Adjustments

The Company has also included other adjustments that were identified in a subsequent period but deemed to be not material, either individually or in the aggregate, and were therefore initially corrected in that subsequent period. Such adjustments impacted the timing of expense items, including income tax expenses previously recognized in the first quarter of 2006. The cumulative amount of such other adjustments was a net aggregate increase to pre-tax income of \$132 and an additional \$389 of income tax expense for the nine months ended September 30, 2005.

Materiality Assessment

The Company evaluated the materiality of these adjustments to its previously issued interim and annual financial statements including its interim financial statements as of and for the three months ended March 31, 2006. The Company determined that the impact of these errors was not material to its previously issued consolidated financial statements; however, the Company has determined that the cumulative correction of the errors in the second quarter of 2006 would have been material to the current period. Therefore, in accordance with paragraph 29 of Accounting Principles Board Opinion No. 28 and the SEC's Staff Accounting Bulletin (SAB) Topic 5-F, the Company is restating its previously issued financial statements to reflect the corrections of the errors in each of the periods affected. As a result, the Company has restated herein its condensed consolidated statements of operations for the three and nine months ended September 30, 2005 and 2004, its condensed consolidated statement of cash flows for the nine months ended September 30, 2005 and 2004, and its condensed consolidated balance sheet at September 30, 2005 and December 31, 2004.

Table of Contents*Overview 2005 Restatement*

The Company had previously restated its consolidated statement of operations for the three and nine months ended September 30, 2004, its consolidated statement of cash flows for the nine months ended September 30, 2004, and its condensed consolidated balance sheet as of December 31, 2004. This restatement corrected errors related to (1) the Company's recognition of income related to its preneed funeral and cemetery trust accounts, (2) preneed funeral trust income that was previously understated as a result of a point-of-sale system error, and (3) the computation of gains and losses on certain asset divestiture activities, including the write-off of certain covenant-not-to-compete agreements which should have been recognized in the Company's 2002 consolidated financial statements.

The Company previously restated its unaudited quarterly financial data for the first three quarters of 2004, as included in its 2004 Form 10-K, for correction of errors related to (1) the recognition of deferred preneed cemetery contract revenues, (2) certain reconciliations of the Company's preneed funeral and cemetery trust assets and deferred revenues, and (3) operating leases and other account reconciliations. At that time, the Company concluded that the net aggregate impact of such errors related to periods prior to January 1, 2004 was not material to its consolidated financial statements or to the first quarter of 2004, nor for any quarterly or annual period prior to January 1, 2004, and as a result, the Company recorded the net aggregate impact of such errors (a \$416 increase to pre-tax income) in *Other operating (expense) income* as a correction of an immaterial error in the first quarter of 2004.

However, in light of the material impact of the errors identified in the second quarter of 2005, as detailed below, the Company concluded that prior period financial statements for the fiscal years ended 2004, 2003, and 2002 should be restated and has corrected such prior periods for the \$416 net impact to *Other operating (expense) income* described above.

Preneed Funeral and Cemetery Trust Verification and Reconciliation Project

During 2003, the Company began implementation of the revised Financial Accounting Standards Board (FASB) Interpretation No. 46, *Consolidation of Variable Interest Entities, an Interpretation of Accounting Research Bulletin (ARB) No. 51 (FIN 46R)*, the preparation for the implementation of Section 404 of the Sarbanes Oxley Act, and the implementation of its new funeral and cemetery point-of-sale system. As a result of these events, the Company began a project to reconcile its preneed funeral and cemetery trust accounts and verify its preneed funeral and preneed cemetery contracts.

The preneed funeral and cemetery trust verification and reconciliation project included three primary components: (1) the reconciliation of assets and deferred revenue related to preneed cemetery merchandise and service trusts; preneed funeral merchandise and service trusts; and cemetery perpetual care trusts, (2) the verification of approximately 430,000 preneed funeral contracts to determine if those contracts were appropriately included in the Company's new point-of-sale system, and (3) the verification of each individual item on each preneed cemetery contract (approximately 3.6 million contract items) to determine if revenue was appropriately recognized at the time of delivery or at the time of service.

As these projects progressed, the Company assessed their status and adjusted the applicable general ledger accounts accordingly. At December 31, 2003, June 30, 2004, and December 31, 2004, the Company made certain adjustments to its consolidated financial statements based on its best estimates at that time. These estimates were based on statistical sampling methods which were influenced by the percentage of reconciliations and verifications completed at the location level and the expected error rate of such uncompleted verifications and reconciliations.

By March 2005, the Company had completed its examination of the 430,000 preneed funeral contracts and had also implemented the reconciliation procedures described above, which resulted in the identification of a significant number of reconciling items. In light of these reconciling items, the Company reevaluated previous adjustments related to these projects and the impact to previously issued financial statements. The Company determined that these adjustments had a material impact on its consolidated financial statements for the first three interim periods of 2004. As a result, the Company restated its unaudited quarterly financial data for the first three interim periods of 2004 in its original 2004 Form 10-K. The Company evaluated the materiality of these adjustments on its consolidated financial statements issued prior to January 1, 2004 and concluded that the impact of these adjustments was not material to the fiscal period ended 2004 or any quarterly or annual period prior to January 1, 2004. As a result, the Company recorded the net aggregate impact of these adjustments (\$416 increase to pretax income) in *Other operating income (expense)*

in its restated first quarter 2004 financial statements as a correction of an error.

During the first and second quarters of 2005, the Company continued to find and record these reconciling items to its trust asset and deferred revenue detailed records. During the second quarter of 2005, the Company determined that certain of the reconciling items had been reflected improperly in its initial reconciliation process at December 31, 2004 which resulted in the identification of errors to the Company's consolidated financial statements. The Company recorded a \$1,600 charge in its first quarter 2005 consolidated financial statements for similar prior period adjustments arising from the aforementioned reconciliation process.

Also during the second quarter of 2005, the Company identified other adjustments, one of which related to a point-of-sale system error that caused preneed funeral trust income accounts to be understated in the fourth quarter of 2004 and the first quarter of 2005 by \$1,570 and \$2,700, respectively, and another of which related to the recognition of a loss on a disposition recorded in April 2005 that should have been recognized in the Company's first quarter 2005 unaudited consolidated financial statements. In addition, in connection with the asset divestitures, the Company failed to write off certain covenant-not-to-compete agreements. These write-offs should have been recorded in the Company's 2002 consolidated financial statements.

Additionally, the Company adjusted its method of accounting for certain types of operating leases related primarily to the Company's funeral home properties. Historically, the Company recorded operating lease expense, related primarily to funeral home properties, over the initial lease term without regard to reasonably assured renewal options or fixed escalation provisions. The Company now calculates its straight line operating lease expense over the lease term (including certain renewal options and fixed escalation provisions, to the extent necessary) in accordance with SFAS 13, *Accounting for Leases*.

Materiality Assessment

The Company evaluated the materiality of these adjustments (including the \$1,600 charge recorded in the first quarter of 2005 and the adjustments aggregating to \$416 associated with the restatement of the first three interim periods of 2004 described above) on its consolidated financial statements for the second quarter of 2005, its unaudited quarterly financial statements for 2004 and 2003, and its consolidated financial statements for each of the five prior annual periods ended December 31, 2004. The Company determined that the net effect of these adjustments (\$5,192 charge to pretax income), which primarily related to periods prior to 2000, was not material to the Company's previously reported consolidated financial statements for periods described above; however, the Company determined that such impact was material to the Company's second quarter 2005 consolidated financial statements. As a result, the Company restated its consolidated statements of operations for the three and nine months ended September 30, 2004, its consolidated statement of cash flows for the nine months ended September 30, 2004, and its consolidated balance sheet at December 31, 2004.

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The effect of the adjustments to the Company's condensed consolidated statement of operations for the three and nine months ended September 30, 2005 and 2004 is as follows (in thousands, except per share data):

| | Three months ended September 30, 2005 | | Three months ended September 30, 2004 | | |
|---|--|-------------------------------|--|-------------------------------|------------------------------------|
| | As | | As | | As |
| | Previously Reported (unaudited) | As Restated (unaudited) | Originally Reported (unaudited) | As Restated (unaudited) | Further Restated (unaudited) |
| Revenues | \$ 406,369 | \$ 406,369 | \$ 397,012 | \$ 397,186 | \$ 397,186 |
| Costs and expenses | (348,094) | (347,526) | (328,932) | (328,891) | (328,519) |
| Gross profit | 58,275 | 58,843 | 68,080 | 68,295 | 68,667 |
| General and administrative expense | (19,753) | (19,744) | (25,298) | (25,298) | (25,295) |
| Operating income | 11,076 | 11,653 | 39,501 | 39,716 | 40,091 |
| Interest expense | (25,821) | (26,170) | (26,609) | (26,609) | (26,955) |
| (Loss) income from continuing operations before income taxes | (10,302) | (10,074) | 17,147 | 17,362 | 17,391 |
| Benefit (provision) for income taxes | 1,131 | 885 | (4,256) | (4,336) | (4,526) |
| Net (loss) income | \$ (9,634) | \$ (9,652) | \$ 13,741 | \$ 13,876 | \$ 13,715 |
| Earnings per share: | | | | | |
| Basic | \$ (.03) | \$ (.03) | \$.04 | \$.04 | \$.04 |
| Diluted | \$ (.03) | \$ (.03) | \$.04 | \$.04 | \$.04 |

| | Nine months ended September 30, 2005 | | Nine months ended September 30, 2004 | | |
|---|---|-------------------------------|---|-------------------------------|------------------------------------|
| | As | | As | | As |
| | Previously Reported (unaudited) | As Restated (unaudited) | Originally Reported (unaudited) | As Restated (unaudited) | Further Restated (unaudited) |
| Revenues | \$ 1,285,521 | \$ 1,285,653 | \$ 1,404,881 | \$ 1,404,597 | \$ 1,404,597 |
| Costs and expenses | (1,057,676) | (1,055,966) | (1,150,403) | (1,150,284) | (1,149,170) |
| Gross profit | 227,845 | 229,687 | 254,478 | 254,313 | 255,427 |
| General and administrative expense | (61,963) | (61,936) | (100,347) | (100,347) | (100,338) |
| Gains and impairment (losses) and dispositions, net | (28,659) | (28,659) | 33,018 | 33,021 | 33,021 |
| Operating income | 137,223 | 139,092 | 187,565 | 186,987 | 188,110 |
| Interest expense | (76,352) | (77,399) | (91,110) | (91,110) | (92,147) |
| (Loss) income from continuing operations before income taxes and cumulative effect of accounting changes | 58,369 | 59,191 | 92,950 | 92,372 | 92,458 |
| Benefit (provision) for income taxes | (25,531) | (26,188) | 6,966 | 7,177 | 6,830 |
| (Loss) income from continuing operations before cumulative effect of accounting changes | 32,838 | 33,003 | 99,916 | 99,549 | 99,288 |
| Cumulative effect of accounting changes | (187,538) | (187,538) | (47,074) | (47,556) | (50,593) |

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| | | | | | |
|---------------------|--------------|--------------|-----------|-----------|-----------|
| Net (loss) income | \$ (150,875) | \$ (150,710) | \$ 87,813 | \$ 86,964 | \$ 83,666 |
| Earnings per share: | | | | | |
| Basic | \$ (.50) | \$ (.50) | \$.28 | \$.28 | \$.27 |
| Diluted | \$ (.49) | \$ (.49) | \$.27 | \$.27 | \$.26 |

The effect of the restatement on the Company's previously reported consolidated balance sheet as of September 30, 2005 and December 31, 2004 is as follows:

| | September 30, 2005 | | December 31, 2004 | | |
|---|---------------------------------|-------------------------|---------------------|-------------|------------------|
| | As | As | As | As | As |
| | Previously Reported (unaudited) | As Restated (unaudited) | Originally Reported | As Restated | Further Restated |
| Selected condensed consolidated balance sheet data: | | | | | |
| Receivables, net of allowances | \$ 82,306 | \$ 82,306 | \$ 102,156 | \$ 102,622 | \$ 102,622 |
| Total current assets | \$ 708,551 | \$ 708,551 | \$ 533,497 | \$ 533,963 | \$ 533,963 |
| Preferred funeral receivables and trust investments | \$1,238,123 | \$1,238,123 | \$1,264,600 | \$1,267,784 | \$1,267,784 |
| Preferred cemetery receivables and trust investments | \$1,295,352 | \$1,295,352 | \$1,402,750 | \$1,399,778 | \$1,399,778 |
| Property and equipment, at cost, net | \$ 947,024 | \$ 955,078 | \$ 970,547 | \$ 970,547 | \$ 978,861 |
| Deferred charges and other assets | \$ 247,327 | \$ 259,375 | \$ 618,565 | \$ 631,839 | \$ 631,839 |
| Total assets | \$7,701,966 | \$7,724,961 | \$8,199,196 | \$8,218,840 | \$8,227,154 |
| Accounts payable and accrued liabilities | \$ 234,281 | \$ 233,634 | \$ 221,877 | \$ 221,877 | \$ 221,235 |
| Current maturities of long-term debt | \$ 88,272 | \$ 91,379 | \$ 75,075 | \$ 77,950 | \$ 78,164 |
| Long-term debt | \$1,172,513 | \$1,195,535 | \$1,178,885 | \$1,189,163 | \$1,200,353 |
| Deferred preneed funeral revenues | \$ 558,381 | \$ 558,381 | \$ 486,191 | \$ 498,571 | \$ 498,571 |
| Deferred preneed cemetery revenues | \$ 789,143 | \$ 789,143 | \$ 801,065 | \$ 803,144 | \$ 803,144 |
| Deferred income taxes | \$ 174,053 | \$ 172,601 | \$ 279,474 | \$ 276,572 | \$ 274,463 |
| Other liabilities | \$ 381,346 | \$ 385,866 | \$ 429,103 | \$ 431,917 | \$ 437,298 |
| Non-controlling interest in funeral and cemetery trusts | \$1,973,091 | \$1,973,091 | \$2,095,852 | \$2,092,881 | \$2,092,881 |
| Accumulated deficit | \$ 980,119 | \$ 985,674 | \$ 824,364 | \$ 829,244 | \$ 834,964 |
| Stockholders' equity | \$1,600,123 | \$1,594,568 | \$1,853,576 | \$1,848,667 | \$1,842,947 |
| Total liabilities and stockholders' equity | \$7,701,966 | \$7,724,961 | \$8,199,196 | \$8,218,840 | \$8,227,154 |

The effect of the restatement on the Company's previously reported condensed consolidated statement of cash flows for the nine months ended September 30, 2005 and 2004 is as follows:

| | Nine months ended September 30, 2005 | | Nine months ended September 30, 2004 | |
|---|--------------------------------------|-------------------------|--------------------------------------|-------------------------|
| | As | As | As | As |
| | Previously Reported (unaudited) | As Restated (unaudited) | Previously Reported (unaudited) | As Restated (unaudited) |
| Net cash provided by operating activities | \$ 258,386 | \$ 258,537 | \$ 169,409 | \$ 169,535 |
| Net cash used in financing activities | \$(204,905) | \$(205,056) | \$(212,248) | \$(212,374) |

We have also reflected the effects of this restatement in notes three, four, five, six, seven, eight, ten, eleven, and twelve to these condensed consolidated financial statements.

Table of Contents**3. Summary of Significant Accounting Policies***Principles of Consolidation and Basis of Presentation*

The consolidated financial statements for the three and nine months ended September 30, 2005 and 2004 include the accounts of the Company and all majority-owned subsidiaries and are unaudited but include all adjustments, consisting of normal recurring accruals and any other adjustments, which management considers necessary for a fair presentation of the results for these periods. These consolidated financial statements have been prepared in a manner consistent with the accounting policies described in the Company's amended Annual Report on Form 10-K (Amendment No. 2) for the year ended December 31, 2004, unless otherwise disclosed herein, and should be read in conjunction therewith. The accompanying year-end consolidated balance sheet was derived from the audited consolidated financial statements but does not include all disclosures required by accounting principles generally accepted in the United States of America. Operating results for interim periods are not necessarily indicative of the results that may be expected for the full year period.

The Company has reclassified certain prior year amounts to conform to the current period financial presentation with no effect on previously reported results of operations, financial condition or cash flows.

Use of Estimates in the Preparation of Financial Statements

The preparation of the consolidated financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that may affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of expenses during the reporting period. As a result, actual results could differ from these estimates.

Stock Options

The Company accounts for employee stock-based compensation expense under the intrinsic value method. Under this method, no compensation expense is recognized on stock options if the grant price equals the market value on the date of grant.

If the Company had elected to recognize compensation expense for its option plans based on the fair value method, net (loss) income and per share amounts would have changed to the pro forma amounts indicated below.

| | Three months ended | | Nine months ended | |
|--|---------------------------|-------------|--------------------------|-------------|
| | September 30, | | September 30, | |
| | 2005 | 2004 | 2005 | 2004 |
| | (Restated) | (Restated) | (Restated) | (Restated) |
| | note 2 | note 2 | note 2 | note 2 |
| Net (loss) income | \$ (9,652) | \$ 13,715 | \$ (150,710) | \$ 83,666 |
| Deduct: Total additional stock-based employee compensation expense determined under fair value based method for all awards, net of related tax expense | (391) | (806) | (1,174) | (2,407) |
| Pro forma net (loss) income | \$ (10,043) | \$ 12,909 | \$ (151,884) | \$ 81,259 |
| Basic (loss) earnings per share: | | | | |
| Net (loss) income | \$ (.03) | \$.04 | \$ (.50) | \$.27 |
| Deduct: Total additional stock-based employee compensation expense determined under fair value based method for all awards, net of related tax expense | | | | (.01) |
| Pro forma basic (loss) earnings per share | \$ (.03) | \$.04 | \$ (.50) | \$.26 |

Diluted (loss) earnings per share:

| | | | | | | | | |
|--|----|-------|----|-----|----|-------|----|-------|
| Net (loss) earnings | \$ | (.03) | \$ | .04 | \$ | (.49) | \$ | .26 |
| Deduct: Total additional stock-based employee compensation expense determined under fair value based method for all awards, net of related tax expense | | | | | | | | (.01) |
| Pro forma diluted (loss) earnings per share | \$ | (.03) | \$ | .04 | \$ | (.49) | \$ | .25 |

The fair value of the Company's stock options used to compute the pro forma net (loss) income and per share disclosures is determined by calculating the estimated fair value at grant date using the Black-Scholes option-pricing model.

The Company currently computes stock-based compensation cost for employees eligible to retire over the three-year standard vesting period of the grants. Upon adoption of SFAS 123R, the Company will amortize new option grants to such retirement-eligible employees over a shorter period, consistent with the retirement vesting acceleration provisions of these grants. If the Company had historically computed stock-based compensation cost for these employees under this accelerated method, \$549 or less than \$.01 per diluted share of after-tax compensation cost would have been accelerated and cumulatively included in the pro forma expense above through September 30, 2005. The tax benefit associated with the additional compensation expense discussed above would have been \$211 and \$632 for the three and nine months ended September 30, 2005 and \$474 and \$1,419 for the three and nine months ended September 30, 2004, respectively.

Income Taxes

The Company reported an income tax benefit of 8.8% in the three months ended September 30, 2005 compared to a provision of 26.0% in the three months ended September 30, 2004. For the nine months ended September 30, 2005 and 2004, the Company reported an income tax provision of 44.2% and an income tax benefit of 7.4%, respectively.

The tax rates in 2005 were impacted by permanent differences between book and tax bases of North American asset dispositions. The tax rates in 2004 are due to non-cash tax benefits recognized from the disposition of the Company's French operations consummated in the first quarter of 2004 and the sale of the Company's equity investment in a United Kingdom company in the second quarter of 2004. For more information regarding these transactions, see note twelve to the condensed consolidated financial statements.

4. Accounting Changes and New Accounting Pronouncements

Accounting Changes and Error Corrections

In May 2005, the FASB issued Statement No. 154, *Accounting Changes and Error Corrections - A Replacement of APB Opinion No. 20 and FASB Statement No. 3* (SFAS 154). SFAS 154 primarily requires retrospective application to prior period financial statements for the direct effects of changes in accounting principles, unless it is impracticable to determine either the period-specific effects or the cumulative effect of the change. SFAS 154 is effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005.

Deferred Selling Costs

Effective January 1, 2005, the Company changed its method of accounting for direct selling costs related to the acquisition of preneed funeral and preneed cemetery contracts. Prior to this change, the Company capitalized such direct selling costs and amortized these deferred selling costs in proportion to the revenue recognized. Under the new method of accounting, the Company expenses these direct selling costs as incurred. The Company believes the new method is preferable because it better reflects the economics of the Company's business.

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As of January 1, 2005, the Company recorded a cumulative effect of \$187,538, net of tax of \$117,428. This amount represents the cumulative balance of deferred selling costs recorded on the Company's consolidated balance sheet in *Deferred charges and other assets* at the time of the accounting change. If the Company had not changed its method of accounting for direct selling costs as described above, net income for the three months ended September 30, 2005 would have been approximately \$3,582, or \$.01 per basic and diluted share higher than currently reported. If the Company had not changed its method of accounting for direct selling costs as described above, net income for the nine months ended September 30, 2005 would have been approximately \$8,472, or \$.03 per basic and diluted share higher than currently reported.

The three and nine months ended September 30, 2004 pro forma amounts in the table below reflect the new policy to expense selling costs as incurred. The effect of the change for the three and nine months ended September 30, 2004 would have decreased net income from continuing operations before cumulative effects of accounting changes by approximately \$3,073 and \$9,956, or \$.01 and \$.03 per diluted share, respectively.

| | Three months ended September 30, 2004 | | | Nine months ended September 30, 2004 | | |
|---|--|--|--------------------------------------|--------------------------------------|--|--------------------------------------|
| | Historical (Restated) note 2 | Deferred Selling Costs, net (1) | Pro forma (Restated) note 2 | Historical (Restated) note 2 | Deferred Selling Costs, net (1) | Pro forma (Restated) note 2 |
| Gross profit: | | | | | | |
| Funeral | \$ 45,068 | \$ (905) | \$ 44,163 | \$ 182,638 | \$ (3,574) | \$ 179,064 |
| Cemetery | 23,599 | (4,114) | 19,485 | 72,789 | (12,686) | 60,103 |
| | 68,667 | (5,019) | 63,648 | 255,427 | (16,260) | 239,167 |
| Income (loss) from continuing operations before income taxes and cumulative effects of accounting changes | \$ 17,391 | \$ (5,019) | \$ 12,372 | \$ 92,458 | \$ (16,260) | \$ 76,198 |
| Net income (loss) | 13,715 | \$ (3,073) | \$ 10,642 | \$ 83,666 | \$ (9,956) | \$ 73,710 |
| Amounts per common share: | | | | | | |
| Net income (loss) basic | \$.04 | \$ (.01) | \$.03 | \$.27 | \$ (.04) | \$.23 |
| Net income (loss) diluted | \$.04 | \$ (.01) | \$.03 | \$.26 | \$ (.03) | \$.23 |

(1) Represents net deferred selling costs that would have been expensed under the new method of accounting adopted on January 1, 2005.

Other-Than-Temporary Impairments

In June 2005, the FASB decided not to provide additional guidance on the meaning of other-than-temporary impairment, and directed the staff to issue proposed FSP EITF 03-1-a, *Implementation Guidance for the Application of Paragraph 16 of EITF Issue No. 03-1*, as final. The final FSP supersedes EITF Issued No. 03-1, *The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments*, and EITF Topic No. D-44, *Recognition of Other-Than-Temporary Impairment upon the Planned Sale of a Security Whose Cost Exceeds Fair Value*. The final FSP (retitled FSP FAS 115-1, *The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments*) replaces the guidance set forth in paragraphs 10-18 of EITF Issue 03-1 with references to existing other-than-temporary impairment guidance. FSP FAS 115-1 codifies the guidance set forth in EITF Topic D-44 and clarifies that an investor should recognize an impairment loss no later than when the impairment is deemed other-than-temporary, even if a decision to sell has not been made. FSP FAS 115-1 is effective for other-than-temporary analysis conducted in periods beginning after December 15, 2005. The Company has adopted the provisions of FSP FAS 115-1 and as of the date of adoption, this Statement has had no material impact on its consolidated financial statements, results of operations, financial position, or cash flows.

Inventory Costs

In November 2004, the FASB issued SFAS No. 151, *Inventory Costs an amendment of ARB 43, Chapter 4* (SFAS 151). SFAS 151 amends the guidance in Accounting Research Bulletin (ARB) No. 43, Chapter 4, *Inventory Pricing*, to clarify the

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accounting for abnormal amounts of idle facility expense, freight, handling costs and wasted material. SFAS 151 requires that those items be recognized as current-period charges, rather than as a portion of the inventory cost. In addition, SFAS 151 requires that allocation of fixed production overhead to the costs of conversion be based on the normal capacity of the production facilities. SFAS 151 is effective for inventory costs incurred during fiscal years beginning after June 15, 2005. The Company does not expect this statement to have a material impact on its consolidated financial statements, results of operations, financial position, or cash flows.

Share-Based Payment

In December 2004, the FASB issued SFAS No. 123R, *Share-Based Payment* (SFAS 123R). SFAS 123R is a revision of SFAS No. 123, *Accounting for Stock-Based Compensation*, and supersedes APB Opinion No. 25, *Accounting for Stock Issued to Employees*. Among other items, SFAS 123R eliminates the use of the intrinsic value method of accounting, and requires companies to recognize the cost of employee services received in exchange for awards of equity instruments, based on the grant date fair value of those awards, in the financial statements. The effective date of SFAS 123R is the first annual reporting period beginning after June 15, 2005, which is the first quarter of 2006 for the Company.

The Company currently uses the intrinsic value method to account for stock options. For disclosure purposes, the Company currently utilizes a standard option pricing model (i.e., Black-Scholes) to measure the fair value of stock options granted to employees. The Company will continue to utilize the Black-Scholes option pricing model to measure the fair value of its stock options. The Company expects to adopt SFAS 123R effective January 1, 2006. The Company is currently evaluating the impact that this adoption will have on its results of operations.

Variable Interest Entities

In January 2003, the FASB issued FIN 46. This interpretation clarifies the application of ARB No. 51, *Consolidated Financial Statements*, to certain entities in which equity investors do not have the characteristics of a controlling financial interest or do not have sufficient equity at risk for the entity to finance its activities without additional subordinated financial support from other parties. In December 2003, the FASB revised FIN 46.

Under the provisions of FIN 46R, the Company is required to consolidate certain cemeteries and trust assets. Merchandise and service trusts and cemetery perpetual care trusts are considered variable interest entities because the trusts meet the conditions of paragraphs 5(a) and 5(b)(1) of FIN 46R. That is, as a group, the equity investors (if any) do not have sufficient equity at risk and do not have the direct or indirect ability through voting or similar rights to make decisions about the trusts' activities that have a significant effect on the success of the trusts. FIN 46R requires the Company to consolidate merchandise and service trusts and cemetery perpetual care trusts for which the Company is the primary beneficiary (i.e., those for which the Company absorbs a majority of the trusts' expected losses). The Company is the primary beneficiary of a trust whenever a majority of the assets of the trust are attributable to deposits of customers of the Company.

Consolidation of Trusts: The Company implemented FIN 46R as of March 31, 2004, which resulted in the consolidation of the Company's preneed funeral and cemetery merchandise and service trust assets and the Company's cemetery perpetual care trusts. No cumulative effect of an accounting change was recognized by the Company as a result of the implementation of FIN 46R as it relates to the consolidation of the trusts. The implementation of FIN 46R affects certain line items on the Company's consolidated balance sheet and statement of operations as described below; however, as it relates to the consolidation of trusts, there is no impact to net income in the statement of operations as a result of the implementation. Additionally, the implementation of FIN 46R did not result in any net changes to the Company's consolidated statement of cash flows; however, it does require certain financing and investing activities to be disclosed.

Although FIN 46R requires consolidation of most of the merchandise and service and perpetual care trusts, it does not change the legal relationships among the trusts, the Company and its customers. In the case of merchandise and service trusts, the customers are the legal beneficiaries. In the case of cemetery perpetual care trusts, the Company does not have a legal right to the perpetual care trust assets. For these reasons, upon consolidation of the trusts, the Company recognizes non-controlling interests in its financial statements to reflect third party interests in these trusts in accordance with FASB Statement No. 150, *Accounting for Certain Financial*

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Instruments with Characteristics of Both Liability and Equity (SFAS 150). The Company classifies deposits to merchandise and service trusts as non-controlling liability interests and classifies deposits to cemetery perpetual care trusts as non-controlling equity interests.

The Company records cash received from customers that is payable to the trusts but not yet required to be deposited in the trusts as restricted cash in *Deferred charges and other assets* in its consolidated balance sheet. At September 30, 2005 and December 31, 2004, these pending deposits totaled \$10,668 and \$11,218, respectively. The Company continues to account for amounts received from customers prior to delivery of merchandise or services that are not required to be deposited in merchandise and service trusts as deferred revenue.

Beginning March 31, 2004, the Company recognizes net realized investment earnings of the merchandise and service trusts and perpetual care trusts, as well as the related trustee investment expenses and taxes, within *Other income, net*. The Company then recognizes a corresponding expense within *Other income, net* representing the net realized earnings of those trusts that are attributable to the non-controlling interest holders. The corresponding credit for this expense is reflected in the Company's consolidated balance sheet in *Non-controlling interest in funeral and cemetery trusts* for merchandise and service trusts or *Non-controlling interest in perpetual care trusts* for cemetery perpetual care trusts. The sum of these expenses recorded in *Other income, net* offsets the net realized earnings of such trusts also recognized within *Other income, net*. Accordingly, the Company's net income in the consolidated statement of operations is not affected by consolidation of the trusts in accordance with FIN 46R.

To the extent the earnings of the trusts are distributed prior to the delivery of merchandise and/or services, a corresponding amount of non-controlling interest is reclassified to deferred revenue until the amounts qualify for revenue recognition. In the case of merchandise and service trusts, the Company recognizes as revenues amounts previously attributed to non-controlling interests and deferred revenues upon the performance of services and delivery of merchandise, including earnings accumulated in these trusts. In the case of the cemetery perpetual care trusts, distributable earnings are recognized in cemetery revenues to the extent of qualifying cemetery maintenance costs.

Prior to the implementation of FIN 46R and the consolidation of the trusts, funds received from customers and deposited into merchandise and service trusts until maturity of the preneed contract were recorded as receivables due from trust assets. Upon implementation of FIN 46R, the Company replaced receivables due from trust assets with the trust assets, at market.

An allowance for contract cancellation is provided based on historical experience. An allowance is no longer provided on the funds associated with the preneed contracts that are held in trust, currently recorded as trust assets, but previously recorded as receivables due from trust assets. As such, the amount has decreased since the implementation of FIN 46R.

Both the merchandise and services trusts and the cemetery perpetual care trusts hold investments in marketable securities that are classified as available-for-sale by the Company under the requirements of SFAS No. 115,

Accounting for Certain Investments in Debt and Equity Securities (SFAS 115). In accordance with SFAS 115, available-for-sale securities of the trusts are recorded at fair value, with unrealized gains and losses excluded from earnings and initially recorded as a component of *Accumulated other comprehensive income (loss)* in the Company's consolidated balance sheet. Using the guidance in EITF Topic D-41, *Adjustments in Assets and Liabilities for Holding Gains and Losses as Related to the Implementation of FASB Statement No. 115* (Topic D-41), unrealized gains and losses on available-for-sale securities of the trusts attributable to the non-controlling interest holders are not recorded as *Accumulated other comprehensive income (loss)*, but are recorded as an adjustment to either *Non-controlling interest in funeral and cemetery trusts* or *Non-controlling interest in perpetual care trusts*. Therefore, unrealized gains and losses attributable to the non-controlling interest holders are reclassified from *Accumulated other comprehensive income (loss)* to either *Non-controlling interest in funeral and cemetery trusts* or *Non-controlling interest in perpetual care trusts*. The gross effect from applying Topic D-41 on the Company's *Accumulated other comprehensive income (loss)* is disclosed in note eleven of the consolidated financial statements. However, the Company's *Accumulated other comprehensive income (loss)* balance on the face of the balance sheet is ultimately not affected by consolidation of the trusts.

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Consolidation of Certain Cemeteries: Prior to December 31, 2003, the Company operated certain cemeteries in Michigan which the Company managed but did not own. During the Company's evaluation of FIN 46R, the Company evaluated these cemeteries to determine whether such cemeteries were within the scope of FIN 46R. The investment capital of these cemeteries was financed by the Company in exchange for a long-term sales, accounting, and cash management agreement. In accordance with this agreement, the Company receives the majority of the cash flows from these cemeteries. Additionally, the Company absorbs the majority of these cemeteries' expected losses and receives a majority of the cemeteries' residual returns. As a result, the Company concluded that it was the primary beneficiary of these cemeteries and that the long-term sales, accounting, and cash management agreement is a variable interest as defined by FIN 46R. Given the circumstances above, the Company consolidated such cemeteries at March 31, 2004. The Company recognized an after tax charge of \$13,957, representing the cumulative effect of an accounting change, as a result of consolidating these cemeteries. The results of operations and cash flows of these cemeteries are included in the Company's consolidated statements of operations and cash flows beginning March 31, 2004. Excluding the cumulative effect of accounting change, the effect of consolidating these entities did not have a significant impact on the Company's reported results of operations.

Pension Plans

Effective January 1, 2004, the Company changed its accounting for gains and losses on its pension plan assets and obligations. The Company now recognizes such gains and losses in its consolidated statement of operations as such gains and losses are incurred. Prior to January 1, 2004, the Company amortized the difference between actual and expected investment returns and actuarial gains and losses over seven years (except to the extent that settlements with employees required earlier recognition). The Company believes the new method of accounting better reflects the economic nature of the Company's pension plans and recognizes gains and losses on the pension plan assets and liabilities in the year the gains or losses occur. As a result of this accounting change, the Company recognized a charge for the cumulative effect of an accounting change of \$36,636 (net of tax) as of January 1, 2004. This amount represents accumulated unrecognized net losses related to the pension plan assets and liabilities. In addition, for interim periods, the Company records net pension expense or income reflecting estimated returns on plan assets and obligations. The Company will recognize actual gains and losses on plan assets and obligations as actuarial information becomes available upon review of the annual remeasurement.

5. Debt

Debt was as follows:

| | September 30, 2005 | December 31, 2004 |
|---|-------------------------------|------------------------------|
| | (Restated) | (Restated) |
| | note 2 | note 2 |
| 6.0% notes due December 2005 | \$ 63,497 | \$ 63,801 |
| 7.2% notes due June 2006 | 10,698 | 150,000 |
| 6.875% notes due October 2007 | 13,497 | 143,475 |
| 6.5% notes due March 2008 | 195,000 | 195,000 |
| 7.7% notes due April 2009 | 341,635 | 358,266 |
| 7.875% debentures due February 2013 | 55,627 | 55,627 |
| 6.75% notes due April 2016 | 250,000 | 250,000 |
| 7.0% notes due June 2017 | 300,000 | |
| Convertible debentures, maturities through 2013, fixed interest rates from 4.75% to 5.5%, conversion prices from \$13.02 to \$50.00 per share | 28,327 | 30,375 |
| Mortgage notes and other debt, maturities through 2050 | 54,044 | 60,076 |
| Unamortized pricing discounts and other | (25,411) | (28,103) |
| Total debt | 1,286,914 | 1,278,517 |

| | | |
|-------------------------|--------------|--------------|
| Less current maturities | (91,379) | (78,164) |
| Total long-term debt | \$ 1,195,535 | \$ 1,200,353 |

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The Company's consolidated debt had a weighted average interest rate of 7.05% at September 30, 2005 and 7.07% at December 31, 2004. Approximately 99% of the total debt had a fixed interest rate at September 30, 2005 and December 31, 2004.

Bank Credit Agreements

The Company's bank credit agreement, which was executed on August 11, 2004, and matures in August of 2007, provides a total lending commitment of \$200,000, including a sub-limit of \$175,000 for letters of credit. As of September 30, 2005, the Company has no cash borrowings outstanding under this credit facility, but has used the facility to support \$59,794 of letters of credit. This bank credit facility is secured by the stock of the Company's domestic subsidiaries and these domestic subsidiaries have guaranteed the Company's indebtedness associated with this facility. The subsidiary guarantee is a guarantee of payment of the outstanding amount of the total lending commitment. It covers the term of the agreement, including extensions and totaled a maximum potential amount of \$59,794 and \$66,985 at September 30, 2005 and December 31, 2004, respectively. The facility contains certain financial covenants, including a minimum interest coverage ratio, a maximum leverage ratio, maximum capital expenditure limitations, minimum net worth requirements and certain cash distribution restrictions. Interest rates for the outstanding borrowings will be based on various indices as determined by the Company. The Company also pays a quarterly fee on the unused commitment, which ranges from 0.25% to 0.50%.

Debt Extinguishment, Reductions and Additions

In the first quarter of 2005, the Company purchased \$7,131 aggregate principal amount of its 7.70% notes due 2009 in the open market. As a result of this transaction, the Company recognized a loss of \$1,207 recorded in *Loss on early extinguishment of debt*, in its consolidated statement of operations. In the second quarter of 2005, the Company purchased an additional \$9,500 aggregate principal amount of its 7.70% notes due 2009, and \$304 aggregate principal amount of its 6.00% notes due 2005 in the open market. Also in the second quarter of 2005, the Company redeemed \$129,978 aggregate principal amount of its 6.875% notes due 2007 and \$139,302 aggregate principal amount of its 7.20% notes due 2006 pursuant to a tender offer for such notes. As a result of these second quarter 2005 transactions, the Company incurred a loss of \$13,051 recorded in *Loss on early extinguishment of debt*, which is comprised of the redemption premiums paid of \$12,186 and the write-off of unamortized debt issuance costs of \$2,072.

On June 15, 2005, the Company issued \$300,000 in an unregistered offering of senior unsecured 7.00% notes due June 15, 2017, which pay interest semi-annually beginning December 15, 2005. The Company used the net proceeds, together with available cash, to purchase existing indebtedness pursuant to the tender offer described in the previous paragraph. The notes are subject to the provisions of the Company's Senior Indenture dated as of February 1, 1993, as amended, which includes certain covenants limiting, among other things, the creation of liens securing indebtedness and sale-leaseback transactions. The Company is entitled to redeem the notes at any time by paying a make-whole premium. Under the terms of the issuance of the unregistered notes, the Company has an obligation to register the notes with the Securities and Exchange Commission (SEC). Because the Company did not file the related SEC registration statement within the required time period, it incurred an aggregate incremental interest expense of \$31 in the third quarter of 2005.

Additional Debt Disclosures

At September 30, 2005 and December 31, 2004, the Company had deposited \$11,746 and \$26,707, respectively, in restricted, interest-bearing accounts that were pledged as collateral for various credit instruments and commercial commitments. This restricted cash is included in *Deferred charges and other assets* in the consolidated balance sheet.

Table of Contents**6. Retirement Plans**

The components of net periodic pension plan benefit cost for the three and nine months ended September 30 were as follows:

| | Three months ended | | Nine months ended | |
|---|---------------------------|-------------|--------------------------|-------------|
| | September 30, | | September 30, | |
| | 2005 | 2004 | 2005 | 2004 |
| | (Restated) | (Restated) | (Restated) | (Restated) |
| | note 2 | note 2 | note 2 | note 2 |
| Interest cost on projected benefit obligation | \$ 2,028 | \$ 2,281 | \$ 6,083 | \$ 6,843 |
| Actual return on plan assets | (1,807) | (2,672) | (5,420) | (8,018) |
| Amortization of prior service cost | 46 | 47 | 138 | 137 |
| Recognized net actuarial loss (gain) and trust related expenses | 1,078 | (2,392) | 3,593 | (864) |
| | \$ 1,345 | \$ (2,737) | \$ 4,394 | \$ (1,902) |

Effective January 1, 2001, the Company curtailed its US Pension Plan, SERP, Senior SERP and Directors' Plan. As these plans have been frozen, the participants do not earn additional benefit from additional years of service and the Company has not incurred service costs subsequent to 2000.

7. Segment Reporting

The Company's operations are both product based and geographically based, and the reportable operating segments presented below include the Company's funeral and cemetery operations. The Company's geographic areas include North America and Other Foreign.

In 2005, Other Foreign consists of the Company's operations in Singapore and Germany. In 2004, Other Foreign also included operations in France, which were disposed of in the first quarter of 2004. Results from the Company's funeral and cemetery businesses in Argentina and Uruguay, which were sold in the first quarter of 2005, and its cemetery business in Chile, which was sold in the third quarter of 2005, are classified as discontinued operations for all periods. The Company conducts both funeral and cemetery operations in North America and funeral operations in Other Foreign geographic areas.

The Company's reportable segment information is as follows:

| | Funeral | Cemetery | Reportable |
|-----------------------------------|----------------|-----------------|-------------------|
| | (Restated) | (Restated) | segments |
| | note 2 | note 2 | (Restated) |
| | | | note 2 |
| Revenues from external customers: | | | |
| Three months ended September 30, | | | |
| 2005 | \$ 262,665 | \$ 143,704 | \$ 406,369 |
| 2004 | \$ 266,704 | \$ 130,482 | \$ 397,186 |
| Nine months ended September 30, | | | |
| 2005 | \$ 866,705 | \$ 418,948 | \$ 1,285,653 |
| 2004 | \$ 980,716 | \$ 423,881 | \$ 1,404,597 |
| Gross profit: | | | |
| Three months ended September 30, | | | |
| 2005 | \$ 36,043 | \$ 22,800 | \$ 58,843 |
| 2004 | \$ 45,068 | \$ 23,599 | \$ 68,667 |
| Nine months ended September 30, | | | |

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| | | | |
|------|------------|-----------|------------|
| 2005 | \$ 166,878 | \$ 62,809 | \$ 229,687 |
| 2004 | \$ 182,638 | \$ 72,789 | \$ 255,427 |

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The following table reconciles gross profit from reportable segments to the Company's consolidated income from continuing operations before income taxes and cumulative effects of accounting changes:

| | Three months ended | | Nine months ended | |
|---|---------------------------|-------------|--------------------------|-------------|
| | September 30, | | September 30, | |
| | 2005 | 2004 | 2005 | 2004 |
| | (Restated) | (Restated) | (Restated) | (Restated) |
| | note 2 | note 2 | note 2 | note 2 |
| Gross profit from reportable segments | \$ 58,843 | \$ 68,667 | \$ 229,687 | \$ 255,427 |
| General and administrative expenses | (19,744) | (25,295) | (61,936) | (100,338) |
| Gains and impairment (losses) on dispositions, net | (27,446) | (3,281) | (28,659) | 33,021 |
| Operating income | 11,653 | 40,091 | 139,092 | 188,110 |
| Interest expense | (26,170) | (26,955) | (77,399) | (92,147) |
| Loss on early extinguishment of debt | | | (14,258) | (16,770) |
| Other income, net | 4,443 | 4,255 | 11,756 | 13,265 |
| (Loss) income from continuing operations before income taxes and cumulative effects of accounting changes | \$ (10,074) | \$ 17,391 | \$ 59,191 | \$ 92,458 |

The Company's geographic area information is as follows:

| | North | Other | Total |
|---|----------------|----------------|--------------|
| | America | Foreign | Total |
| | (Restated) | | (Restated) |
| | note 2 | | note 2 |
| Revenues from external customers: | | | |
| Three months ended September 30, | | | |
| 2005 | \$ 403,579 | \$ 2,790 | \$ 406,369 |
| 2004 | \$ 393,432 | \$ 3,754 | \$ 397,186 |
| Nine months ended September 30, | | | |
| 2005 | \$ 1,276,832 | \$ 8,821 | \$ 1,285,653 |
| 2004 | \$ 1,267,391 | \$ 137,206 | \$ 1,404,597 |
| Gains and impairment (losses) on dispositions, net: | | | |
| Three months ended September 30, | | | |
| 2005 | \$ (27,446) | \$ | \$ (27,446) |
| 2004 | \$ (3,476) | \$ 195 | \$ (3,281) |
| Nine months ended September 30, | | | |
| 2005 | \$ (28,659) | \$ | \$ (28,659) |
| 2004 | \$ 32,929 | \$ 92 | \$ 33,021 |
| Operating income: | | | |
| Three months ended September 30, | | | |
| 2005 | \$ 11,588 | \$ 65 | \$ 11,653 |
| 2004 | \$ 39,261 | \$ 830 | \$ 40,091 |
| Nine months ended September 30, | | | |

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| | | | |
|----------------------------------|--------------|------------|--------------|
| 2005 | \$ 138,303 | \$ 789 | \$ 139,092 |
| 2004 | \$ 174,789 | \$ 13,321 | \$ 188,110 |
| Depreciation and amortization: | | | |
| Three months ended September 30, | | | |
| 2005 | \$ 22,419 | \$ 194 | \$ 22,613 |
| 2004 | \$ 32,601 | \$ 244 | \$ 32,845 |
| Nine months ended September 30, | | | |
| 2005 | \$ 64,806 | \$ 316 | \$ 65,122 |
| 2004 | \$ 103,141 | \$ 1,058 | \$ 104,199 |
| Total assets at: | | | |
| September 30, 2005 | \$ 7,713,038 | \$ 11,923 | \$ 7,724,961 |
| December 31, 2004 | \$ 8,069,804 | \$ 157,350 | \$ 8,227,154 |

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Included in the North America figures above are the following United States amounts:

| | Three months ended | | Nine months ended | |
|----------------------------------|---------------------------|--------------|--------------------------|--------------|
| | September 30, | | September 30, | |
| | 2005 | 2004 | 2005 | 2004 |
| | (Restated) | (Restated) | (Restated) | (Restated) |
| | note 2 | note 2 | note 2 | note 2 |
| Revenues from external customers | \$ 376,530 | \$ 372,365 | \$ 1,196,374 | \$ 1,196,071 |
| Operating income | \$ 6,471 | \$ 35,962 | \$ 120,198 | \$ 157,940 |
| Depreciation and amortization | \$ 21,219 | \$ 31,025 | \$ 61,252 | \$ 97,448 |
| Total assets (a) | \$ 7,301,135 | \$ 7,692,638 | \$ 7,301,135 | \$ 7,692,638 |

(a) Prior year amounts are as of December 31, 2004.

Included in the Other Foreign figures above are the following France amounts:

| | Three months ended | | Nine months ended | |
|----------------------------------|---------------------------|-------------|--------------------------|-------------|
| | September 30, | | September 30, | |
| | 2005 | 2004 | 2005 | 2004 |
| Revenues from external customers | \$ | \$ | \$ | \$ 127,282 |
| Operating income | \$ | \$ | \$ | \$ 11,664 |

The changes in the carrying amounts of goodwill for the Company's two reportable segments are as follows:

| | Funeral | Cemetery | Total |
|---------------------------------------|----------------|-----------------|--------------|
| Balance as of December 31, 2004 | \$ 1,166,657 | \$ 2,383 | \$ 1,169,040 |
| Dispositions | (29,627) | (2,507) | (32,134) |
| Effects of foreign currency and other | 3,479 | 124 | 3,603 |
| Balance as of September 30, 2005 | \$ 1,140,509 | \$ | \$ 1,140,509 |

Table of Contents**8. Supplementary Information**

The detail of certain income statement accounts is as follows for the three and nine months ended September 30:

| | Three months ended | | Nine months ended | |
|---|---------------------------|-------------|--------------------------|--------------|
| | September 30, | | September 30, | |
| | 2005 | 2004 | 2005 | 2004 |
| | (Restated) | (Restated) | (Restated) | (Restated) |
| | note 2 | note 2 | note 2 | note 2 |
| North America goods and services revenues | | | | |
| Goods | | | | |
| Funeral | \$ 113,965 | \$ 120,805 | \$ 380,149 | \$ 379,363 |
| Cemetery | 97,351 | 85,884 | 283,508 | 287,524 |
| Total goods | 211,316 | 206,689 | 663,657 | 666,887 |
| Services | | | | |
| Funeral | 138,899 | 135,228 | 456,369 | 441,543 |
| Cemetery | 37,797 | 34,046 | 108,785 | 104,347 |
| Total services | 176,696 | 169,274 | 565,154 | 545,890 |
| North America goods and services revenues | 388,012 | 375,963 | 1,228,811 | 1,212,777 |
| International revenues | 2,790 | 3,754 | 8,821 | 137,206 |
| Other revenues | 15,567 | 17,469 | 48,021 | 54,614 |
| Total revenues | \$ 406,369 | \$ 397,186 | \$ 1,285,653 | \$ 1,404,597 |
| North America goods and services costs | | | | |
| Goods | | | | |
| Funeral | \$ 71,039 | \$ 70,907 | \$ 223,583 | \$ 219,853 |
| Cemetery | 41,138 | 30,239 | 120,418 | 117,372 |
| Total cost of goods | 112,177 | 101,146 | 344,001 | 337,225 |
| Services | | | | |
| Funeral | 63,217 | 59,902 | 200,408 | 183,704 |
| Cemetery | 23,395 | 22,848 | 73,438 | 75,030 |
| Total cost of services | 86,612 | 82,750 | 273,846 | 258,734 |
| North America goods and services costs | 198,789 | 183,896 | 617,847 | 595,959 |

| | | | | |
|----------------------------------|------------|------------|--------------|--------------|
| International costs and expenses | 2,725 | 3,119 | 8,032 | 123,977 |
| Overhead and other expenses | 146,012 | 141,504 | 430,087 | 429,234 |
| Total costs and expenses | \$ 347,526 | \$ 328,519 | \$ 1,055,966 | \$ 1,149,170 |

9. Commitments and Contingencies

Purchase Commitments

The Company entered into a purchase agreement for its North America operations with a major casket manufacturer, having an original minimum commitment of \$750,000 for a six-year period that expired at the end of 2004. The agreement contained provisions for annual price adjustments and provided for a one-year extension period to December 31, 2005 in which the Company is allowed to satisfy any remaining commitment that exists at the end of the original term. The Company elected to extend the contract to December 31, 2005 in order to satisfy its minimum commitment. In the first quarter of 2005, the Company amended its original purchase

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agreement. This amendment allows the Company to continue purchasing caskets through 2006 subject to price increase limitations. At September 30, 2005, the remaining commitment was \$67,700.

Management, Consulting and Non-Competition Agreements

The Company has entered into management, employment, consulting and non-competition agreements, generally for five to ten years, with certain officers and employees of the Company and former owners of businesses acquired. The Company has modified several of the above agreements as part of cost rationalization programs (see note twelve to the consolidated financial statements). At September 30, 2005, the maximum estimated future cash commitment under agreements with remaining commitment terms was as follows:

| | Employment | Consulting | Non-Compete | Total |
|-------------------|-------------------|-------------------|--------------------|------------------|
| Remainder of 2005 | \$ 761 | \$ 615 | \$ 5,254 | \$ 6,630 |
| 2006 | 2,802 | 2,356 | 17,418 | 22,576 |
| 2007 | 1,125 | 2,110 | 11,937 | 15,172 |
| 2008 | 759 | 885 | 5,365 | 7,009 |
| 2009 | 346 | 804 | 1,960 | 3,110 |
| 2010 and after | 168 | 548 | 4,873 | 5,589 |
| Total | \$ 5,961 | \$ 7,318 | \$ 46,807 | \$ 60,086 |

Litigation

The Company is a party to various litigation matters, investigations and proceedings. For each of its outstanding legal matters, the Company evaluates the merits of the case, its exposure to the matter, possible legal or settlement strategies and the likelihood of an unfavorable outcome. If the Company determines that an unfavorable outcome is probable and can be reasonably estimated, it establishes the necessary accruals. Certain insurance policies held by the Company may reduce cash outflows with respect to an adverse outcome of certain of these litigation matters. The Company accrues such insurance recoveries when they become probable of being paid and can be reasonably estimated. The following discussion describes certain litigation and proceedings as of November 9, 2005.

Conley Investment Counsel v. Service Corporation International, et al.; Civil Action 04-MD-1609; In the United States District Court for the Southern District of Texas, Houston Division (the 2003 Securities Lawsuit). The 2003 Securities Lawsuit resulted from the transfer and consolidation by the Judicial Panel on Multidistrict Litigation of three lawsuits *Edgar Neufeld v. Service Corporation International, et al.*; Cause No. CV-S-03-1561-HDM-PAL; In the United States District Court for the District of Nevada; and *Rujira Srisythemp v. Service Corporation International, et al.*; Cause No. CV-S-03-1392-LDG-LRL; In the United States District Court for the District of Nevada; and *Joshua Ackerman v. Service Corporation International, et al.*; Cause No. 04-CV-20114; In the United States District Court for the Southern District of Florida. The 2003 Securities Lawsuit names as defendants the Company and several of the Company's current and former executive officers or directors. The 2003 Securities Lawsuit is a purported class action alleging that the defendants failed to disclose the unlawful treatment of human remains and gravesites at two cemeteries in Fort Lauderdale and West Palm Beach, Florida. Since the action is in its preliminary stages, no discovery has occurred, and the Company cannot quantify its ultimate liability, if any, for the payment of damages.

David Hajar v. SCI Texas Funeral Services, Inc., SCI Funeral Services, Inc., and Service Corporation International; In the County Court of El Paso, County, Texas, County Court at Law Number Three; Cause Number 2002-740, with an interlocutory appeal pending in the El Paso Court of Appeals, No. 08-05-00182-CV, and a mandamus proceeding pending in the El Paso Court of Appeals, No. 08-05-00335-CV (collectively, the Hajar Lawsuit). The Hajar Lawsuit involves a state-wide class action brought on behalf of all persons, entities and organizations who purchased funeral services from the Company or its subsidiaries in Texas at any time since March 18, 1998. Plaintiffs allege that federal and Texas funeral related regulations and/or statutes (Rules) required the Company to disclose its markups on all items obtained from third parties in connection with funeral service contracts and that the failure to make certain disclosures of markups resulted in breach of contract and other legal claims. The Plaintiffs seek to recover an unspecified amount of monetary damages. The plaintiffs also seek attorneys' fees, costs of

court, pre- and post-judgment interest, and unspecified

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injunctive and declaratory relief. The Company denies that plaintiffs have standing to sue for violations of the Texas Occupations Code or the Rules, denies that any breaches of contractual terms occurred, and on other grounds denies liability on all of the plaintiffs' claims. Finally, the Company denies that the Hjar Lawsuit satisfies the requirements for class certification.

Over the course of the Hjar Lawsuit, the parties have disputed the proper scope and substance of discovery. Each side has filed various motions to compel, motions for protection and/or to quash, motions for sanctions, motions to reconsider, and/or motions to lift sanctions. The trial court has signed several discovery orders against the Company, some of which were effectively vacated when the Company sought relief from the Texas Supreme Court and when, in response to that Court's stay and request for briefing, the sole plaintiff at that time withdrew his requested discovery until summary judgment issues were decided the following year.

Each side in the Hjar Lawsuit filed motions to summarily establish that its interpretation of the Rules was correct. The Company contends that the items at issue, which plaintiffs contend were not disclosed properly under the Rules, were not cash advance items that would have been required by the Federal Trade Commission (FTC) Funeral Rule and Texas counterpart to be disclosed in a certain way on invoices. The International Cemetery and Funeral Association, the Texas Funeral Directors Association, the National Funeral Directors Association, the National Funeral Directors and Morticians Association, Inc., the Texas Funeral Service Commission, and three industry competitors filed Amicus Curiae briefs during the course of the Hjar Lawsuit, asserting that their interpretation of the Rules was the same as the Company's. Additionally, the FTC provided the Company with an informal staff opinion supporting the Company's interpretation, which the Company provided to the trial court. Despite these authorities, the trial court granted and refused to reconsider its ruling on Hjar's summary judgment motion, which summarily determined certain elements of liability based on a finding that the items at issue were cash advance items. This ruling allowed the plaintiffs to proceed to a certification hearing.

The trial court entered an order certifying the class and two subclasses on April 15, 2005. On April 29, 2005, the trial court entered an order imposing sanctions against the Company and (i) finding that the Company breached its contracts by failing to disclose that funeral goods and services were purchased from third parties and resold to customers at higher prices, and by failing to disclose the amount of price mark-ups, and (ii) approving a damage calculation methodology proposed by the plaintiffs under which the damages would equal the difference between the costs to the Company of items of funeral goods and services purchased from third parties and the price at which they were resold to persons arranging funerals, minus any legally proper off-sets. On April 29, 2005, pursuant to section 51.014(a)(3) of the Texas Civil Practice and Remedies Code, the Company filed a notice of appeal regarding the trial court's order certifying a class, and it appears from section 51.014(b) that this interlocutory appeal also stays all other proceedings in the trial court pending resolution of that appeal. The Company filed its appellants' brief of the case with the El Paso Court of Appeals in October 2005.

Concurrently with the filing of the Company's appellate brief, the Company filed a petition for writ of mandamus in a separate original proceeding. The petition seeks mandamus relief from the trial court's January and April 2005 sanction orders. The Company contends that the sanctions imposed by the trial court do not satisfy the applicable standards set forth under Texas case law, purport to change Texas law, misinterpret and misapply federal and Texas law, and were imposed on (among others) a non-party and a party to whom no discovery was ever sent. In addition, the Company contends that the April 2005 sanctions order constitutes an abuse of discretion because it was entered after the plaintiffs withdrew their request for additional discovery sanctions and during a stay on all proceedings under Texas Civil Practice and Remedies Code section 51.014(b). The Company moved to consolidate the record in the appeal and the mandamus, and to consolidate the appeal and the mandamus for hearing and decision. In October 2005, the El Paso Court of Appeals granted the motion in part, consolidating the record. The court of appeals also requested a response to the petition, with a due date of November 26, 2005. The court of appeals stated that it will consider the remainder of the consolidation request after the response is filed.

On July 7, 2005, after the trial court entered its April 2005 certification and sanction orders, the FTC issued a letter advisory opinion regarding the lawful construction of the term "cash advance item" as used in the federal Funeral Rule. This opinion had been requested by a Texas legislator who had asked whether a Texas trial court is correct in ruling that all goods or services purchased from a third-party vendor, even though not included on the contract, are "cash

advances under the Funeral Rule. The FTC expressly identified this Texas trial court as the trial court in the Hijar Lawsuit and specifically referenced the trial court's summary judgment

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ruling. As stated in the letter, The Commission believes that the court is incorrect in ruling that *all* goods or services purchased from a third-party vendor are cash advance items. This interpretation sweeps far too broadly, potentially bringing within its scope every component good or service that comprise a funeral. This was not and is not the Commission's intention in the cash advance provisions of the Rule. In our opinion, the term cash advance item in the Rule applies only to those items that the funeral provider represents expressly to be cash advance items or represents by implication to be procured on behalf of a particular customer and provided to that customer at the same price the funeral provider paid for them. The FTC set forth its analysis in the remainder of the letter. The Company has referenced the FTC letter opinion, among other authorities, in its briefing in the court of appeals.

Mary Louise Baudino, et al v. Service Corporation International, et al; the plaintiffs' counsel in the Hajar Lawsuit initiated an arbitration claim raising similar issues in California and filed in November 2004 a case styled *Mary Louise Baudino, et al v. Service Corporation International, et al*; in Los Angeles County Superior Court; Case No. BC324007 (Baudino Lawsuit). The Baudino Lawsuit makes claims similar to those made in the Hajar lawsuit. However, the Baudino Lawsuit seeks a nation-wide class of plaintiffs.

The Company has learned that a group of parties, including three represented by plaintiffs' counsel in the Hajar Lawsuit and the Baudino Lawsuit, filed an original proceeding in the U.S. Circuit Court of Appeals challenging the July 7, 2005 FTC letter advisory opinion. The court in the Baudino Lawsuit has stayed the case pending the outcome of such challenge to the FTC letter advisory opinion. The Baudino Lawsuit is in its early stages and no discovery has been conducted.

Funeral and Casket Antitrust Litigation: As previously reported, the Company is a defendant in Cause No 4:05-CV-03394; *In re: Funeral Consumers Antitrust Litigation*; In the United States District Court for the Southern District of Texas - Houston (Funeral Consumers Case). This is a purported class action on behalf of casket consumers throughout the United States. The plaintiffs allege that the Company and several other companies involved in the funeral industry violated federal antitrust laws and state consumer laws by engaging in various anti-competitive conduct associated with the sale of caskets.

The Company is also a defendant in Cause No. 4:05-CV-03399; *Pioneer Valley Casket, et al. v. Service Corporation International, et al.*; In the United States District Court of Southern District of Texas - Houston Division. This lawsuit makes the same allegations as the Funeral Consumers Case and is also brought against several other companies involved in the funeral industry. Unlike the Funeral Consumers Case, this case is a purported class action on behalf of all independent casket distributors that are in the business or were in the business any time between July 18, 2001 and to present.

Another class action lawsuit that makes the same allegations as the Funeral Consumers Case has been filed against the Company in the United States District Court for the Northern District of California-San Francisco Division. It is styled Cause No. C-05-3855; *Ralph Lee Fancher v. Service Corporation International, et al.* This lawsuit has been filed on behalf of all Tennessee consumers who purchased caskets from Batesville Casket Company, The York Group, Inc. and Aurora Casket Company. The parties have agreed to transfer this case to the United States District Court for the Southern District of Texas.

Another class action lawsuit that makes the same allegations as the Funeral Consumers Case has been filed against the Company in Cameron County, Texas. It is styled Cause No. 2005-CCL-1023-C; *Leoncio Solis v. Service Corporation International*; In the County Court at Law No. 3 of Cameron County, Texas. This lawsuit has been filed on behalf of all consumers located in the state of Texas who purchased Batesville Casket Company, Inc. caskets from SCI and all consumers who are threatened with injury by the alleged conspiracies. SCI has removed this case to federal court.

The funeral and casket antitrust lawsuits seek injunctions, unspecified amounts of monetary damages and treble damages. Since the litigation is in its preliminary stages, the Company cannot quantify its ultimate liability, if any, for the payment of damages.

In addition to the funeral and casket antitrust lawsuits, the Company has received a Civil Investigative Demand, dated August 4, 2005, from the Attorney General of Maryland on behalf of itself and other state attorneys general, who have commenced an investigation of alleged anticompetitive practices in the funeral industry. The Company has also received similar Civil Investigative Demands from the Attorneys General of Florida and Connecticut.

The ultimate outcome of the litigation matters described above cannot be determined at this time. An adverse decision in one or more of such matters could have a material adverse effect on the Company, its financial condition, results of operation and cash flows. However, the Company intends to aggressively defend the lawsuits.

Table of Contents**10. Earnings per Share**

Basic (loss) earnings per share (EPS) excludes dilution and is computed by dividing net (loss) income by the weighted average number of common shares outstanding for the period. Diluted EPS reflects the potential dilution that could occur if securities or other obligations to issue common stock were exercised or converted into common stock or resulted in the issuance of common stock that then shared in the Company's (loss) earnings.

A reconciliation of the numerators and denominators of the basic and diluted (loss) earnings per share computations is presented below:

| | Three months ended | | Nine months ended | |
|---|---------------------------|-------------|--------------------------|-------------|
| | September 30, | | September 30, | |
| | 2005 | 2004 | 2005 | 2004 |
| | (Restated) | (Restated) | (Restated) | (Restated) |
| | note 2 | note 2 | note 2 | note 2 |
| (Loss) income from continuing operations before cumulative effects of accounting changes (numerator): | | | | |
| (Loss) income from continuing operations before cumulative effects of accounting changes basic | \$ (9,189) | \$ 12,865 | \$ 33,003 | \$ 99,288 |
| After tax interest on convertible debt | | | | 6,419 |
| (Loss) income from continuing operations before cumulative effects of accounting changes diluted | \$ (9,189) | \$ 12,865 | \$ 33,003 | \$ 105,707 |
| Net (loss) income (numerator): | | | | |
| Net (loss) income basic | \$ (9,652) | \$ 13,715 | \$ (150,710) | \$ 83,666 |
| After tax interest on convertible debt | | | | 6,419 |
| Net (loss) income diluted | \$ (9,652) | \$ 13,715 | \$ (150,710) | \$ 90,085 |
| Shares (denominator): | | | | |
| Shares basic | 297,421 | 336,590 | 304,366 | 315,656 |
| Stock options | | 3,588 | 4,341 | 4,143 |
| Restricted stock | | 37 | 100 | 48 |
| Convertible debt | | | | 29,047 |
| Shares diluted | 297,421 | 340,215 | 308,807 | 348,894 |
| (Loss) income from continuing operations per share before cumulative effects of accounting changes: | | | | |
| Basic | \$ (.03) | \$.04 | \$.11 | \$.32 |
| Diluted | \$ (.03) | \$.04 | \$.11 | \$.30 |
| Income from discontinued operations per share, net of tax: | | | | |
| Basic | \$ | \$ | \$.01 | \$.11 |
| Diluted | \$ | \$ | \$.01 | \$.10 |

Cumulative effects of accounting changes per share, net of tax:

| | | | | | | | | |
|---------|----|--|----|--|----|-------|----|-------|
| Basic | \$ | | \$ | | \$ | (.62) | \$ | (.16) |
| Diluted | \$ | | \$ | | \$ | (.61) | \$ | (.14) |

Net (loss) income per share:

| | | | | | | | | |
|---------|----|-------|----|-----|----|-------|----|-----|
| Basic | \$ | (.03) | \$ | .04 | \$ | (.50) | \$ | .27 |
| Diluted | \$ | (.03) | \$ | .04 | \$ | (.49) | \$ | .26 |

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The computation of diluted (loss) earnings per share excludes outstanding stock options and convertible debt in certain periods in which the inclusion of such items would be antidilutive in the periods presented. Total options and convertible debt not currently included in the computation of dilutive (loss) earnings per share for the respective periods are as follows:

| | Three months ended | | Nine months ended | |
|--|---------------------------|-------------|--------------------------|-------------|
| | September 30, | | September 30, | |
| | 2005 | 2004 | 2005 | 2004 |
| Antidilutive options | 12,091 | 13,436 | 7,052 | 10,204 |
| Antidilutive convertible debt | 942 | 1,012 | 967 | 859 |
| Total common stock equivalents excluded from computation | 13,033 | 14,448 | 8,019 | 11,063 |

11. Stockholders Equity

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Table of Contents*Accumulated Other Comprehensive (Loss) Income*

The components of *Accumulated other comprehensive (loss) income* are as follows:

| | Foreign currency translation adjustment | Minimum pension liability adjustment (Restated) note 2 | Unrealized gains and losses | Accumulated other comprehensive (loss) income (Restated) note 2 |
|--|--|---|--|--|
| Balance at December 31, 2004 | \$ (38,349) | \$ | \$ | \$ (38,349) |
| Activity in 2005 | 6,056 | | | 6,056 |
| Reduction in net unrealized gains associated with available-for-sale securities of the trusts | | | (74,654) | (74,654) |
| Reclassification of net unrealized gains activity attributable to the non-controlling interest holders | | | 74,654 | 74,654 |
| Reclassification for translation adjustment realized in net loss | 101,588 | | | 101,588 |
| Balance at September 30, 2005 | \$ 69,295 | \$ | \$ | \$ 69,295 |
| Balance at December 31, 2003 (Restated note 2) | \$ (78,113) | \$ (36,636) | \$ | \$ (114,749) |
| Activity in 2004 (Restated note 2) | 23,639 | 36,636 | | 60,275 |
| Balance at September 30, 2004 (Restated note 2) | \$ (54,474) | \$ | \$ | \$ (54,474) |

The reclassification adjustment of \$101,588 during the nine months ended September 30, 2005 includes \$71,770 related to the sale of the Company's operations in Argentina and Uruguay and \$29,818 related to the sale of its cemetery businesses in Chile. The foreign currency translation activity in the nine months ended September 30, 2004 relates to the sale of the Company's operations in France.

The components of Comprehensive income (loss) are as follows:

| | Three months ended September 30, | | Nine months ended September 30, | |
|----------------------------------|---|----------------------|--|----------------------|
| | 2005 | 2004 | 2005 | 2004 |
| | (Restated) note 2 | (Restated) note 2 | (Restated) note 2 | (Restated) note 2 |
| Comprehensive income (loss): | | | | |
| Net (loss) income | \$ (9,652) | \$ 13,715 | \$ (150,710) | \$ 83,666 |
| Total other comprehensive income | 43,771 | 16,972 | 107,644 | 60,275 |
| Comprehensive income (loss) | \$ 34,119 | \$ 30,687 | \$ (43,066) | \$ 143,941 |

Share Repurchase Program

On June 23, 2005, the Company announced an increase in its stock repurchase program authorizing the investment of an additional \$100,000 to repurchase our common stock, for an aggregate authorized amount of \$400,000. The Company, subject to market conditions and normal trading restrictions, makes purchases in the open market or through privately negotiated transactions. During the third quarter of 2005, the Company repurchased 170 shares of common stock at an aggregate cost of \$1,412. The Company repurchased 26,914 shares of common stock at an aggregate cost of \$191,221 during the nine months ended September 30, 2005. During the third quarter of 2004, the Company repurchased 5,612 shares of common stock at a cost of \$34,812. From October 1 to

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October 31, 2005, the Company repurchased 1,625 shares for a total cost of \$13,344. As of October 31, 2005, the remaining dollar value of shares that may yet be purchased under the share repurchase program was approximately \$85,178.

Cash Dividends

In the first quarter of 2005, the Company's Board of Directors approved the initiation of a quarterly cash dividend of \$.025 per common share. In the second quarter of 2005, the Company paid a dividend totaling \$7,729 recorded in *Capital in Excess of Par Value* in the consolidated balance sheet. In the third quarter of 2005, the Company paid an additional dividend totaling \$7,455 and the Company's Board of Directors approved another dividend totaling \$7,457, payable in the fourth quarter of 2005.

12. Gains and Impairment (Losses) on Dispositions, Net

As dispositions occur in the normal course of business, gains or losses on the sale of such businesses are recognized in the income statement line item *Gains and impairment (losses) on dispositions, net*. Additionally, as dispositions occur pursuant to the Company's ongoing asset sale programs, adjustments are made through this income statement line item to reflect the difference between actual proceeds received from the sale compared to the original estimates.

Gains and impairment (losses) on dispositions, net consists of the following:

| | Three months ended | | Nine months ended | |
|---|---------------------------|-------------|--------------------------|-------------|
| | September 30, | | September 30, | |
| | 2005 | 2004 | 2005 | 2004 |
| Gains on dispositions | \$ 18,447 | \$ 1,022 | \$ 43,255 | \$ 59,436 |
| Impairment losses on assets held for sale | (48,208) | (6,486) | (76,381) | (28,580) |
| Changes to previously estimated impairment losses | 2,315 | 2,183 | 4,467 | 2,165 |
| | \$ (27,446) | \$ (3,281) | \$ (28,659) | \$ 33,021 |

Sale of Operations in Chile

In September 2005, the Company completed the sale of its cemetery operations in Chile for proceeds of approximately \$105,752. The Company received net cash proceeds of \$90,421 upon completion of the sale and expects to receive additional cash proceeds totaling CLP 8,200,226 or approximately \$15,331 in 2006. In the third quarter of 2005, the Company recognized a pre-tax loss of \$227 in *(Loss) income from discontinued operations* in its consolidated statement of operations as a result of this transaction. Included in this loss is a foreign currency gain of \$142 on the expected cash proceeds.

Sales of Assets to StoneMor Partners LP

In November 2005, the Company sold 21 cemeteries and six funeral homes to StoneMor Partners LP for \$12,748. As a result, the Company has classified these properties as held for sale in its September 2005 consolidated financial statements and has recorded an impairment loss of approximately \$30,039, in its consolidated statement of operations for the three months ended September 30, 2005. The Company received \$6,848 in cash and 280,952 StoneMor Limited Partner units, valued at \$5,900, in November of 2005.

Net assets held for sale related to this transaction at September 30, 2005 were as follows:

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| | September 30, 2005 |
|--|-------------------------------|
| Assets: | |
| Receivables, net of allowances | \$ 5,889 |
| Other current assets | 7,070 |
| Preneed funeral receivables and trust investments | 1,146 |
| Preneed cemetery receivables and trust investments | 11,227 |
| Cemetery property | 20,372 |
| Deferred charges and other assets | 7,418 |
| Cemetery perpetual care trust investments | 9,611 |
| Total assets | 62,733 |
| Liabilities: | |
| Deferred preneed funeral revenues | 1,069 |
| Deferred preneed cemetery revenues | 39,305 |
| Non-controlling interest in perpetual care trusts | 9,611 |
| Total liabilities | 49,985 |
| Net assets held for sale | \$ 12,748 |

Sale of Argentina and Uruguay Operations

During the second quarter of 2004, the Company recorded an impairment of its funeral and cemetery operations in Argentina totaling \$15,189 in *Loss from discontinued operations* in its consolidated statement of operations. As a result of the sale of the Argentina and Uruguay businesses in the first quarter of 2005, the Company recorded a gain of \$2,041 in *Income from discontinued operations* in the consolidated statement of operations for the twelve months ended December 31, 2004 associated with the revised estimated fair value. The new carrying amount reflected the fair value based on current market conditions less costs to sell. Additionally, the Company recognized a non-cash tax benefit of \$49,236 in discontinued operations during the second quarter of 2004, which represents the reduction of a previously recorded valuation allowance. The Company also recognized an additional tax benefit of \$2,629 in discontinued operations during the fourth quarter of 2004, which represents the revised estimated fair value and differences between book and tax basis. In the first quarter of 2005, the Company received proceeds of \$21,597 related to the sale of the operations in Argentina and Uruguay.

Proceeds from Investment in United Kingdom Company

During the second quarter of 2004, the Company received proceeds of \$53,839 from the sale of its minority interest equity investment in the United Kingdom and the prepayment of its note receivable, with accrued interest, following a successful public offering transaction of its United Kingdom company. Associated with the disposition, the Company recognized income of \$41,163, recorded in *Gains and impairment (losses) on dispositions, net*, in its second quarter 2004 consolidated statement of operations (\$27,179 to adjust the carrying amount of its note receivable from its former United Kingdom company to its realizable value and \$13,984 as a pretax gain as a result of the sale). This pretax gain was reduced by an accrual for the tax related indemnification liabilities of \$8,000. In addition, the Company recognized interest income on the receivable in the amount of \$4,478 and a foreign currency gain of \$198 recorded in *Other income, net* in the consolidated statement of operations and recognized a non-cash tax benefit of \$8,000 recorded in *Gains and impairment (losses) on dispositions, net* in the consolidated statement of operations. This pretax gain is attributable to the reduction of the tax related accrual upon the release of a contingency, which was accrued as an indemnification liability in the second quarter of 2004.

Table of Contents*Sale of French Operations*

In March 2004, the Company sold 100% of the stock of its French subsidiary to a newly formed company (NEWCO). In connection with this sale, the Company acquired a 25% share of the voting interest of NEWCO, received cash proceeds of \$281,667, net of transaction costs, and received a note receivable in the amount of EUR 10,000. Also received in this transaction were EUR 15,000 of preferred equity certificates and EUR 5,955 of convertible preferred equity certificates. The sale of stock of the Company's French subsidiary in March 2004 resulted in a pretax gain of \$12,639 and a non-cash tax benefit of \$24,929 (described below) resulting in an after tax gain of \$37,568. The Company accounted for the sale of its French subsidiary in accordance with the guidance set forth in EITF 01-2, *Interpretations of APB Opinion No. 29*, Issues 8(a) and 8(b). Consequently, the Company deferred approximately 25% of the gain associated with the sale of its French subsidiary representing the economic interest it retained in that subsidiary through its ownership of approximately 25% of NEWCO.

In July 2004, the Company paid \$6,219 pursuant to the joint venture agreement, as a purchase price adjustment, which reduced the pretax gain to \$6,420 and reduced the after tax gain to \$33,624 as summarized below.

| | Original Calculation Q1 2004 | Adjustment in Q2 2004 | Total |
|-----------------------|---|----------------------------------|--------------|
| Pretax gain (loss) | \$ 12,639 | \$ (6,219) | \$ 6,420 |
| Tax benefit | (24,929) | (2,275) | (27,204) |
| After tax gain (loss) | \$ 37,568 | \$ (3,944) | \$ 33,624 |

The \$24,929 non-cash tax benefit associated with the sale of the Company's French subsidiary is primarily attributable to the reduction of \$18,610 of tax accruals, which were accrued as an indemnification liability upon the sale of the Company's French subsidiary. The remaining amount of \$6,319 was a non-cash tax benefit associated with the difference between book and tax basis.

Included in the pretax gain, the Company recognized \$35,768 of contractual obligations related to representations and warranties and other indemnifications resulting from the joint venture contract. During 2004, \$2,400 in charges were applied to the indemnifications and related primarily to foreign taxes and legal expenses. The Company applied \$772, \$830, and \$232 to the indemnifications during the first, second, and third quarters of 2005, respectively. Also, goodwill in the amount of \$23,467 was removed from the Company's consolidated balance sheet as a result of this transaction.

NEWCO completed refinancings in May 2005 and July 2005 in order to reduce its cost of debt. Included in this refinancing was the repayment of the note payable to the Company plus interest and the redemption of the Company's investment in preferred equity certificates and convertible preferred equity certificates and associated interest, which were received in the original disposition. In the second quarter of 2005, the Company received \$32,070 related to the note payable and preferred equity certificates with associated interest of \$3,064. In the third quarter of 2005, the Company received additional proceeds of \$7,604 on convertible preferred equity certificates. The Company's investment in common stock and 25% voting interest remain unchanged following this transaction.

13. Discontinued Operations

The Company committed to a plan during the second quarter of 2004 to divest its existing funeral and cemetery operations in Argentina and Uruguay. During the first quarter of 2005, the Company disposed of its operations in Argentina and Uruguay. During the third quarter of 2005 the Company also disposed of its cemetery operations in Chile. Accordingly, the operations in these countries are classified as discontinued operations for all periods presented.

The provision for income taxes in the three and nine months ended September 30, 2005 was negatively impacted by differences between book and tax bases related to the sale of the Company's operations in Chile. The benefit for income taxes for the nine months ended September 30, 2004, includes a non-cash tax benefit of \$49,236, which represents the reduction of a previously recorded valuation allowance related to the sale of the Company's operations

in Argentina.

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The results of the Company's discontinued operations for the three and nine months ended September 30, 2005 and 2004 were as follows:

| | Three months ended September 30, | | Nine months ended September 30, | |
|---|-------------------------------------|----------|------------------------------------|-----------|
| | 2005 | 2004 | 2005 | 2004 |
| Revenues | \$ 5,187 | \$ 8,770 | \$ 22,891 | \$ 29,735 |
| Impairment loss on dispositions | (227) | | (227) | (15,189) |
| Other costs and expenses | (2,817) | (7,297) | (14,252) | (27,077) |
| Income (loss) from discontinued operations before income taxes | 2,143 | 1,473 | 8,412 | (12,531) |
| Provision (benefit) for income taxes | 2,606 | 623 | 4,587 | (47,502) |
| (Loss) income from discontinued operations | \$ (463) | \$ 850 | \$ 3,825 | \$ 34,971 |

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

At September 30, 2005, we owned and operated 1,111 funeral service locations (1,093 in North America) and 380 cemeteries (all of which are in North America). We also had a 25% minority interest equity investment in our former funeral operations in France. We also own Kenyon International Emergency Services, a disaster response team that engages in mass fatality and emergency response services.

Our funeral and cemetery operations are organized into a North America division covering the United States and Canada, and an Other Foreign division including operations in Germany and Singapore. In 2004, our Other Foreign division also included operations in France, which were sold in the first quarter of 2004. Results from our funeral and cemetery businesses in Argentina and Uruguay, which were sold in the first quarter of 2005, and our cemetery business in Chile, which was sold in the third quarter of 2005, are classified as part of discontinued operations for all periods presented. For both the three and nine months ended September 30, 2005, our North America operations represented 99.3% of our consolidated revenues. For the three and nine months ended September 30, 2005, our North America operations represented 99.9% and 99.7%, respectively of our consolidated gross profits.

Our operations in the North America division are organized into 31 major markets and 42 middle markets. Each market is led by a market director with responsibility for funeral and/or cemetery operations and preneed sales. Within each market, the funeral homes and cemeteries realize efficiencies by sharing common resources such as personnel, preparation services and vehicles. There are four market support centers in North America to assist market directors with financial, administrative and human resource needs. These support centers are located in Houston, Miami, New York and Los Angeles. The primary functions of the market support centers are to help facilitate the execution of corporate strategies, coordinate communications between the field and corporate offices and serve as liaisons for implementation of policies and procedures.

Our Competitive Strengths

Industry leader. We are the leading provider of funeral, cremation and cemetery services in North America. Despite some consolidation, the industry remains fragmented. We estimate that SCI and the other public companies combined generate approximately 20% of total industry revenue in North America. The other 80% is generated by independent funeral and cemetery operators.

Geographically diverse network. We operate businesses in North America in 41 states and seven Canadian provinces. We believe we are able to provide funeral services to more than 70% of the households in the United States. We believe this comprehensive national coverage enables us to be the only company in our industry to successfully implement a national branding strategy and to develop alliances with national strategic partners.

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National branding strategy. In 2000, we launched the first national branding strategy in the funeral service industry in North America under the name Dignity Memorial®. While this branding process is intended to emphasize our seamless national network of funeral service locations and cemeteries, the original names associated with acquired locations generally remain the same. The Dignity Memorial® brand name is a co-brand to the existing name of the business. Signage, advertising and promotional efforts emphasize both names. We believe that a national brand gives us a competitive advantage.

Favorable demographics over the long term. According to the U.S. Census Bureau, the number of persons 65 years or older totaled 36 million in 2004. They represented 12.4% of the population, or about one in every eight Americans. The number of Americans aged 65 and older is expected to climb to approximately 16% of the total population by 2020, and to approximately 20% by 2030. Approximately 75% of all deaths in the United States are at ages 65 and older. We believe these demographic trends will provide a growing demand in the future for our services on both an atneed and preneed basis.

Stable revenues and cash flows. Our core business can be described as stable, with relatively consistent revenue and cash flows on an annual basis. We believe our ability to consistently generate strong cash flows sets us apart from others in the industry. This stability is enhanced by a large backlog of future revenues associated with preneed funeral and cemetery sales. In North America, our backlog of preneed funeral and cemetery sales consists of more than \$5 billion of revenues that will be recognized in future periods. These unfulfilled preneed funeral and cemetery contracts are primarily supported by investments in trust funds, which are included in our consolidated balance sheet or third party insurance policies, which are not included in our consolidated balance sheet.

Financial flexibility. We believe we have significant opportunities to grow shareholder value due to our strong cash flows and liquidity, and modest debt maturities in the near term. For a further discussion about our financial flexibility, please see Financial Condition, Liquidity and Capital Resources in this section of this Form 10-Q.

Business Challenges

No meaningful near-term increase in the numbers of deaths. The numbers of deaths in the United States are not expected to increase meaningfully in the near term. Modern advances in medicine and healthier lifestyles are contributing to record levels of life expectancy in the United States. In 2003, life expectancy in the United States reached 77.6 years according to the Centers for Disease Control and Prevention. The Baby Boom generation is expected to have an impact on the numbers of deaths in the future; however, the first Baby Boomers do not reach age 65 until the year 2011.

Increasing trend toward cremation. In North America, social trends (such as a mobile, less rooted society), changes in religious preferences, environmental issues, and cultural preferences are driving an increasing preference for cremation. We are the largest provider of cremation services in North America, where approximately 40% of the total funeral services we perform are cremation services. The mix of cremation in our business has been increasing approximately 100 to 150 basis points each year and we expect this trend to continue in the near term. Historically, cremation services have generated less revenue and gross profit dollars than traditional funeral services that involve burials. Additionally, the cremation consumer may choose not to purchase cemetery property or merchandise. Industry research has shown that most consumers choose cremation for reasons other than cost, which we believe provides us significant opportunities to better serve the cremation consumer.

We believe a successful cremation strategy is built on product differentiation, personalization and simplicity. Along with the sale of Dignity Memorial® cremation plans, we are developing new displays to be used in the arrangement process that clearly explain the products and services available to cremation consumers. We also own and operate National Cremation®, which specifically targets the cremation consumer. Within the cemetery segment, we are promoting cremation gardens, which are separate sections located within certain of our cemeteries where cremated remains can be permanently placed and which contain other unique memorialization products.

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Where We are Today

We have taken significant actions in recent years to improve our infrastructure and reduce overhead costs as further described below. In doing so, we believe we have now established a solid platform for future growth. We believe strategies centered on our national brand, Dignity Memorial®, and other revenue growth initiatives, such as a continued focus on cost management and gaining a better understanding of our customers, will provide the framework for sustainable growth over the longer term.

Improving the infrastructure. Historically, our infrastructure did not allow us to fully realize the inherent efficiencies of our business organization. As a result, we were unable to capitalize on all of the benefits of standardization, technology, and process improvement. Beginning in late 2002 and continuing through 2003, we moved to reduce fixed costs by reformulating our infrastructure. We redesigned our sales organization, improved business and financial processes, and outsourced certain of our accounting functions. In 2003 and continuing through 2004, we implemented a new information system in our field locations. In November 2003, we eliminated the dual management structures of sales and operations and replaced them with a single-line business management structure while also improving our corporate support system by establishing market support centers. In the second quarter of 2005, the Company announced its decision to outsource additional accounting functions.

Promoting the brand. We have implemented the first national brand in the funeral service industry. This brand is called Dignity Memorial®. We believe that a national brand name will provide us access to new customers over the long term given the increasingly mobile nature of families in North America. Internally, we are focused on ensuring that we have consistency in service standards and processes across our network of businesses.

We market the brand nationally through a multi-faceted advertising campaign that focuses on the distinct benefits and values that set Dignity Memorial® apart from other providers. Through our national brand we are also the sponsor of several nationally recognized community programs.

Most importantly, a national brand requires us to focus on instilling a culture of discipline throughout the Company and ensuring that we have consistency amongst service standards and processes throughout our network of businesses.

Employee development. We have developed a comprehensive education strategy throughout an online campus format called Dignity University . Dignity University features job-focused curriculum for positions within SCI. Upon completion of coursework, participants are required to pass examinations to obtain certification in their individual jobs. Dignity University utilizes a combination of traditional classroom, web-based, virtual classroom and on-the-job training for the approximate 18,000 individuals that we employ in North America.

Contemporary offerings and marketing strategies. Through our Dignity Memorial® brand we are developing more contemporary and comprehensive products and services that we believe will help the consumer create a personal experience as well as help them with the administrative and legal challenges that occur when a loved one dies. Some of the exclusive items offered through Dignity Memorial® providers include special rates on airfare, car rentals and hotel accommodations; grief counseling services; a legal services membership; internet memorial archive capabilities through Making Everlasting Memories®, or MeM® (www.mem.com); and the Aftercare® Planner a comprehensive organization system that helps families manage the many financial details that arise after a death occurs. Importantly, these products and services appeal to both burial and cremation consumers.

We are also focused on offering consumers new ways to personalize funeral services and create value in the experience. Examples include creating movies from pictures that span the deceased's life and important events; displaying items that were special to the deceased or that reflect a hobby; having a dove, butterfly or balloon release; or holding a memorial service in a favorite place such as a park, marina or sports venue.

In conjunction with these new offerings, we have improved our funeral home merchandising strategies to place less emphasis on traditional funeral merchandise and more focus on the comprehensive product and service offerings unique to Dignity Memorial® providers. In late 2004, we began to roll-out enhanced merchandise displays and other presentation models in our funeral homes that

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offer personalization options. In addition, funeral personnel at each of these locations have completed a comprehensive training and certification program to ensure their effectiveness and optimal customer satisfaction.

In late 2004, we also developed and began to implement a standardized pricing methodology for each of our cemeteries. This approach incorporates marketplace demographic information and data about competitive cemeteries in the market, as well as historical retail and wholesale prices. This new pricing methodology complements our tiered-product strategy and ensures that we are capturing appropriate values for the different levels of our products. We are particularly focused on the development of high-end cemetery property such as private family estates.

The Path to Growth

Customer satisfaction. We have recently partnered with J.D. Power and Associates, one of the world's premier marketing firms specializing in customer satisfaction, to assist us with better understanding and measuring feedback from our consumers. We launched new customer surveys in March 2005. Our new survey to client families utilizes a combined approach—measuring satisfaction and loyalty and the relationship between the two.

Developing access to new customers. We believe that we have opportunities to grow market share due to our size and geographic diversity. We believe that better understanding our customers will increase market share over the long term. Our strategy to deliver profitable growth will be based on three platforms as described below.

Approach the business by customer segment. We are beginning to develop an operating strategy that will segment our customers and locations utilizing a needs-based approach. Today, we serve all customers the same regardless of their wants and needs. As we identify customer segments based on needs, we will develop pricing and product and marketing strategies tailored to these segments. Customer segmentation will allow us to focus on increasing our penetration in the most attractive segments, including those growing segments of the population.

Leverage our scale and drive operating discipline. We believe we can benefit from more centralization and standardization to take advantage of our scale. We will develop operating standards in the areas of location staffing, central care, maintenance and business planning. We will align our pricing and preneed strategies with customer segments and centralize and simplify our pricing process. We intend to continue to capitalize on our nationwide network of properties by pursuing affinity relationships and opportunities to more fully utilize our purchasing power.

Manage the footprint. We will position our businesses to support our customer strategy while continually monitoring the market and competitive dynamics. We will target expansion through acquisition or construction in the highest return segments. We will also use our customer segmentation model to prioritize our capital spending to ensure facilities meet customers' expectations.

Critical Accounting Policies and Accounting Changes

Accounting Changes and Error Corrections

In May 2005, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 154, *Accounting Changes and Error Corrections, A Replacement of Accounting Principles Board (APB) Opinion No. 20 and FASB Statement No. 3* (SFAS 154). SFAS 154 requires retrospective application to prior period financial statements for the direct effects of changes in accounting principle, unless it is impracticable to determine either the period-specific effects or the cumulative effect of the change. SFAS 154 is effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005.

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Deferred Selling Costs

Effective January 1, 2005, we changed our method of accounting for direct selling costs related to the acquisition of preneed funeral and preneed cemetery contracts. Prior to this change, we capitalized such direct selling costs and amortized these deferred selling costs in proportion to the revenue recognized. Under the new method of accounting, we expense these direct selling costs as incurred. We believe the new method is preferable because it better reflects the economics of our business.

The direct selling costs were capitalized based on deferral rates that we established and varied by preneed funeral contracts and preneed cemetery items, based on the ratio of the direct selling compensation and related fringe costs to preneed funeral and cemetery production. We did not attribute deferred selling costs to each individual contract (or each item in the case of cemetery deferred selling costs). Management believed that using the proportionate method of amortization allowed for a systematic match of costs with related revenues given the relatively homogenous nature of the preneed funeral and preneed cemetery contract items. However, management believes that expensing direct selling costs as incurred is preferable as expensing such costs is consistent with Statement of Position 93-7 *Reporting on Advertising Costs* for similar types of items, given that we do not maintain direct selling costs by individual contract or item.

Prior to the accounting change, we allocated significant employee resources to accounting for deferred selling costs and did not maintain deferred selling costs at a contract level or item level detail in order to exactly amortize the item level costs when the associated revenue was appropriately recognized. We believe that expensing these selling costs as incurred is the preferable method of accounting for the reasons noted above and because it eliminates the burden of maintaining deferred selling cost records.

Finally, we manage our business based on cash flow. Management believed that expensing these deferred selling costs was preferable as it better aligns the costs of obtaining the preneed funeral and preneed cemetery contract with the cash outflows associated with obtaining such contracts.

As of January 1, 2005, we recorded a charge to the cumulative effect of an accounting change of \$187.5 million, net of tax of \$117.4 million. This amount represents the cumulative balance of deferred selling costs recorded on our consolidated balance sheet in *Deferred charges and other assets* at the time of the accounting change. If we had not changed our method of accounting for direct selling costs as described above, net income for the three months ended September 30, 2005 would have been approximately \$3.6 million, or \$.01 per basic and diluted share higher than currently reported. If we had not changed our method of accounting for direct selling costs as described above, net income for the nine months ended September 30, 2005 would have been approximately \$8.5 million, or \$.03 per basic and diluted share higher than currently reported.

The three and nine months ended September 30, 2004 pro forma amounts in the table below reflect the new policy to expense selling costs as incurred. The effect of the change for the three and nine months ended September 30, 2004 would have decreased net income from continuing operations before cumulative effects of accounting changes by approximately \$3.1 million and \$10.0 million, or \$.01 and \$.03 per diluted share, respectively.

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| | Three months ended September 30, 2004 | | | Nine months ended September 30, 2004 | | |
|---|--|--|----------------------------|---|--|----------------------------|
| | Historical (Restated) | Deferred Selling Costs, net (1) | Pro forma (Restated) | Historical (Restated) | Deferred Selling Costs, net (1) | Pro forma (Restated) |
| Gross profits: | | | | | | |
| Funeral | \$ 45.1 | \$ (0.9) | \$ 44.2 | \$ 182.6 | \$ (3.6) | \$ 179.0 |
| Cemetery | 23.6 | (4.1) | 19.5 | 72.8 | (12.7) | 60.1 |
| | 68.7 | (5.0) | 63.7 | 255.4 | (16.3) | 239.1 |
| Income (loss) from continuing operations before income taxes and cumulative effects of accounting changes | \$ 17.4 | \$ (5.0) | \$ 12.4 | \$ 92.5 | \$ (16.3) | \$ 76.2 |
| Net income (loss) | \$ 13.7 | \$ (3.1) | \$ 10.6 | \$ 83.7 | \$ (10.0) | \$ 73.7 |
| Amounts per common share: | | | | | | |
| Net income (loss) basic | \$.04 | \$ (.01) | \$.03 | \$.27 | \$ (.04) | \$.23 |
| Net income (loss) diluted | \$.04 | \$ (.01) | \$.03 | \$.26 | \$ (.03) | \$.23 |

(1) Represents net deferred selling costs that would have been expensed under the new method of accounting adopted on January 1, 2005.

Other-Than-Temporary Impairments

In June 2005, the FASB decided not to provide additional guidance on the meaning of other-than-temporary impairment, and directed the staff to issue proposed FSP EITF 03-1-a, *Implementation Guidance for the Application of Paragraph 16 of EITF Issue No. 03-1*, as final. The final FSP supersedes EITF Issued No. 03-1, *The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments*, and EITF Topic No. D-44, *Recognition of Other-Than-Temporary Impairment upon the Planned Sale of a Security Whose Cost Exceeds Fair Value*. The final FSP (retitled FSP FAS 115-1, *The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments*) replaces the guidance set forth in paragraphs 10-18 of EITF Issue 03-1 with references to existing other-than-temporary impairment guidance. FSP FAS 115-1 codifies the guidance set forth in EITF Topic D-44 and clarifies that an investor should recognize an impairment loss no later than when the impairment is deemed other-than-temporary, even if a decision to sell has not been made. FSP FAS 115-1 is effective for other-than-temporary analysis conducted in periods beginning after September 15, 2005. We have adopted the provisions of FSP FAS 115-1 and as of the date of adoption, this statement has had no material impact on our

consolidated financial statements, results of operations, financial position, or cash flows.

Inventory Costs

In November 2004, the FASB issued SFAS No. 151, *Inventory Costs – an amendment of ARB 43, Chapter 4* (SFAS 151). SFAS 151 amends the guidance in Accounting Research Bulletin (ARB) No. 43, Chapter 4, *Inventory Pricing*, to clarify the accounting for abnormal amounts of idle facility expense, freight, handling costs and wasted material. SFAS 151 requires that those items be recognized as current-period charges, rather than as a portion of the inventory cost. In addition, SFAS 151 requires that allocation of fixed production overhead to the costs of conversion be based on the normal capacity of the production facilities. SFAS 151 is effective for inventory costs incurred during fiscal years beginning after June 15, 2005. We do not expect this statement to have a material impact on our consolidated financial statements, results of operations, financial position, or cash flows.

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In December 2004, the FASB issued SFAS No. 123R, *Share-Based Payment* (SFAS 123R). SFAS 123R is a revision of SFAS No. 123, *Accounting for Stock-Based Compensation*, and supersedes APB Opinion No. 25, *Accounting for Stock Issued to Employees*. Among other items, SFAS 123R eliminates the use of the intrinsic value method of accounting, and requires companies to recognize the cost of employee services received in exchange for awards of equity instruments, based on the grant date fair value of those awards, in the financial statements. The effective date of SFAS 123R is the first annual reporting period beginning after June 15, 2005, which is the first quarter of 2006 for SCI.

We currently use the intrinsic value method to account for stock options. For disclosure purposes, we currently utilize a standard option pricing model (i.e., Black-Scholes) to measure the fair value of stock options granted to employees. We will continue to utilize the Black-Scholes option pricing model to measure the fair value of our stock options. We expect to adopt SFAS 123R effective January 1, 2006. We are currently evaluating the impact that this adoption will have on our results of operations.

Variable Interest Entities

In January 2003, the FASB issued FASB Interpretation No. 46, *Consolidation of Variable Interest Entities, an Interpretation of ARB No. 51*. This interpretation clarifies the application of ARB No. 51, *Consolidated Financial Statements*, to certain entities in which equity investors do not have the characteristics of a controlling financial interest or do not have sufficient equity at risk for the entity to finance its activities without additional subordinated financial support from other parties. In December 2003, the FASB revised FASB Interpretation No. 46 (FIN 46R).

Under the provisions of FIN 46R, we are required to consolidate certain cemeteries and trust assets. Merchandise and service trusts and cemetery perpetual care trusts are considered variable interest entities because the trusts meet the conditions of paragraphs 5(a) and 5(b)(1) of FIN 46R. That is, as a group, the equity investors (if any) do not have sufficient equity at risk and do not have the direct or indirect ability through voting or similar rights to make decisions about the trusts' activities that have a significant effect on the success of the trusts. FIN 46R requires consolidation of merchandise and service trusts and cemetery perpetual care trusts for which we are the primary beneficiary (i.e., those for which we absorb a majority of the trusts' expected losses). We are the primary beneficiary of a trust whenever a majority of the assets of the trust are attributable to deposits of our customers.

Consolidation of Trusts: We implemented FIN 46R as of March 31, 2004, which resulted in the consolidation of our preneed funeral and cemetery merchandise and service trust assets and our cemetery perpetual care trusts. No cumulative effect of an accounting change was recognized as a result of the implementation of FIN 46R as it relates to the consolidation of the trusts. The implementation of FIN 46R affects certain line items on our consolidated balance sheet and statement of operations as described below; however, there is no impact to net income in the statement of operations as a result of the implementation. Additionally, the implementation of FIN 46R did not result in any net changes to our consolidated statement of cash flows; however, it does require certain financing and investing activities to be disclosed.

Although FIN 46R requires consolidation of most of the merchandise and service and perpetual care trusts, it does not change the legal relationships among the trusts, SCI and our customers. In the case of merchandise and service trusts, the customers are the legal beneficiaries. In the case of cemetery perpetual care trusts, we do not have a legal right to the perpetual care trust assets. For these reasons, upon consolidation of the trusts, we recognize non-controlling interests in our financial statements to reflect third party interests in these trusts in accordance with FASB Statement No. 150, *Accounting for Certain Financial Instruments with Characteristics of Both Liability and Equity* (SFAS 150). We classify deposits to merchandise and service trusts as non-controlling liability interests and classify deposits to cemetery perpetual care trusts as non-controlling equity interests.

We record cash received from customers that is payable to the trusts but not yet required to be deposited in the trusts as restricted cash in *Deferred charges and other assets* in our consolidated balance sheet. At September 30, 2005 and December 31, 2004, these pending deposits totaled \$10.7 million and \$11.2 million, respectively. We continue to account for amounts received from customers prior to delivery of merchandise or services that are not required to be deposited in merchandise and service trusts as deferred revenue.

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Beginning March 31, 2004, we recognize net realized investment earnings of the merchandise and service trusts and perpetual care trusts, as well as the related trustee investment expenses and taxes, within *Other income, net*. We then recognize a corresponding expense within *Other income, net* representing the net realized earnings of those trusts that are attributable to the non-controlling interest holders. The corresponding credit for this expense is reflected in our consolidated balance sheet in *Non-controlling interest in funeral and cemetery trusts* for merchandise and service trusts or *Non-controlling interest in perpetual care trusts* for cemetery perpetual care trusts. The sum of these expenses recorded in *Other income, net* offsets the net realized earnings of such trusts also recognized within *Other income, net*. Accordingly, our net income in the consolidated statement of operations is not affected by consolidation of the trusts in accordance with FIN 46R.

To the extent the earnings of the trusts are distributed prior to the delivery of merchandise and/or services, a corresponding amount of non-controlling interest is reclassified to deferred revenue until the amounts qualify for revenue recognition. In the case of merchandise and service trusts, we recognize as revenues amounts previously attributed to non-controlling interests and deferred revenues upon the performance of services and delivery of merchandise, including earnings accumulated in these trusts. In the case of the cemetery perpetual care trusts, distributable earnings are recognized in cemetery revenues to the extent of qualifying cemetery maintenance costs.

Prior to the implementation of FIN 46R and the consolidation of the trusts, funds received from customers and deposited into merchandise and service trusts until maturity of the preneed contract were recorded as receivables due from trust assets. Upon implementation of FIN 46R, we replaced receivables due from trust assets with the trust assets, at market, to the extent we were required to consolidate the trusts.

An allowance for contract cancellation is provided based on historical experience. An allowance is no longer provided on the funds associated with the preneed contracts that are held in trust, currently recorded as trust assets, but previously recorded as receivables due from trust assets. As such, the amount has decreased since the implementation of FIN 46R.

Both the merchandise and services trusts and the cemetery perpetual care trusts hold investments in marketable securities that are classified as available-for-sale under the requirements of SFAS 115. In accordance with SFAS 115, available-for-sale securities of the trusts are recorded at fair value, with unrealized gains and losses excluded from earnings and initially recorded as a component of *Accumulated other comprehensive income (loss)* in our consolidated balance sheet. Using the guidance in EITF Topic D-41, *Adjustments in Assets and Liabilities for Holding Gains and Losses as Related to the Implementation of FASB Statement No. 115* (Topic D-41), unrealized gains and losses on available-for-sale securities of the trusts attributable to the non-controlling interest holders are not recorded as *Accumulated other comprehensive income (loss)*, but are recorded as an adjustment to either *Non-controlling interest in funeral and cemetery trusts* or *Non-controlling interest in perpetual care trusts*. Therefore, unrealized gains and losses attributable to the non-controlling interest holders are reclassified from *Accumulated other comprehensive income (loss)* to either *Non-controlling interest in funeral and cemetery trusts* or *Non-controlling interest in perpetual care trusts*. The gross effect from applying Topic D-41 on our *Accumulated other comprehensive income (loss)* is disclosed in note eleven of the consolidated financial statements. However, our *Accumulated other comprehensive income (loss)* balance on the face of the balance sheet is ultimately not affected by consolidation of the trusts.

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Consolidation of Certain Cemeteries: Prior to December 31, 2003, we operated certain cemeteries in Michigan which we managed but did not own. During our evaluation of FIN 46R, we evaluated these cemeteries to determine whether such cemeteries were within the scope of FIN 46R. The investment capital of these cemeteries was financed by SCI in exchange for a long-term sales, accounting, and cash management agreement. In accordance with this agreement, we receive the majority of the cash flows from these cemeteries. Additionally, we absorb the majority of these cemeteries' expected losses and receive a majority of the cemeteries' residual returns. As a result, we concluded that it was the primary beneficiary of these cemeteries and that the long-term sales, accounting, and cash management agreement is a variable interest as defined by FIN 46R. Given the circumstances above, we consolidated such cemeteries at March 31, 2004. We recognized an after tax charge of \$14.0 million, representing the cumulative effect of an accounting change, as a result of consolidating these cemeteries. The results of operations and cash flows of these cemeteries are included in our consolidated statements of operations and cash flows beginning March 31, 2004. Excluding the cumulative effect of accounting change, the effect of consolidating these entities did not have a significant impact on our reported results of operations.

Pension Plans

Effective January 1, 2004, we changed our accounting for gains and losses on our pension plan assets and obligations. We now recognize such gains and losses in our consolidated statement of operations as such gains and losses are incurred. Prior to January 1, 2004, we amortized the difference between actual and expected investment returns and actuarial gains and losses over seven years (except to the extent that settlements with employees required earlier recognition). We believe the new method of accounting better reflects the economic nature of our pension plans and recognize gains and losses on the pension plan assets and liabilities in the year the gains or losses occur. As a result of this accounting change, we recognized a charge for the cumulative effect of an accounting change of \$36.6 million (net of tax) as of January 1, 2004. This amount represents accumulated unrecognized net losses related to the pension plan assets and liabilities. In addition, for interim periods, we record net pension expense or income reflecting estimated returns on plan assets and obligations. We will recognize actual gains and losses on plan assets and obligations as actuarial information becomes available upon review of the annual remeasurement.

Restatement of Financial Statements

We have restated herein our condensed consolidated statement of operations for the three and nine month periods ended September 30, 2005 and 2004. In addition, we have restated herein our condensed consolidated statement of cash flows for the nine month periods ended September 30, 2005 and 2004 and our condensed consolidated balance sheets as of September 30, 2004 and December 31, 2005. This restatement has been reported in an amendment to our Annual Report on Form 10-K for the year ended December 31, 2005 and our Quarterly Report on Form 10-Q for the quarterly periods ended March 31, 2006 and June 30, 2006.

In addition, we have previously restated our condensed consolidated statement of operations for the three and nine month period ended September 30, 2004, our condensed consolidated statement of cash flows for the nine month period ended September 30, 2004, and our condensed consolidated balance sheet as of December 31, 2004.

For details related to these restatements, please see note two to the condensed consolidated financial statements in Item 1 of this amended Form 10-Q.

Results of Operations – Three Months Ended September 30, 2005 and 2004

Effective January 1, 2005, we changed our accounting for preneed selling costs. For details surrounding this accounting change, see note four to the consolidated financial statements in Item 1 of this Form 10-Q/A.

In the following discussion of results of operations, certain prior period amounts have been reclassified to conform to the current period financial presentation with no effect on previously reported net income, financial position or cash flows.

Our net loss for the three months ended September 30, 2005, was \$9.7 million or \$.03 per diluted share compared to net income of \$13.7 million or \$.04 per diluted share in the same period of 2004.

Net (loss) income in the periods presented was affected by the following items, which are presented here on an after-tax basis:

Three Months Ended September 30, 2005:

Net losses on dispositions of \$20.2 million or \$.07 per diluted share.

Loss of \$0.5 million or less than \$.01 per diluted share from discontinued operations.

Three Months Ended September 30, 2004:

Net loss on dispositions of \$1.8 million or less than \$.01 per diluted share

Expenses of \$5.2 million or \$.02 per diluted share related to outstanding litigation matters.

Income of \$0.9 million or less than \$.01 per diluted share from discontinued operations.

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The consolidated effective tax rate in the third quarter of 2005 was a benefit of 8.8% compared to a provision of 26.0% in the third quarter of 2004.

The tax benefit in 2005 was negatively impacted by increases in tax expense resulting from permanent differences between book and tax bases of North America asset dispositions.

The diluted weighted average number of shares decreased to 297.4 million at September 30, 2005 compared to 340.2 million at September 30, 2004. This decrease is mainly due to our share repurchase program which began in the third quarter of 2004.

Consolidated Funeral Results

Funeral revenue in the three months ended September 30, 2005 decreased \$4.0 million from the same period in 2004. North America funeral revenue decreased \$3.4 million primarily as a result of a decrease in atneed revenues, partially offset by a \$5.2 million increase in revenue from Kenyon, our subsidiary that engages in mass fatality and emergency response services. Kenyon revenue was higher in the third quarter of 2005 than in the third quarter of 2004 primarily due to its involvement with the incidents in Greece and Louisiana.

Funeral gross profit decreased \$9.0 million in the three months ended September 30, 2005 compared to the same period in 2004. North America funeral gross profit decreased \$8.5 million during the third quarter of 2005. Our change in accounting related to deferred selling costs contributed approximately \$0.9 million to our decline in gross profit. Additionally, gross profit was negatively impacted by the decrease in revenues described above and an inflationary increase in the cost of merchandise, an increase in vehicle and utility costs, which were impacted by rising fuel prices; and higher salaries and fringes due to inflationary increases and higher health and pension costs. Partially offsetting these items was an increase of approximately \$2.9 million of gross profit related to Kenyon.

Consolidated Cemetery Results

Cemetery revenue increased \$13.2 million in the three months ended September 30, 2005 compared to the same period of 2004. North America cemetery revenue increased \$13.6 million primarily as a result of higher preneed and atneed sales production combined with an increase in legacy revenues associated with constructed cemetery property. Cemetery gross profit decreased \$0.8 million in the three months ended September 30, 2005 compared to the same period of 2004. Our increase in revenues described above was partially offset by our change in accounting related to deferred selling costs which contributed approximately \$4.1 million to our decline in gross profit. Additionally, gross profit was negatively impacted by inflationary increases in the cost of merchandise and higher fringe expenses, primarily health care and pension costs.

General and Administrative Expenses

General and administrative expenses were \$19.7 million in the three months ended September 30, 2005 compared to \$25.3 million in the same period of 2004.

- In the third quarter of 2004, we recognized \$8.3 million in expense associated with the settlement of outstanding litigation matters.

- However, we have incurred significantly higher professional fees associated with Sarbanes-Oxley compliance and external audit fees. During 2005, we have spent a significant amount of money to improve internal controls to comply with Section 404 of the Sarbanes Oxley Act. We believe that these improvements will continue to help increase the effectiveness of the organization.

Gains and Impairment (Losses) on Dispositions, Net

Gains and impairment (losses) on dispositions, net was a net pretax loss of \$27.4 million in the third quarter of 2005 compared to a net pretax loss of \$3.3 million in the same period of 2004. The net pretax losses in the third quarter of 2005 and 2004 are primarily associated with losses associated with underperforming funeral and cemetery businesses in North America that were divested or planned to be divested in the short term.

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Interest expense was \$0.8 million lower in the third quarter of 2005 compared to the third quarter of 2004 primarily due to declines in debt during 2005 and 2004.

Other Income, Net

Other income increased \$0.2 million in the third quarter of 2005 compared to the same period of 2004. The components of other income for the periods presented were as follows:

- Interest income on notes receivable and commercial paper was \$3.3 million and \$1.1 million in the third quarter of 2005 and 2004, respectively.
- Cash overrides received from a third party insurance provider related to the sale of insurance funded preneed funeral contracts were \$1.5 million in the third quarter of 2005 compared to \$1.6 million in the third quarter of 2004.
- Surety bond premium costs were \$1.0 million in the third quarter of 2005 compared to \$1.1 million in the third quarter of 2004.
- The remaining income of \$0.7 million in the third quarter of 2005 and \$2.7 million in the third quarter of 2004 is primarily related to net gains and losses from foreign currency transactions, respectively.

Comparable Results of Operations Three Months Ended September 30, 2005 and 2004

The table below reconciles our actual results to our comparable or same store results for the quarters ended September 30, 2005 and 2004. We regard same store results of operations as analogous to our comparable results of operations. We consider comparable operations as operations that were not acquired or constructed after January 1, 2004 or divested prior to September 30, 2005. Therefore, in the following two periods presented, we are providing results of operations for the same funeral and cemetery locations. Comparable results are a non-GAAP financial measure; however, we believe this non-GAAP measure is useful to investors as it provides a consistent basis for comparison between periods and better reflects the performance of our core operations.

| (Dollars in thousands) | Consolidated (Restated) | Activity associated with acquisition/new construction | Activity associated with dispositions | Comparable (Restated) |
|--|----------------------------|---|--|--------------------------|
| Three months ended September 30, 2005 | | | | |
| North America | | | | |
| Funeral revenue | \$ 259,875 | \$ 895 | \$ 1,484 | \$ 257,496 |
| Cemetery revenue | 143,704 | 485 | 366 | 142,853 |
| | 403,579 | 1,380 | 1,850 | 400,349 |
| Other foreign | | | | |
| Funeral revenue | 2,790 | | | 2,790 |
| Cemetery revenue | | | | |
| | 2,790 | | | 2,790 |
| Total revenue | \$ 406,369 | \$ 1,380 | \$ 1,850 | \$ 403,139 |
| North America | | | | |
| Funeral gross profit | \$ 35,978 | \$ 86 | \$ (1,043) | \$ 36,935 |
| Cemetery gross profit | 22,800 | 379 | (466) | 22,887 |

| | | | | |
|-----------------------|-----------|--------|------------|-----------|
| | 58,778 | 465 | (1,509) | 59,822 |
| Other foreign | | | | |
| Funeral gross profit | 65 | | | 65 |
| Cemetery gross profit | | | | |
| | 65 | | | 65 |
| Total gross profit | \$ 58,843 | \$ 465 | \$ (1,509) | \$ 59,887 |

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| (Dollars in thousands) | Consolidated (Restated) | Activity associated with acquisition/new construction | Activity associated with dispositions | Comparable (Restated) |
|--|----------------------------|---|--|--------------------------|
| Three months ended September 30, 2004 | | | | |
| North America | | | | |
| Funeral revenue | \$ 263,289 | \$ 102 | \$ 10,951 | \$ 252,236 |
| Cemetery revenue | 130,143 | | 2,507 | 127,636 |
| | 393,432 | 102 | 13,458 | 379,872 |
| Other foreign | | | | |
| Funeral revenue | 3,415 | | | 3,415 |
| Cemetery revenue | 339 | | 339 | |
| | 3,754 | | 339 | 3,415 |
| Total revenue | \$ 397,186 | \$ 102 | \$ 13,797 | \$ 383,287 |
| North America | | | | |
| Funeral gross profit | \$ 44,490 | \$ (4) | \$ 393 | \$ 44,101 |
| Cemetery gross profit | 23,542 | | (326) | 23,868 |
| | 68,032 | (4) | 67 | 67,969 |
| Other foreign | | | | |
| Funeral gross profit | 578 | | | 578 |
| Cemetery gross profit | 57 | | 57 | |
| | 635 | | 57 | 578 |
| Total gross profit | \$ 68,667 | \$ (4) | \$ 124 | \$ 68,547 |

The following table provides the components to calculate our comparable average revenue per funeral service in North America for the three months ended September 30, 2005 and 2004. We calculate average revenue per funeral service as adjusted comparable North America funeral revenue divided by the comparable number of funeral services performed in North America during the applicable period. In the calculation of average revenue per funeral service, General Agency (GA) revenue and Kenyon International Emergency Services (Kenyon) revenue are excluded from comparable North America funeral revenue to avoid distorting our averages of normal funeral case volume.

(Dollars in thousands, except average revenue per funeral service)

| | 2005 (Restated) | 2004 (Restated) |
|--|--------------------|--------------------|
| Comparable North America funeral revenue | \$ 257,496 | \$ 252,236 |
| Less: GA Revenue (1) | 6,937 | 7,025 |
| Kenyon revenue (2) | 5,614 | 457 |

| | | |
|---|----------|----------|
| Adjusted Comparable North America funeral revenue | 244,945 | 244,754 |
| Comparable North America funeral services performed | 56,519 | 56,494 |
| North America average revenue per funeral service | \$ 4,334 | \$ 4,332 |

(1) General Agency revenue is the commission we receive from third-party insurance companies when customers purchase insurance contracts from such third-party insurance companies to fund funeral services and merchandise at a future date.

(2) Kenyon is our disaster response subsidiary that engages in mass fatality and emergency response services. Revenue and gross profit associated with Kenyon are subject to significant variation due to the nature of their operations.

Table of Contents*Comparable North America Funeral*

Comparable North America funeral revenue in the third quarter of 2005 increased \$5.3 million or 2.1% from the same period in 2004 primarily due to a \$5.2 million increase in revenue from Kenyon and increases in funeral volume.

The number of funeral services performed and the comparable average revenue per funeral service were relatively flat in the third quarter of 2005 compared to the same period in 2004. Average revenue per funeral service fell below expectations during the third quarter of 2005 primarily as a result of higher than expected discounts to consumers at the local level and a higher than expected mix of cremation consumers during the third quarter of 2005. Of the total comparable funeral services performed in the third quarter of 2005, 40.9% were cremation services versus 39.5% in the same period of 2004.

Comparable North America funeral gross profit decreased \$7.2 million or 16.2% in the third quarter of 2005 compared to the same period of 2004. Our change in accounting related to deferred selling costs contributed approximately \$0.9 million to our decline in gross profit. Additionally, gross profit was negatively impacted by inflationary increases in the cost of merchandise; an increase in vehicle and utility costs, which were impacted by rising fuel prices; and higher salaries and fringes due to inflationary increases and higher health and pension costs. Partially offsetting the decrease in gross profit was an increase in Kenyon gross profit of \$2.9 million. Prior to 2005, we deferred and amortized preneed funeral direct selling costs. Effective January 1, 2005, we are now expensing these costs as incurred. Had we expensed funeral preneed selling costs as incurred in 2004, funeral gross profit in the third quarter of 2004 would have been reduced by approximately \$0.9 million.

Comparable North America Cemetery

Comparable North America cemetery revenue increased \$15.2 million or 11.9% to \$142.9 million in the third quarter of 2005 compared to the same period of 2004. This increase is primarily a result of increased preneed and atneed sales production combined with an increase in legacy revenues associated with constructed cemetery property.

Comparable North America cemetery gross profit decreased 4.1% or \$1.0 million in the three months ended September 30, 2005 compared to the same period in 2004. The increase in revenues described above was offset by our change in accounting related to deferred selling costs of approximately \$4.1 million. Additionally, gross profit was negatively impacted by inflationary increases in the cost of merchandise, higher maintenance expenses, and higher fringe expenses, primarily health and pension costs. Prior to 2005, we deferred and amortized preneed cemetery direct selling costs. Effective January 1, 2005, we are now expensing these costs as incurred. Had we expensed cemetery preneed selling costs as incurred in 2004, cemetery gross profit in the third quarter of 2004 would have been reduced by approximately \$4.1 million.

Results of Operations – Nine Months Ended September 30, 2005 and 2004

Effective January 1, 2005, we changed our accounting for preneed selling costs. For details surrounding this accounting change, see note four to the consolidated financial statements in Item 1 of this Form 10-Q/A.

In the following discussion of results of operations, certain prior period amounts have been reclassified to conform to the current period financial presentation with no effect on previously reported net income, financial position or cash flows.

Net loss for the nine months ended September 30, 2005, was \$150.7 million or \$.49 per diluted share compared to net income of \$83.7 million or \$.26 per diluted share in the same period of 2004. Our former funeral operations in France (which were sold in March 2004) contributed \$8.1 million or \$.02 of earnings per diluted share in the first nine months of 2004.

Net (loss) income in the periods presented was affected by the following items, which are presented here on an after-tax basis:

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Nine Months Ended September 30, 2005:

A charge of \$187.5 million or \$.61 per diluted share for the cumulative effect of the change in accounting related to preneed selling expenses.

Net loss on early extinguishment of debt of \$9.3 million or \$.03 per diluted share primarily related to the tender offer of our 7.20% notes originally due 2006 and our 6.875% notes originally due 2007.

Net losses on dispositions of \$23.7 million or \$.07 per diluted share.

Income of \$3.8 million or \$.01 per diluted share from discontinued operations.

Nine Months Ended September 30, 2004:

Net gain on dispositions of \$58.5 million or \$.17 per diluted share (including tax benefits realized from the disposition of our French operations and a minority interest in our former United Kingdom company).

A charge of \$50.6 million or \$.14 per diluted share for the cumulative effect of accounting changes related to the implementation of FIN 46R and changes in pension accounting.

Net earnings of \$35.0 million or \$.10 per diluted share from discontinued operations. This includes a non-cash tax benefit of \$49.2 million.

Expense of \$30.6 million or \$.09 per diluted share related to outstanding litigation matters.

Loss on the early extinguishment of debt of \$10.5 million or \$.03 per diluted share primarily related to the tender offer of our notes originally due in 2005 and the redemption of our convertible notes originally due in 2008.

Interest income on a note receivable from our former United Kingdom company of \$2.7 million, or \$.01 per diluted share.

Foreign currency transactional loss of \$2.3 million or \$.01 per diluted share associated with the payment of a contingent purchase obligation in Chile.

The consolidated effective tax rate in the first nine months of 2005 was a provision of 44.2% compared to a benefit of 7.4% in the same period of 2004. The tax rate in the first nine months of 2005 was negatively impacted by permanent differences between book and tax bases of North American asset dispositions. The tax rate in the first nine months of 2004 was favorably impacted by non-cash tax benefits realized from the disposition of our funeral operations in France and the United Kingdom. The tax benefits from dispositions result from differences between book and tax bases and the reversal of tax liabilities that were subsequently recorded as warranty indemnification liabilities.

The diluted weighted average number of shares decreased to 308.8 million at September 30, 2005 compared to 348.9 million at September 30, 2004. This decrease is mainly due to the conversion of our convertible senior notes in June of 2004 and our share repurchase program which began in the third quarter of 2004.

Consolidated Funeral Results

Funeral revenue in the nine months ended September 30, 2005 declined \$114.0 million from the same period of 2004 primarily due to a decline of \$127.3 million in revenue associated with our funeral operations in France, which were sold on March 11, 2004. North America funeral revenue increased \$13.6 million primarily as a result of a \$16.0 million increase in revenues from Kenyon, our subsidiary that engages in mass fatality and emergency response services. Kenyon revenue was higher in the first nine months of 2005 than in the first nine months of 2004 primarily due to its involvement with incidents in Asia, Greece, and Louisiana. The increase in Kenyon revenues were slightly offset by a decrease in general agency revenues during the first nine months of 2005.

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Funeral gross profit decreased \$15.8 million in the nine months ended September 30, 2005 compared to the same period in 2004 primarily as a result of an \$11.6 million decline in gross profit related to our former operations in France, which were sold in March 2004. North America funeral gross profit decreased \$3.4 million. Our change in accounting related to deferred selling costs reduced pretax earnings in the first nine months of 2005 by approximately \$3.6 million. Additionally, gross profit was negatively impacted by an inflationary increase in the cost of merchandise, higher salary and fringe expenses (primarily health care and pension costs), and increases related to our trust reconciliation project and increased Sarbanes-Oxley expenses. These decreases in profit were offset by an increase in gross profit related to Kenyon.

Consolidated Cemetery Results

Cemetery revenue decreased \$4.9 million in the nine months ended September 30, 2005 compared to the same period of 2004. North America cemetery revenue decreased \$4.1 million primarily as a result of a decrease in interest earned on trade receivables. Cemetery gross profit decreased \$10.0 million in the nine months ended September 30, 2005 compared to the same period of 2004, primarily as result of the decreases in revenue described above and our change in accounting related to deferred selling costs, which reduced pretax earnings in the first nine months of 2005 by approximately \$12.7 million.

General and Administrative Expense

General and administrative expenses were \$61.9 million in the nine months ended September 30, 2005 compared to \$100.3 million in the same period of 2004.

- In the first nine months of 2004, we recognized \$48.3 million in expense associated with the settlement of outstanding litigation matters including \$35.0 million related to the securities class action lawsuit.
- However, in 2005 we incurred significant increases in general and administrative expenses related to increased professional fees associated with Sarbanes-Oxley compliance, external audit fees, and costs associated with our funeral and cemetery verification projects.

Gains and Impairment (Losses) on Dispositions, Net

Gains and impairment (losses) on dispositions, net was a pretax loss of \$28.7 million in the first nine months of 2005 compared to a pretax gain of \$33.0 million in the same period of 2004. The net pretax loss in 2005 is primarily associated with the disposition of underperforming funeral and cemetery businesses in North America partially offset by the release of an indemnification liability related to the sale of our operations in the United Kingdom and various gains in disposition of real estate in North America. The 2004 net pretax gain includes a gain on the sale of our equity and debt holding in the United Kingdom and a gain with the sale of our funeral operations in France partially offset by net losses associated with various dispositions in North America.

Interest Expense

Interest expense was \$14.7 million lower in the first nine months of 2005 compared to the same period of 2004 primarily due to the reduction of debt during 2005 and 2004.

Other Income, Net

Other income decreased \$1.5 million in the first nine months of 2005 compared to the same period of 2004. The components of other income for the period presented were as follows:

- Interest income was \$11.2 million and \$9.6 million in the first nine months of 2005 and 2004, respectively. Included in 2005 was \$1.9 million of interest income on preferred equity certificates and convertible preferred equity certificates from our former funeral operations in France. The first nine months of 2004 included the receipt of \$4.5 million of interest income related to a note receivable collected from our former United Kingdom company.

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- Cash overrides received from a third party insurance provider related to the sale of insurance funded preneed funeral contracts were \$4.7 million in 2005 compared to \$4.9 million in 2004.
- Surety bond premium costs were \$3.0 million in 2005 compared to \$3.4 million in 2004.
- The remaining expense of \$1.1 million in 2005 and income of \$2.2 million in 2004 is primarily related to net losses from foreign currency transactions.

Comparable Results of Operations Nine Months Ended September 30, 2005 and 2004

The table below reconciles our actual results to our comparable or same store results for the nine months ended September 30, 2005 and 2004. We regard same store results of operations as analogous to our comparable results of operations. We consider comparable operations as operations that were not acquired or constructed after January 1, 2004 or divested prior to September 30, 2005. Therefore, in the following two periods presented, we are providing results of operations for the same funeral and cemetery locations. Comparable results are a non-GAAP financial measure; however, we believe this non-GAAP measure is useful to investors as it provides a consistent basis for comparison between periods and better reflects the performance of our core operations.

| (Dollars in thousands) | Consolidated (Restated) | Activity associated with acquisition/new construction | Activity associated with dispositions | Comparable (Restated) |
|---|----------------------------|---|--|--------------------------|
| Nine months ended September 30, 2005 | | | | |
| North America | | | | |
| Funeral revenue | \$ 857,966 | \$ 2,535 | \$ 16,672 | \$ 838,759 |
| Cemetery revenue | 418,866 | 485 | 2,787 | 415,594 |
| | 1,276,832 | 3,020 | 19,459 | 1,254,353 |
| Other foreign | | | | |
| Funeral revenue | 8,739 | | | 8,739 |
| Cemetery revenue | 82 | | 82 | |
| | 8,821 | | 82 | 8,739 |
| Total revenue | \$ 1,285,653 | \$ 3,020 | \$ 19,541 | \$ 1,263,092 |
| North America | | | | |
| Funeral gross profit | \$ 166,049 | \$ 153 | \$ 873 | \$ 165,023 |
| Cemetery gross profit | 62,849 | 141 | (888) | 63,596 |
| | 228,898 | 294 | (15) | 228,619 |
| Other foreign | | | | |
| Funeral gross profit | 829 | | | 829 |
| Cemetery gross profit | (40) | | (40) | |
| | 789 | | (40) | 829 |

| | | | | |
|--------------------|------------|--------|---------|------------|
| Total gross profit | \$ 229,687 | \$ 294 | \$ (55) | \$ 229,448 |
|--------------------|------------|--------|---------|------------|

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| (Dollars in thousands) | Consolidated (Restated) | Activity associated with acquisition/new construction | Activity associated with dispositions | Comparable (Restated) |
|---|----------------------------|---|--|--------------------------|
| Nine months ended September 30, 2004 | | | | |
| North America | | | | |
| Funeral revenue | \$ 844,405 | \$ 119 | \$ 38,680 | \$ 805,606 |
| Cemetery revenue | 422,986 | | 8,180 | 414,806 |
| | 1,267,391 | 119 | 46,860 | 1,220,412 |
| Other foreign | | | | |
| Funeral revenue | 136,311 | | 127,282 | 9,029 |
| Cemetery revenue | 895 | | 895 | |
| | 137,206 | | 128,177 | 9,029 |
| Total revenue | \$ 1,404,597 | \$ 119 | \$ 175,037 | \$ 1,229,441 |
| North America | | | | |
| Funeral gross profit | \$ 169,480 | \$ (144) | \$ 2,604 | \$ 167,020 |
| Cemetery gross profit | 72,718 | | (249) | 72,967 |
| | 241,084 | (144) | 2,355 | 239,987 |
| Other foreign | | | | |
| Funeral gross profit | 13,158 | | 11,572 | 1,586 |
| Cemetery gross profit | 71 | | 71 | |
| | 13,229 | | 11,643 | 1,586 |
| Total gross profit | \$ 255,427 | \$ (144) | \$ 13,998 | \$ 241,573 |

The following table provides the components to calculate our comparable average revenue per funeral service in North America for the nine months ended September 30, 2005 and 2004. We calculate average revenue per funeral service as adjusted comparable North America funeral revenue divided by the comparable number of funeral services performed in North America during the applicable period. In the calculation of average revenue per funeral service, General Agency revenue and Kenyon revenue are excluded from comparable North America funeral revenue to avoid distorting our averages of normal funeral case volume.

(Dollars in thousands, except average revenue per funeral service)

| | 2005 (Restated) | 2004 (Restated) |
|--|--------------------|--------------------|
| Comparable North America funeral revenue | \$ 838,759 | \$ 805,606 |
| Less: GA Revenue (1) | 21,057 | 22,680 |
| Kenyon revenue (2) | 19,044 | 3,013 |

| | | |
|---|----------|----------|
| Adjusted Comparable North America funeral revenue | 798,658 | 779,913 |
| Comparable North America funeral services performed | 183,849 | 182,075 |
| North America average revenue per funeral service | \$ 4,344 | \$ 4,283 |

(1) General Agency revenue is the commission we receive from third-party insurance companies when customers purchase insurance contracts from such third-party insurance companies to fund funeral services and merchandise at a future date.

(2) Kenyon is our disaster response subsidiary that engages in mass fatality and emergency response services. Revenue and gross profit associated with Kenyon are subject to significant variation due to the nature of their operations.

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Comparable North America funeral revenue in the first nine months of 2005 increased \$33.2 million or 4.1% from the same period in 2004 primarily due to increases in funeral volume and average revenue per funeral service and a \$16.0 million increase in revenue from Kenyon, partially offset by a decline in GA revenue.

The number of funeral services performed increased 1.0% in the first nine months of 2005 compared to the same period in 2004. The comparable average revenue per funeral service increased 1.4% in the nine months ended September 30, 2005 compared to the same period of 2004. We have generated increases in the average revenue per funeral despite an increase in the rate of cremation. Of the total comparable funeral services performed in the first nine months of 2005, 40.4% were cremation services versus 39.3% in the same period of 2004.

Comparable North America funeral gross profit decreased \$2.0 million or 1.2% in the first nine months of 2005 compared to the same period of 2004. The increase in revenue described above was offset by our change in accounting for deferred selling costs of approximately \$3.6 million. Also, negatively impacting gross profit were inflationary increases in merchandise costs, an increase in group health and pension costs, and an increase related to our trust reconciliation projects and higher Sarbanes-Oxley costs. Kenyon contributed an increase to gross profits of approximately \$2.6 million for the first nine months of 2005. Prior to 2005, we deferred and amortized preneed funeral direct selling costs. Effective January 1, 2005, we are now expensing these costs as incurred. Had we expensed funeral preneed selling costs as incurred in 2004, funeral gross profit in the first nine months of 2004 would have been reduced by approximately \$3.6 million.

Comparable North America Cemetery

Comparable North America cemetery revenue improved \$0.8 million or 0.2% to \$415.6 million in the nine months ended September 30, 2005 compared to the same period of 2004. This increase is primarily a result of improvements in operating atneed revenues and trust fund income, partially offset by a decline in interest on trade receivables.

Comparable North America cemetery gross profit decreased 12.8% or \$9.4 million in the nine months ended September 30, 2005 compared to the same period in 2004. Cemetery gross profit was negatively impacted by \$12.7 million related to our change in accounting for preneed cemetery direct selling costs. Additionally, gross profit was negatively impacted by inflationary increases in the cost of merchandise, higher salary and fringe expenses (primarily health care and pension costs), increases in vehicle and utility costs driven by higher fuel prices, and an increase in auto lease expense driven by higher variable interest rates. Prior to 2005, we deferred and amortized preneed cemetery direct selling costs. Effective January 1, 2005, we are now expensing these costs as incurred. Had we expensed cemetery preneed selling costs as incurred in 2004, cemetery gross profit in the first nine months of 2004 would have been reduced by \$12.7 million.

Financial Condition, Liquidity and Capital Resources*Overview*

Our primary financial objectives are to capitalize on our financial flexibility and to continue generating strong operating cash flows. We believe that we are financially sound and have liquidity to consider opportunities to deploy capital and strategic acquisitions at reasonable market values. During the first nine months of 2005, we continued to invest in our share repurchase program and paid our first quarterly dividend since 1999. Our current credit ratings of BB with Standard and Poor's (S&P) and Ba3 with Moody's Investors Service (Moody's) provide us with adequate access to obtain funds at a reasonable cost, if necessary. Our financial position continues to improve as demonstrated by the following trend in our cash and debt balances:

| (In millions) | September 30, 2005 (Restated) | 2004 (Restated) | December 31, 2003 (Restated) | 2002 (Restated) |
|---|--|--------------------|------------------------------------|--------------------|
| Total debt | \$ 1,286.9 | \$ 1,278.5 | \$ 1,713.0 | \$ 1,985.7 |
| Cash and cash equivalents | 492.1 | 287.8 | 239.4 | 200.6 |
| Total debt less cash and cash equivalents | \$ 794.8 | \$ 990.7 | \$ 1,473.6 | \$ 1,785.1 |

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Total debt less cash and cash equivalents at September 30, 2005 was \$780.0 million. Total debt has been reduced by \$713.6 million or 35.9% since December 31, 2002. This reduction is a result of strong operating cash flows, which included the receipt of tax refunds of approximately \$130 million and a successful asset divestiture and joint venture program that produced over \$750 million of net cash proceeds.

Cash Flow

We believe our ability to generate strong operating cash flow is one of our fundamental financial strengths and provides us with substantial flexibility in meeting operating and investing needs. Highlights of cash flow for the first nine months of 2005 compared to the same period of 2004 are as follows:

Operating Activities Cash flows from operations in the first nine months of 2005 increased by \$89.0 million compared to the same period of 2004. The first nine months of 2005 included a \$29.0 million unusual tax refund. Included in the first nine months of 2004 was a \$20.0 million voluntary cash contribution to our pension plan, the payment of \$11.4 million to retire life insurance policy loans, and \$18.3 million in operating cash flows provided by our French operations for the period January 1, 2004 through March 11, 2004. Excluding these items in both periods, cash flows from operations increased \$46.9 million or 25.7%. Cash flows from operating activities that exclude the items above are a non-GAAP financial measure; however, we believe this non-GAAP measure is useful to investors as it better reflects the performance of our core operations, as it is not influenced by non-recurring items.

Positively affecting cash flow from operations in the first nine months of 2005 compared to the first nine months of 2004 was an approximate \$32.0 million decrease in payroll and bonus payments due primarily to an additional pay period in the prior year, \$15.8 million more in net trust fund withdrawals over the prior period, a \$14.4 million decrease in cash interest paid due to debt reductions, and a \$2.0 million decrease in payments related to restructuring charges. Cash receipts from Kenyon increased \$10.4 million (offset by a \$13.4 million increase in Kenyon expenses) in the first nine months of 2005 compared to the same period in 2004 due to its involvement with the incidents in Asia, Greece and Louisiana. Other improvements in cash flows from operating activities resulting from our working capital initiatives were offset by cash outflows of \$12.0 million associated with the Company funding employee matches to our 401(k) plan using cash in 2005 and a \$10.1 million increase in cash outflows to improve internal controls in order to comply with Section 404 of the Sarbanes-Oxley Act.

Investing Activities Cash flows from investing activities in the first three quarters of 2005 increased by \$28.6 million compared to the same period of 2004 primarily due to a \$134.8 million favorable change in restricted cash, a \$51.7 million payment of a purchase obligation in 2004, \$39.7 million in distributions from our equity investment in France in 2005, and \$27.8 million in increased proceeds from our North America divestiture program partially offset by a decrease in proceeds of \$218.8 million from sales of international businesses.

In the first nine months of 2005, we received \$90.4 million from the disposition of our cemetery operations in Chile, \$42.7 million related to the collection of our note receivable and the redemption of preferred equity certificates related to our equity investment in our former French operations (of which \$39.7 million is reported as an investing activity), and \$21.6 million from the disposition of our Argentina and Uruguay businesses. In the nine months ended September 30, 2004, we received \$330.8 million from the disposition of our French and United Kingdom operations. For additional information related to these disposition activities, see note twelve to the consolidated financial statements in Item 1 of this Form 10-Q.

Net withdrawals of restricted funds and other increased from a use of \$120.9 million in 2004 to a source of \$13.9 million in 2005, providing a \$134.8 million net source of cash in the first nine months of 2005 compared to the same period of 2004. This favorable change was primarily attributable to a \$135.0 million deposit into escrow in 2004 related to the settlement of certain legal matters and a \$9.2 million return of cash collateral in 2005 previously pledged in connection with various commercial commitments.

Capital expenditures increased \$4.7 million in the first three quarters of 2005 compared to the same period of 2004. Capital expenditures in North America increased \$7.4 million due to additional spending on existing facilities, including the renovation of our corporate headquarters as well as new growth initiatives primarily related to cemetery development construction. Capital expenditures in 2004 included \$2.8 million associated with our French operations that were sold in March of 2004.

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Financing Activities Cash used for financing activities decreased by \$7.3 million in the first nine months of 2005 compared to the same period in 2004 primarily due to a \$116.7 million decrease in scheduled debt payments, a \$50.2 million increase in proceeds from issuance of debt, and a \$13.7 million decrease in payments for the early extinguishment of debt. These cash outflows were partially offset by an increase in the repurchase of Company stock totaling \$156.4 million and the payment of \$15.2 million in dividends in the first nine months of 2005.

As of June 8, 2005, we completed our previously authorized \$300 million share repurchase program. In late June 2005, we expanded our share repurchase program by an additional \$100 million. As of November 5, 2005, we have repurchased a total of 45.3 million shares at a cost of approximately \$314.8 million under these programs. At October 31, 2005, we had approximately 296.6 million shares outstanding.

We made improvements in both the first nine months of 2005 and 2004 to significantly extend our debt maturity schedule. During the second quarter of 2004, we completed a private offering of \$250 million principal amount of 6.75% notes due 2016 and received net cash proceeds of approximately \$243 million. Including the premium, \$219.0 million of the net cash proceeds was applied to the early retirement of \$208.7 million in principal of our 6% notes due 2005. Immediately following the June 22, 2004 conversion into common stock of approximately 71% of our outstanding 6.75% bonds due 2008, we exercised our option to redeem the remaining outstanding \$91.1 million of the bonds for \$94.6 million in cash, including premium. Also, we paid \$124.8 million in scheduled debt payments in the first nine months of 2004.

During the second quarter of 2005, we issued \$300 million of senior unsecured 7.00% notes due June 15, 2017, and received net proceeds of \$291.5 million. We used these proceeds to redeem \$130.0 million aggregate principal amount of our 6.875% notes due 2007 and \$139.3 million aggregate principal amount of our 7.20% notes due 2006 for a total of \$280.5 million, including premium, as part of a tender offer. During the first nine months of 2005, we also purchased \$16.6 million of our 7.7% notes due 2009 and \$0.3 million of our 6.00% notes due 2005 in the open market for a total of \$17.9 million, including premium. We also paid \$8.1 million in scheduled debt payments.

Liquidity

We believe we have sufficient cash and cash equivalents and a strong trend of operating cash flows. This liquidity affords us the option to consider opportunities to deploy capital including strategic acquisitions at reasonable prices, continued investment in our share repurchase program and other considerations.

As of September 30, 2005, our cash balance was \$492.1 million. We also have a \$200 million credit facility that was executed in August 2004. We have no cash borrowings outstanding under this credit facility, but have used it to support \$59.8 million of letters of credit as of September 30, 2005. We believe these resources are adequate to meet our near and intermediate term debt obligations, planned capital expenditures and other cash requirements, as well as to have funds available for future growth.

We expect to generate cash flows in the next several years above our operating and financing needs. We currently have approximately \$113.6 million in debt maturing during the remainder of 2005 and 2006. We believe that this financial flexibility coupled with our liquidity allows us to consider investments or capital structure related transactions that will enhance shareholder value. We will continue to evaluate internal opportunities such as construction of new funeral homes and development of high-end cemetery property development. We expect to make acquisitions, if such acquisitions are available at reasonable market prices.

We currently have approximately \$85.2 million authorized for our share repurchase program. We plan to continue to make purchases from time to time in the open market or through privately negotiated transactions, subject to market conditions and normal trading restrictions. In the first quarter of 2005, we announced the reinstatement of a quarterly dividend. The first disbursement of this dividend, totaling \$7.7 million, or \$.025 per common share, was paid in April of 2005. In July 2005, we paid a second quarter dividend totaling \$7.5 million. We paid a third dividend, totaling \$7.5 million, in October of 2005. We intend to pay regular quarterly cash dividends in the foreseeable future; however, all subsequent dividends are subject to final determination by our Board of Directors each quarter.

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We received approximately \$42.7 million in the first nine months of 2005 related to the collection of our note receivable resulting from the sale of our funeral operations in France in March 2004 and the redemption of other various preferred equity instruments. For more details related to this transaction, see note twelve to the consolidated financial statements in Item 1 of this Form 10-Q.

We are continuing our program to divest of our operations outside of North America. In the first half of 2005, we sold our operations in Argentina and Uruguay for net cash proceeds of \$21.6 million. In the third quarter of 2005, we sold our cemetery operations in Chile for net cash proceeds of approximately \$105.7 million, of which \$90.4 million was received in the third quarter of 2005 and approximately \$15.3 million is expected to be received in 2006. We currently own funeral businesses in Germany and Singapore that we will look to exit when market values and economic conditions are conducive to a sale. In addition, our improved financial condition and credit profile have allowed us to receive cash collateral previously pledged in connection with various commercial commitments. As of September 30, 2005, we have no cash pledged as collateral with surety companies.

Preneed Funeral and Cemetery Activities

In addition to selling our products and services to client families at the time of need, we believe an active funeral and cemetery preneed program can increase future market share and result in revenue and profit growth in our service markets. Preneed arrangement is a means through which a customer contractually agrees to the terms of a funeral service, cremation service, and/or cemetery burial interment right, merchandise or cemetery service to be performed or provided in the future (that is, in advance of when needed or preneed).

Preneed Funeral Activities

Since preneed funeral services or merchandise will not be provided until some time in the future, most states and provinces require that all or a portion of the funds collected from customers on preneed funeral contracts be protected for the benefit of the customer pursuant to state or provincial law. Some or all of the funds may be required to be placed into trust accounts, or a surety bond may be posted in lieu of trusting (collectively trust funded preneed funeral contracts). Alternatively, where allowed, customers may choose to purchase a life insurance or annuity policy from third party insurance companies to fund their preneed funeral (insurance funded preneed funeral contract). Only certain of these customer funding options may be applicable in any given market we serve.

The contract amounts associated with unfulfilled insurance funded preneed funeral contracts are not reflected on our consolidated balance sheet. However, when customers enter into a trust funded preneed contract, we record an asset, *Preneed funeral receivables and trust investments*, and a corresponding obligation, *Deferred preneed funeral revenues*, in our consolidated balance sheet for the contract price. The preneed funeral receivable is then decreased by the cash received from the customer at the time of sale. The funeral revenues are deferred and will not be recognized in the consolidated statement of operations until the funeral services are performed or the merchandise is delivered. When we receive payments on a trust funded preneed funeral contract from the customer, we deposit the amount required by law into the trust and reclassify the corresponding amount from *Deferred preneed funeral revenues* into *Non-controlling interest in funeral and cemetery trusts*. While some customers may pay for their contract in a single payment, most trust funded preneed funerals are sold on an installment basis over a period of one to seven years. On these installment contracts, we receive, on average, a down payment at the time of sale of approximately 10%. Historically, the majority of our trust funded preneed funeral contracts have not included a finance charge. However, we began a phased roll-out of implementing finance charges during the fourth quarter of 2004. We are continuing a phased roll-out during 2005 to the states where such finance charges are allowed but not required to be trusted on trust funded preneed funeral trust contracts. We plan to complete this roll-out during the fourth quarter of 2005.

Trust Funded Preneed Funeral Contracts: Where the state or provincial law requires that all or a portion of the funds collected from preneed funeral contracts be placed in trust accounts, the funds deposited into trust are invested by the independent trustees in accordance with the investment guidelines established by statute or, where the prudent investor rule is applicable, the guidelines established by the Investment Committee of our Board of Directors. The trustees utilize professional investment advisors to select and monitor the money managers that make the individual investment decisions in accordance with the guidelines. We retain any funds above the amounts required to be deposited into trust accounts and use them for working capital purposes, generally to offset the

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selling and administrative costs of the preneed programs. State or provincial law governs the timing of the required deposits into the trust accounts, which generally ranges from five to 45 days after receipt of the funds from the customer.

The trust investments are expected to generate earnings sufficient to offset the inflationary costs of providing the preneed funeral services and merchandise in the future for the prices that were guaranteed at the time of sale. As a result of the adoption of the revised Financial Accounting Standards Board Interpretation No. 46, *Consolidation of Variable Interest Entities, an Interpretation of Accounting Research Bulletin No. 51* (FIN 46R), the preneed funeral trust assets have been consolidated and are recorded in our consolidated balance sheet at market value in accordance with Statement of Financial Accounting Standards No. 115, *Accounting for Certain Investments in Debt and Equity Securities* (SFAS 115). Investment earnings on trust assets are generally accumulated in the trust and distributed as each preneed contract is either utilized upon the death of, or cancelled by, the customer. However, in certain states, the trusts are allowed to distribute a portion of the investment earnings to us prior to that date. See the Critical Accounting Policies and Accounting Changes of this section of this Form 10-Q for additional information regarding the implementation of FIN 46R.

Prior to January 1, 2005, direct selling costs incurred pursuant to the sales of trust funded preneed funeral contracts were deferred and included in *Deferred charges and other assets* in the consolidated balance sheet. The deferred selling costs were expensed in proportion to the corresponding trust funded preneed funeral contract revenues when recognized. Other selling costs associated with the sales and marketing of preneed funeral contracts (e.g., lead procurements costs, brochures and marketing materials, advertising and administrative costs) were expensed as incurred. An allowance for cancellation was recorded for trust funded preneed funeral contract deferred selling costs based on historical contract cancellation experience.

Beginning January 1, 2005, we have made an accounting change to expense all direct selling costs as incurred with the sales of preneed funeral contracts. See Critical Accounting Policies and Accounting Changes in this section of this Form 10-Q for additional information regarding this change in accounting for selling costs.

If a customer cancels the trust funded preneed funeral contract, state or provincial law determines the amount of the refund owed to the customer, including in certain situations the amount of the attributed investment earnings. Upon cancellation, we receive the amount of principal deposited to trust and previously undistributed net investment earnings and pay the customer the required refund. We retain any excess funds and recognize the amounts as funeral revenues in our consolidated statement of operations. In certain jurisdictions, we may be obligated to fund any shortfall if the amounts deposited on behalf of the customer exceed the funds in trust. As a result, when realized or unrealized losses of a trust result in trust funded preneed funeral contracts being under-funded, we will assess those contracts to determine whether a loss provision should be recorded. We have not been required to recognize any loss amounts at September 30, 2005 or December 31, 2004.

The cash flow activity over the life of a trust funded preneed funeral contract from the date of sale to its death maturity or cancellation is captured in the line items *Net effect of preneed funeral production and maturities* and *Net income (loss)* in the consolidated statement of cash flows. While the contract is outstanding, cash flow is provided by the amount retained from funds collected from the customer and any distributed investment earnings. Prior to January 1, 2005, this was reduced by the payment of trust funded preneed funeral selling costs and the effect of amortizing trust funded preneed funeral deferred selling costs was reflected in *Depreciation and amortization* in the consolidated statement of cash flows. Effective January 1, 2005, the payment of direct selling expenses associated with trust funded preneed funeral contracts is reflected in the consolidated statement of cash flows as cash flows from operating activities in the line item *Net income (loss)*. At the time of death maturity, we receive the principal and undistributed investment earnings from the trust and any remaining receivable due from the customer. This cash flow at the time of service is generally less than the revenue recognized, thus creating a negative effect on working capital cash flow from operating activities.

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In certain situations pursuant to state or provincial laws, we can post a surety bond as financial assurance for an amount that would otherwise be required to be deposited in trust accounts for trust funded preneed funeral contracts. See the *Financial Assurances* section within this Preneed Funeral and Cemetery Activities section for further details on our practice of posting such surety bonds. We believe the deferred revenues associated with preneed funeral bonded contracts exceed the expected cost of meeting our obligations to provide funeral services and merchandise for the outstanding preneed funeral bonded contracts, and our future operating cash flows will be sufficient to fulfill these contracts without use of the surety bonds. If the expected costs were to exceed the deferred revenues, we would be required to record a loss provision in our consolidated statements of operations.

If a customer cancels the trust funded preneed funeral contract that has been bonded prior to death maturity, state or provincial law determines the amount of the refund owed to the customer. Because the funds have not been held in trust, there are no earnings to be refunded to the customer or us. We pay the customer refund out of our operating funds, which reduces working capital cash flow from operating activities.

The cash flow activity over the life of a preneed funeral contract that has been bonded from the date of sale to its death maturity or cancellation is captured in the line items *Net effect of preneed funeral production and maturities* and *Net income (loss)* in the consolidated statement of cash flows. The payments received from our customers for their trust funded preneed funeral contracts that have been bonded are a source of working capital cash flow from operating activities until the contracts mature. When a trust funded preneed funeral contract that has been bonded matures upon the death of the beneficiary, there is no additional cash flow to us unless the customer owed an outstanding balance, thus creating a negative effect on the cash flow from operating activities. Refunds on customer cancellations of bonded contracts are also a reduction of working capital from operating activities reflected in the line item *Net effect of preneed funeral production and maturities*. Effective January 1, 2005, the payment of direct selling costs pursuant to the sales of trust funded preneed contracts that have been bonded are included in the line item *Net income (loss)*. Prior to January 1, 2005, the payment of direct selling costs was included in the line item *Net effect of preneed funeral production and maturities* and the effect of amortizing the deferred selling costs was reflected in *Depreciation and amortization*. The premiums paid to the surety companies for the bond coverage are reflected in the line item *Net income (loss)* as a use of working capital.

Insurance Funded Preneed Funeral Contracts: Where permitted, customers may arrange the funding of their funeral contract by purchasing a life insurance or annuity policy from third party insurance companies, for which we earn a commission for being the general agent for the insurance company. The policy amount of the insurance contract between the customer and the third party insurance company generally equals the amount of the preneed funeral contract. However, we do not reflect the unfulfilled insurance funded preneed funeral contract amounts in our consolidated balance sheet, as these contracts are not assets and liabilities as defined by Statement of Financial Accounting Concepts No. 6, *Elements in Financial Statements* .

The third party insurance company collects funds related to the insurance contract directly from the customer. The life insurance contracts include increasing death benefit provisions, which are expected to offset the inflationary costs of providing the preneed funeral services and merchandise in the future for the prices that were guaranteed at the time of the preneed sale. The customer/policy holder assigns the policy benefits to our funeral home to pay for the preneed funeral contract at the time of need. Approximately 60% of our 2005 North America preneed funeral production is insurance funded preneed funeral contracts.

We receive general agency (GA) commissions from third party insurance companies when customers purchase insurance contracts from such third party insurance companies to fund funeral services and merchandise at a future date. These general agency commissions are based on a percentage per contract sold (typically ranging between 11% and 16%) and are recognized as funeral revenues when the insurance purchase transaction between the customer and third party insurance provider is completed. GA commissions totaled \$7.0 million and \$7.3 million in the third quarter of 2005 and 2004, respectively and \$21.3 million and \$23.5 million in the nine months ended September 30, 2005 and 2004, respectively. Direct selling costs incurred pursuant to the sale of insurance funded preneed funeral contracts are expensed as incurred and are reflected in *Costs and expenses* in the consolidated statement of operations.

Additionally, we may receive cash overrides based on achieving certain dollar volume targets of life insurance policies sold as a result of marketing agreements entered into in connection with the sale of our insurance subsidiaries

in 2000. These overrides are recorded in *Other income, net* in the consolidated statement of operations.

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If a customer cancels the insurance funded preneed funeral contract prior to death maturity, the insurance company pays the cash surrender value under the insurance policy directly to the customer. If the contract was outstanding for less than one year, the insurance company charges back the GA revenues and overrides we received on the contract. An allowance for these chargebacks is included in the consolidated balance sheet based on our historical chargeback experience.

Because insurance funded preneed funeral contracts are not reflected in our consolidated balance sheet, the cash flow activity associated with these contracts generally occurs only at the time of sale and at death maturity or cancellation and is recorded in the *Net effect of preneed funeral production and maturities* and *Net income (loss)* line items in the consolidated statement of cash flows. At the time of sale, the GA revenues and overrides received net of the direct selling costs provide a net source of cash flow. If the cancellation occurs within the one year following the date of sale, our cash flow is reduced by the charge-back of GA revenues and overrides. When the funeral service is performed at death maturity, atneed funeral revenues and related accounts receivable are recorded for the services and merchandise included on the insurance funded preneed contracts, the increasing death benefit associated with the insurance policy, and any additional items purchased by the family. Proceeds from the insurance policies are applied to satisfy the receivables due and any remaining funds due are collected from the family. The insurance proceeds (which include the increasing death benefit of approximately 1% per year) less the funds used to provide the funeral goods and services provide a net source of cash flow. There is no guarantee that the increasing insurance benefit will cover future increases in the cost of providing a price guaranteed funeral service, which could materially adversely affect our future cash flows, revenues, and profit margins.

The table below details the North America results of trust and insurance funded preneed funeral production for the three and nine months ended September 30, 2005 and 2004 and the total selling costs incurred to obtain the preneed arrangements. Total selling costs incurred to obtain the preneed arrangements include compensation and associated fringe benefits, facility expense, advertising and lead procurement costs, sales supplies expense, and other associated costs.

| (In millions) | North America Funeral | | North America Funeral | |
|--------------------------|---|---------|--|----------|
| | Three months ended September 30, 2005 | 2004 | Nine months ended September 30, 2005 | 2004 |
| Preneed Production: | | | | |
| Trust (including bonded) | \$ 33.9 | \$ 33.8 | \$ 104.0 | \$ 91.2 |
| Insurance (1) | 47.7 | 55.7 | 151.2 | 187.8 |
| Total | \$ 81.6 | \$ 89.5 | \$ 255.2 | \$ 279.0 |
| Total selling costs | \$ 19.3 | \$ 20.4 | \$ 59.3 | \$ 62.4 |

(1) Amounts are not included in the consolidated balance sheet.

The following table reflects the North America backlog of deferred trust funded preneed funeral contract revenues (including amounts related to *Non-controlling interest in funeral and cemetery trusts*) at September 30, 2005 and December 31, 2004. Additionally, we have reflected the North American backlog of unfulfilled insurance funded contracts (not included in our consolidated balance sheet) and total North American backlog of preneed funeral contract revenues at September 30, 2005 and December 31, 2004. The backlog amounts presented are reduced by an

amount that we believe will cancel before maturity.

The table also reflects the North America trust funded preneed funeral receivables and trust investments (investments at market and cost basis) associated with the backlog of deferred trust funded preneed funeral contract revenues, net of an estimated cancellation allowance. The cost and market values associated with funeral trust investments included in the assets associated with the backlog of trust funded deferred preneed funeral revenues at September 30, 2005 and December 31, 2004 are computed as follows. Cost reflects the investment (net of redemptions) of control holders in common trust funds, mutual funds and private equity investments. Market reflects the fair market value of securities or cash held by the common trust funds, mutual funds at published values and the estimated

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market value of private equity investments (including debt as well as the estimated fair value related to the contract holders' equity in majority-owned real estate investments). The market value of funeral trust investments was based primarily on quoted market prices at September 30, 2005 and December 31, 2004. The difference between the backlog and asset amounts represents the contracts for which we have posted surety bonds as financial assurance in lieu of trusting and the amounts collected from customers that were not required to be deposited to trust. The table also reflects the amounts expected to be received from insurance companies from the assignment of policy proceeds related to insurance funded contracts.

| | North America | | | |
|--|---------------------------|-------------|--------------------------|-------------|
| | Funeral | | | |
| | September 30, 2005 | | December 31, 2004 | |
| | Market | Cost | Market | Cost |
| Backlog of trust funded deferred preneed funeral revenues (1) | \$ 1,491.9 | \$ 1,477.0 | \$ 1,475.9 | \$ 1,440.8 |
| Backlog of insurance funded preneed funeral revenues (2) | 2,160.0 | 2,160.0 | \$ 2,202.6 | \$ 2,202.6 |
| Total backlog of preneed funeral revenues (including bonded) | \$ 3,651.9 | \$ 3,637.0 | \$ 3,678.5 | \$ 3,643.4 |
| Assets associated with backlog of trust funded deferred preneed funeral revenues, net of estimated allowance for cancellation | \$ 1,162.0 | \$ 1,147.1 | \$ 1,165.8 | \$ 1,130.6 |
| Insurance policies associated with insurance funded deferred preneed funeral revenues, net of estimated allowance for cancellation (2) | \$ 2,160.0 | \$ 2,160.0 | \$ 2,202.6 | \$ 2,202.6 |
| Total assets associated with backlog of preneed funeral revenues | \$ 3,322.0 | \$ 3,307.1 | \$ 3,368.4 | \$ 3,333.2 |

(1) Includes amounts reflected as *Non-controlling interest in funeral and cemetery trusts* in the consolidated balance sheet, net of estimated allowance for cancellation.

(2) Insurance funded preneed funeral contracts

net of estimated allowance for cancellation are not included in the consolidated balance sheet.

Preneed Cemetery Activities

When purchasing cemetery property interment rights, merchandise, and services on a preneed basis, approximately 30% of our consumers choose to pay the entire amount of the contract at the time of sale. The remaining customers choose to pay for their contracts on an installment basis generally over a period of one to seven years. On these installment contracts, we receive an average down payment at the time of sale of approximately 14%. Historically, the installment contracts have included a finance charge ranging from 0.0% to 15.7% depending on the date sold, the payment period selected, state laws and the payment method (i.e., monthly statement billing or automated bank draft). Unlike trust funded preneed funeral contracts, where the entire purchase price is deferred and the revenue is recognized as one event at the time of death maturity, the revenues associated with a preneed cemetery contract can be recognized as different contract events occur. Preneed sales of cemetery interment rights (cemetery burial property) are recognized when a minimum of 10% of the sales price has been collected and the property has been constructed or is available for interment. With the customer's direction, which is generally obtained at the time of sale, we can choose to order, store, and transfer title to the customer of their personalized marker merchandise. Upon the earlier of vendor storage of these items or delivery in our cemetery, we recognize the associated revenues and record the cost of sale. For services, personalized marker merchandise where the customer chooses not to elect vendor storage or early delivery to our cemetery, and non-personalized merchandise (such as vaults), we defer the revenues until the services are performed and the merchandise is delivered.

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Because the services or merchandise will not be provided until some time in the future, all or a portion of the proceeds from the sale of preneed cemetery merchandise and services may be required by law to be paid into merchandise and services trusts until the merchandise is delivered or the service is provided. As with trust funded preneed funeral contracts, the funds deposited into trust are invested by the independent trustees in accordance with the investment guidelines established by statute or, where the prudent investor rule is applicable, the guidelines as established by the Investment Committee of our Board of Directors. The trustees utilize professional investment advisors to select and monitor the money managers that make the investment decisions in accordance with the guidelines. We retain any funds above the amounts required to be deposited into trust accounts and use them for working capital purposes, generally to offset the selling and administrative costs of the preneed programs. State or provincial law governs the timing of the required deposits into the trust accounts, which generally ranges from five to 45 days after receipt of the funds from the customer. In certain situations pursuant to state or provincial laws, we post a surety bond as financial assurance for a certain amount of the preneed cemetery contract in lieu of placing funds into trust accounts. See the *Financial Assurances* section within this Preneed Funeral and Cemetery Activities section for further details on our practice of posting such surety bonds.

The trust investments are expected to generate earnings sufficient to offset the inflationary costs of providing the preneed cemetery services and merchandise in the future for the prices that were guaranteed at the time of sale. As a result of the adoption of FIN 46R, the preneed cemetery trust investments have been consolidated in our balance sheet and are recorded at market value in accordance with SFAS 115. Investment earnings on trust assets are generally accumulated in the trust and distributed as each preneed contract item is delivered or cancelled. However, in certain states, the trustees are allowed to distribute a portion of the investment earnings to us before the preneed cemetery service or merchandise item is delivered (distributable states). Until delivered or cancelled, any investment earnings are attributed to the individual contract items. Recognition of the net investment earnings is independent of the timing of the receipt of the related cash flows, but generally will be the same in states that are not distributable states.

As a result of our 2003 restatement and other events including the implementation of Section 404 of the Sarbanes Oxley Act and the implementation of the new point-of-sale system, we began a process to examine all cemetery contracts in our deferred preneed cemetery contract balance to ensure that revenue was recognized in the appropriate period (when merchandise and services were delivered). We completed the reconciliation process for our cemetery contracts in May 2005 and our results indicated no significant fluctuations from our expectations.

Prior to January 1, 2005, direct selling costs incurred pursuant to the sales of preneed cemetery contracts were deferred and included in *Deferred charges and other assets* in the consolidated balance sheet. The deferred selling costs were expensed in proportion to the corresponding revenues when recognized. Other selling costs associated with the sales and marketing of preneed cemetery contracts (e.g., lead procurements costs, brochures and marketing materials, advertising and administrative costs) were expensed as incurred. An allowance for cancellation was recorded for cemetery deferred selling costs based on historical contract cancellation experience.

Beginning January 1, 2005, we made an accounting change to expense all direct selling costs as incurred with the sales of preneed cemetery contracts. See Critical Accounting Policies and Accounting Changes in Item 2 in this Form 10-Q for additional information regarding this change in accounting for selling costs.

If a preneed cemetery contract is cancelled prior to delivery, state or provincial law determines the amount of the refund owed to the customer, if any, including the amount of the attributed investment earnings. Upon cancellation, we receive the amount of principal deposited to trust and previously undistributed investment earnings and, where required, issue a refund to the customer. We retain any excess funds and recognize the attributed investment earnings (net of any investment earnings payable to the customer) as cemetery revenue in our consolidated statement of operations. Based on our historical experience, we have included an allowance for cancellation for preneed cemetery contracts in *Preneed cemetery receivables and trust investments* and *Deferred preneed cemetery revenues* in our consolidated balance sheet.

As the preneed cemetery contract merchandise and service items for which we were required to deposit funds to trust are delivered and recognized as revenues, we receive the principal and previously undistributed investment earnings from the trust. There is generally no remaining receivable due from the customer, as our policy is to deliver preneed cemetery merchandise and service items only upon payment of the contract balance in full. This cash flow at

delivery is generally less than the revenue recognized, thus

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creating a negative effect on working capital cash flow from operating activities, especially if we posted a surety bond in lieu of trusting for the preneed cemetery contract merchandise and service items, as there are no funds in trust available for withdrawal.

The cash flow activity from the date of sale of a preneed cemetery contract (origination) to the date of the recognition of the deferred revenue upon its delivery or cancellation (maturity) is reported in the *Net effect of cemetery production and deliveries* and *Net income (loss)* line items in the consolidated statement of cash flows. Net effect of preneed cemetery production and deliveries is affected by cash flows provided by the amount retained from funds collected from the customer and distributed trust earnings. Effective January 1, 2005, the payment of direct selling costs are included in *Net income (loss)* in the consolidated statement of operations. Prior to January 1, 2005, this was reduced by the use of funds for the payment of trust funded preneed cemetery selling costs when the preneed cemetery contracts were originated.

The table below details the North America results of total cemetery sales production and the total selling costs incurred to obtain the production for the three and nine months ended September 30, 2005 and 2004. Total selling costs incurred to obtain the preneed arrangements include compensation and associated fringe benefits, facility expense, advertising and lead procurement costs, sales supplies expense, and other associated costs. The Company has conformed the data presented in 2004 to be consistent with the presentation in 2005.

| (In millions) | North America Cemetery Three months ended September 30, | | North America Cemetery Nine months ended September 30, | |
|-----------------------------------|--|--------------------|---|--------------------|
| | 2005 | 2004 (Restated) | 2005 | 2004 (Restated) |
| Cemetery sales production: | | | | |
| Total preneed cemetery production | \$ 78.5 | \$ 67.7 | \$ 244.1 | \$ 242.4 |
| Total atneed cemetery production | 50.8 | 49.7 | 159.4 | 149.9 |
| Total cemetery sales production | \$ 129.3 | \$ 117.4 | \$ 403.5 | \$ 392.3 |
| Total selling costs | \$ 24.6 | \$ 23.6 | \$ 78.6 | \$ 91.6 |

The following table reflects the total North America backlog of *Deferred cemetery contract revenues* (including amounts related to *Non-controlling interests in funeral and cemetery trusts*) included in our consolidated balance sheet at September 30, 2005 and December 31, 2004. The backlog amount presented is reduced by an amount that we believe will cancel before maturity.

| | North America Cemetery | | | |
|---|---------------------------|------------|----------------------|--------------------|
| | September 30, 2005 | | December 31, 2004 | |
| | Market | Cost | Market (Restated) | Cost (Restated) |
| Backlog of deferred cemetery revenues (including bonded) (1) | \$ 1,641.3 | \$ 1,591.3 | \$ 1,682.3 | \$ 1,605.4 |
| Assets associated with backlog of deferred cemetery revenues, net of estimated allowance for cancellation | \$ 1,166.1 | \$ 1,122.8 | \$ 1,237.4 | \$ 1,170.8 |

- (1) Includes amounts reflected as *Non-controlling interest in funeral and cemetery trusts* in the consolidated balance sheet, net of estimated allowance for cancellation.

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In support of operations, we have entered into arrangements with certain surety companies whereby such companies agree to issue surety bonds on our behalf as financial assurance and/or as required by existing state and local regulations. The surety bonds are used for various business purposes; however, the majority of the surety bonds issued and outstanding have been used to support our preneed funeral and cemetery sales activities. The underlying obligations these surety bonds assure are recorded on the consolidated balance sheet as *Deferred preneed funeral revenues* and *Deferred preneed cemetery revenues*. The breakdown of surety bonds between funeral and cemetery preneed arrangements, as well as surety bonds for other activities is described below. The decrease in surety bonds for preneed funeral and cemetery merchandise and services is primarily a result of the periodic review (generally annually) performed to adjust the bonds to cover the remaining merchandise and service liabilities and the increased costs for liabilities associated with sales in prior years. We expect this number to continue to decline in subsequent years as merchandise and services related to bonded contracts in Florida are delivered or performed (see further discussion related to Florida bonding below).

| (In millions) | September 30, 2005 | December 31, 2004 |
|---|-----------------------------------|----------------------------------|
| Preneed funeral | \$ 142.9 | \$ 146.7 |
| Preneed cemetery: | | |
| Merchandise and services | 184.8 | 186.7 |
| Preconstruction | 12.8 | 8.3 |
| Bonds supporting preneed funeral and cemetery obligations | 340.5 | 341.7 |
| Bonds supporting preneed business permits | 1.7 | 5.3 |
| Other bonds | 3.5 | 5.5 |
| Total surety bonds outstanding | \$ 345.7 | \$ 352.5 |

When selling preneed funeral and cemetery contracts, we intend to post surety bonds where allowed by state or provincial law, except as noted below for Florida. We post the surety bonds in lieu of trusting a certain amount of funds received from the customer. The amount of the bond posted is generally determined by the total amount of the preneed contract that would otherwise be required to be trusted, in accordance with applicable state law.

Surety bond premiums are paid annually and are automatically renewable until maturity of the underlying preneed contracts, unless we are given prior notice of cancellation. Except for cemetery preconstruction bonds (which are irrevocable), the surety companies generally have the right to cancel the surety bonds at any time with appropriate notice. In the event a surety company was to cancel the surety bond, we are required to obtain replacement surety assurance from another surety company or fund a trust for an amount generally less than the posted bond amount. Management does not expect it will be required to fund material future amounts related to these surety bonds because of lack of surety capacity.

The applicable Florida law that allows posting of surety bonds for preneed contracts expired December 31, 2004; however, it allows for preneed contracts entered into prior to December 31, 2004 to continue to be bonded for the remaining life of those contracts. On February 1, 2004, we elected to begin trusting as a financial assurance mechanism in Florida, rather than surety bonding, on new Florida sales of preneed funeral and cemetery merchandise and services. Our net trust deposits required in the first nine months of 2004 for these eight months of new Florida sales were \$11.9 million, while our net trust deposits required in the first nine months of 2005 for new Florida sales were \$15.8 million. The net deposits in the first nine months of 2004 only represented seven months of cash receipts on seven months of new sales, as deposits in Florida are made in the month following receipt of the cash. The net deposits in the first nine months of 2005 include amounts required for nine months of receipts on all installment sales

since we elected to begin trusting in February 2004, offset by the withdrawals for contracts delivered or cancelled.

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Cautionary Statement on Forward-Looking Statements

The statements in this Form 10-Q that are not historical facts are forward-looking statements made in reliance on the safe harbor protections provided under the Private Securities Litigation Reform Act of 1995. These statements may be accompanied by words such as believe, estimate, project, expect, anticipate or predict, that convey the uncertainty of future events or outcomes. These statements are based on assumptions that we believe are reasonable; however, many important factors could cause our actual results in the future to differ materially from the forward-looking statements made herein and in any other documents or oral presentations made by us, or on our behalf. Important factors, which could cause actual results to differ materially from those in forward-looking statements include, among others, the following:

Changes in general economic conditions, both domestically and internationally, impacting financial markets (e.g., marketable security values, as well as currency and interest rate fluctuations) that could negatively affect us, particularly, but not limited to, levels of trust fund income, interest expense, pension expense and negative currency translation effects.

The outcomes of pending lawsuits and proceedings against us and the possibility that insurance coverage is deemed not to apply to these matters or that an insurance carrier is unable to pay any covered amounts to us.

Amounts payable by us with respect to our outstanding legal matters exceeding our established reserves.

We maintain accruals for tax liabilities which relate to uncertain tax matters. If these tax matters are unfavorably resolved, we will make any required payments to tax authorities. If these tax matters are favorably resolved, the accruals maintained by us will no longer be required and these amounts will be reversed through the tax provision at the time of resolution.

Our ability to successfully implement our strategic plan related to producing operating improvements and strong cash flows.

Our ability to successfully maintain our plan to reduce costs and increase cash flows associated with significant changes being made to our organization structure, process and quality of our sales efforts.

Changes in consumer demand and/or pricing for our products and services due to several factors, such as changes in numbers of deaths, cremation rates, competitive pressures and local demographic and economic conditions.

Changes in domestic and international political and/or regulatory environments in which we operate, including potential changes in tax, accounting and trusting policies.

Changes in credit relationships impacting the availability of credit and the general availability of credit in the marketplace.

Our ability to successfully complete our ongoing process improvement projects, particularly related to the implementation of new processes and internal controls.

Our ability to successfully access surety and insurance markets at a reasonable cost.

Our ability to successfully exploit our substantial purchasing power with certain of our vendors.

The outcome of a pending Internal Revenue Service audit.

The possibility that the Company will identify and report additional material weaknesses in its internal control over financial reporting.

The effectiveness of our internal controls over financial reporting, and our ability to certify the effectiveness of the internal controls and to obtain a favorable attestation report of our auditors regarding our assessment of our internal controls.

For further information on these and other risks and uncertainties, see our Securities and Exchange Commission filings, including our 2004 Annual Report on Form 10-K/A (Amendment No. 2). Copies of this document as well as other SEC filings can be obtained from our website at www.sci-corp.com. We assume no obligation to publicly update or revise any forward-looking statements made herein or any other forward-looking statements made by us, whether as a result of new information, future events or otherwise.

Item 3. Quantitative and Qualitative Disclosures about Market Risk

We are currently exposed to certain market risks arising from transactions that we enter into in the normal course of business. These risks related to fluctuations in currency exchange rates and changes in interest rates. For information regarding our exposure to certain market risks, see Item 7A.

Table of Contents***Foreign Currency Risk***

The functional currency for our international operations is the applicable local currency. Results of operations for these subsidiaries are translated using average exchange rates during the period. Assets and liabilities of these foreign subsidiaries are translated into U.S. dollars using the exchange rates in effect at the balance sheet date, and the resulting translation adjustments are included in stockholders' equity. However, foreign currency transaction gains and losses are reflected in income for the period. At September 30, 2005, less than 6% of our total net assets was denominated in foreign currency.

We occasionally use derivative instruments, primarily in the form of forward exchange contracts, to hedge our net investment in foreign assets and for other hedging activities. During the third quarter of 2005, we executed a foreign exchange contract as a hedge of our expected proceeds of approximately \$15.3 million related to mandatory Chilean withholding tax to be paid in Chilean pesos in June 2006. This forward contract is carried at fair value. We do not participate in derivative transactions that are leveraged or considered speculative in nature.

Interest Rates

At September 30, 2005, substantially all of our total debt consisted of fixed rate debt at a weighted average rate of 7.00%. Due to the nature of our debt, if the variable interest rates were to increase by 10% from September 30, 2005 levels, our pretax earnings would not change on an annual basis. The fair market value of our debt was approximately \$31.8 million more than its carrying value at September 30, 2005.

Item 4. Controls and Procedures***Disclosure Controls and Procedures***

The Company maintains disclosure controls and procedures that are designed to ensure that information required to be disclosed in the Company's periodic Securities Exchange Act of 1934 reports is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms, and that such information is accumulated and communicated to the Company's management, including its Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required financial disclosure.

As of the end of the period covered by this report, the Company carried out an evaluation, under the supervision and with the participation of the Company's Disclosure Committee and management, including the Chief Executive Officer and the Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures pursuant to Exchange Act Rule 13a-15. Based upon, and as of the date of this evaluation, such officers concluded that the Company's disclosure controls and procedures were not effective because of the material weaknesses described below. In light of the material weaknesses described below, the Company performed additional analysis and other post-closing procedures to ensure our consolidated financial statements are prepared in accordance with generally accepted accounting principles. Accordingly, management believes that the consolidated financial statements included in this report fairly present in all material respects our financial position, results of operations and cash flows for the periods presented.

Internal Control Over Financial Reporting

Management of the Company is responsible for establishing and maintaining adequate internal control over financial reporting as defined in Rule 13a-15(f) under the Securities Exchange Act of 1934. The Company's internal control over financial reporting is a process designed under the supervision of the Company's principal executive and principal financial officers to provide reasonable assurance regarding the reliability of financial reporting and the preparation and fair presentation of the Company's financial statements for external reporting purposes in accordance with U.S. generally accepted accounting principles.

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 policies and procedures may deteriorate.

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Management assessed the effectiveness of the Company's internal control over financial reporting as of December 31, 2004. In making this assessment, management used the criteria described in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

A material weakness is a control deficiency, or combination of control deficiencies, that results in a more than remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected. We identified the following material weaknesses in our assessment of the effectiveness of internal control over financial reporting as of December 31, 2004:

- A. The Company did not maintain effective controls over the completeness of revenue recognition on preneed cemetery contracts. Specifically, the Company did not maintain effective controls over revenue recognition transactions associated with the timely recording of the physical delivery and performance of cemetery goods and services sold on a preneed basis. This control deficiency resulted in the restatement of the Company's 2004, 2003, and 2002 consolidated financial statements, as well as its quarterly financial data for all quarters of both 2004 and 2003. Additionally, this control deficiency could result in the misstatement of cemetery merchandise and service revenues and of deferred revenues and assets associated with cemetery goods and services sold on a preneed basis that would result in a material misstatement to annual or interim financial statements that would not be prevented or detected. Accordingly, management determined that this condition represents a material weakness.
- B. The Company did not maintain effective controls over the reconciliations of preneed funeral and cemetery detailed records to trust fund assets and corresponding deferred revenue and non-controlling interest accounts related to preneed funeral and cemetery activities. This control deficiency resulted in the restatement of the Company's 2004, 2003, and 2002 consolidated financial statements, as well as its condensed consolidated financial statements for the first quarter of 2005 and quarterly financial data for all quarters of both 2004 and 2003. Additionally, this control deficiency could result in the misstatement of funeral and cemetery revenues and of assets and liabilities associated with preneed funeral and cemetery activities that would result in a material misstatement to annual or interim financial statements that would not be prevented or detected. Accordingly, management determined that this condition represents a material weakness.
- C. The Company did not maintain effective controls over its application and monitoring of the appropriate accounting policies related to certain lease accounting. Specifically, the Company did not maintain effective controls over the application and monitoring of its accounting policies relating to lease renewal options and rent escalation provisions. This control deficiency resulted in the restatement of the Company's 2004, 2003 and 2002 consolidated financial statements as well as its quarterly financial data for all quarters of both 2004 and 2003. Additionally, this control deficiency could result in the misstatement of accrued rental liability and related operating rental expense that would result in a material misstatement to annual or interim financial statements that would not be prevented or detected. Accordingly, management determined that this control deficiency represents a material weakness.
- D. The Company did not maintain effective controls over the validity, accuracy and completeness over revenue recognition and deferred revenue from preneed and atneed funeral and cemetery contracts. Specifically, the Company did not maintain effective controls over the proper review of preneed and atneed funeral and cemetery contracts by local management, the proper review by location management for customer and authorized Company signatures and proper completion of customer contracts. This control deficiency did not result in an adjustment to the 2004 annual or interim financial statements. However, this control deficiency could result in a misstatement of revenues, accounts receivable and deferred revenue that would result in a material misstatement to annual or interim financial statements that would not be prevented or detected. Accordingly, management determined that this condition represents a material weakness.
- E. The Company did not maintain effective controls over the use and control of pre-numbered manual contracts, and the accuracy of information pertaining to manual contracts entered into the Company's point-of-sale system over

revenue and deferred revenue from preneed and atneed funeral and cemetery contracts. Specifically, manual contracts are not consistently controlled to ensure that revenues related to preneed and atneed funeral and cemetery manual contracts are reflected in the financial statements in the appropriate time period. Additionally, sales detail reports for atneed funeral and cemetery and preneed cemetery manual contracts are not consistently being reviewed by location personnel to ensure agreement between manual contract information and information entered into the point-of-sale system. This control deficiency did not result in an adjustment to the 2004 annual or

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interim financial statements. However, this control deficiency could result in a misstatement of revenue, accounts receivable and deferred revenues that would result in a material misstatement to annual or interim financial statements that would not be prevented or detected. Accordingly, management determined that this condition represents a material weakness.

- F. The Company did not maintain effective controls over the accuracy, completeness and safeguarding of cash receipts. Specifically, individual cash receipt documentation is not consistently prepared for all cash or check payments made by the customer, daily reconciliations of cash are not consistently reviewed by location personnel and customer payments are not consistently secured at all times prior to deposit. This control deficiency did not result in an adjustment to the 2004 annual or interim financial statements. However, this control deficiency could result in misappropriation of company assets and a misstatement of cash and accounts receivable that would result in a material misstatement to annual or interim financial statements that would not be prevented or detected. Accordingly, management determined that this condition represents a material weakness.
- G. The Company did not maintain effective controls over the approval of adjustments to and review of collectability of atneed funeral and cemetery accounts receivable. Client families commonly request changes to items or services after the initial contract has been signed which requires adjustments to their contract and requires an adjustment to revenue and accounts receivable. The Company did not have effective controls over proper review by location management of adjustments to the customer revenue and accounts receivable related to such items or services or proper review of accounts receivable balances for reasonableness or collectability. Additionally, the Company did not have effective controls over review by location management of the outstanding account balances at period-end to ensure appropriate follow up is performed or write-off of account balance is performed. This control deficiency did not result in an adjustment to the 2004 annual or interim financial statements. However, this control deficiency could result in a misstatement of accounts receivable and revenues that would result in a material misstatement to annual or interim financial statements that would not be prevented or detected. Accordingly, management determined that this condition represents a material weakness.
- H. The Company did not maintain effective controls over the review of cash disbursements at the funeral and cemetery locations. Specifically, the Company did not maintain effective controls over the review by location management of disbursements made at those locations and by the corporate office in Houston on behalf of such locations in order to verify that all expenditures are accurate and reasonable. This control deficiency did not result in an adjustment to the 2004 annual or interim financial statements. However, this control deficiency could result in expenditures being made that are erroneous or not for legitimate business purposes or could result in a misstatement of accounts payable or expenses that would result in a material misstatement to annual or interim financial statements that would not be prevented or detected. Accordingly, management determined that this condition represents a material weakness.
- I. The Company did not maintain effective controls over the existence, completeness and accuracy of merchandise inventory. Specifically, the Company did not maintain effective controls over physical inventory counts at the funeral and cemetery locations. Inventory count sheets were not signed by individuals who performed and verified the counts. Also, in some instances, inventory counts were not conducted on a timely basis or the inventory counts by location personnel were not accurate. This control deficiency did not result in an adjustment to the 2004 annual or interim consolidated financial statements. However, this control deficiency could result in the misstatement of inventory and cost of sales that would result in a material misstatement to annual or interim financial statements that would not be prevented or detected. Accordingly, management determined that this condition represents a material weakness.
- J. The Company did not maintain effective controls over the accounting for capitalized covenant-not-to-compete agreements and the recording of asset impairments and divestitures related to the sale or disposition of locations in

accordance with generally accepted

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accounting principles. Specifically, the Company failed to write off certain previously capitalized covenant-not-to-compete assets resulting in a misstatement of the gain or loss upon existing locations and the ongoing amortization expense. Additionally, the Company did not maintain effective controls over the impairment or disposition of assets related to the sale of certain locations in the proper period. This control deficiency resulted in the restatement of the Company's 2004, 2003 and 2002 consolidated financial statements as well as its condensed consolidated financial statements for the first quarter of 2005 and the quarterly financial data for all quarters of both 2004 and 2003. Furthermore, this control deficiency could result in the misstatement of gains or impairment (losses) on disposition, property, plant, and equipment and deferred charges and other assets that would result in a material misstatement to annual or interim financial statements that would not be prevented or detected. Accordingly, management determined that this condition represents a material weakness.

- K. The Company did not maintain effective controls over its information technology program change control procedures with respect to the Company's point-of-sale system (HMIS) and associated interfaces. Specifically, the Company did not maintain effective controls to assess the impact of HMIS program changes to related interfaces and to adequately test the accuracy and performance of such program changes. This control deficiency contributed to the material weakness and restatement described in (B) and (L) herein. Additionally, this control deficiency could result in the misstatement of funeral revenues, and of assets and liabilities associated with preneed funeral activities that would result in a material misstatement to annual or interim financial statements that would not be prevented or detected. Accordingly, management determined that this control deficiency represents a material weakness.
- L. The Company did not maintain effective controls over the accuracy of preneed funeral trust income recorded upon the maturity of certain preneed funeral contracts. Specifically, the Company did not maintain effective controls over the posting of automated journal entries to the general ledger resulting in the entries being posted to the incorrect account. This control deficiency resulted in the restatement of the Company's 2004 financial statements including an adjustment to the fourth quarter 2004 financial data and its condensed consolidated financial statements for the first quarter of 2005. Additionally, this control deficiency could result in a material misstatement of funeral revenue and of assets and liabilities associated with preneed funeral activities that would result in a material misstatement to annual or interim financial statements that would not be prevented or detected. Accordingly, management determined that this control deficiency represents a material weakness.
- M. The Company did not maintain effective controls over the communication and evaluation by the legal department of information related to legal claims. Specifically, the legal department did not communicate information relevant to the complete and accurate recording of legal accruals in the proper period in accordance with generally accepted accounting principles. This control deficiency resulted in an adjustment detected by the auditor to the Company's second quarter 2005 condensed consolidated financial statements. Additionally, this control deficiency could result in the misstatement of general and administrative expenses and accrued liabilities that would result in a misstatement to annual or interim financial statements that would not be prevented or detected. Accordingly, management has determined that this control deficiency represents a material weakness.

Because of these material weaknesses, we concluded that the Company did not maintain effective internal control over financial reporting as of December 31, 2004 based on the criteria in the *Internal Control – Integrated Framework* issued by the COSO. Except as discussed below in "Changes In Internal Control Over Financial Reporting", the above described material weaknesses continue to exist as of September 30, 2005.

Status of Plan for Remediation

Management, with the oversight of the Audit Committee, has been aggressively addressing all of the above deficiencies and is committed to effectively remediating known weaknesses in our internal control over financial reporting and disclosure controls and procedures as expeditiously as possible. We have devoted significant time and resources to remediate the deficiencies identified and discussed above.

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We previously initiated projects to reconcile our preneed backlog detailed records to trust assets and corresponding liabilities. These reconciliation projects involved examining the contract details for the individual preneed funeral trust contracts and undelivered cemetery contracts in our detail accounting system records against the manual contract files in the individual funeral homes and cemeteries. We then reconciled the adjusted detail accounting system records to the general ledger balances and recorded any required adjustments. For the related trust assets, we reconciled the contract detail balances to the related trustee bank statements and the general ledger balances. The Company has completed these examination projects and implemented the reconciliation procedures as described above, which resulted in the identification of a significant number of reconciling items. Subsequent to the completion of the examination of the contracts, the Company began recording the reconciling items to the trust asset and deferred revenue detailed records. During this review, the Company determined that certain of the reconciling items had been reflected improperly in its initial review which resulted in an error to the Company's consolidated financial statements. However, we have further strengthened the internal controls and procedures surrounding the reconciliation process and anticipate that these internal controls will be operating effectively for the current reconciliations by the end of 2005.

The Company has developed control procedures to ensure that financial information and other business data that is important to the application of generally accepted accounting principles during the period-end financial reporting process is properly communicated among the various departments within the Company, specifically related to the communication of material events that could trigger impairment charges of long-lived tangible and intangible assets or adjustments to gains and losses on dispositions. These procedures include a formal review by management of all pending dispositions including an impairment analysis of long-lived tangible and intangible assets related to such dispositions. Additionally, the controls in place surrounding the communication and evaluation by the legal department of information related to legal claims are being enhanced to include participation of the Company's General Counsel in all reviews.

The Company has made changes to its information technology program change control procedures. Specifically, procedures have been developed and are in place to adequately assess the impact of any application or program change related to system components and interfaces. Additionally, quality assurance control procedures have been developed to ensure the accuracy of any program code changes.

The Company has developed control procedures to ensure lease payments and related asset depreciation are expensed in accordance with generally accepted accounting principles. These procedures were completed and tested by the Company in the second quarter of 2005 and are considered to be operating effectively.

We currently rely on processes that are heavily dependent on manual and detective controls and on human intervention at our funeral and cemetery locations. Many of the funeral and cemetery location controls are widely dispersed across the Company's network of approximately 1,600 locations making it very difficult to achieve a consistently high level of precision. In May 2005 we implemented the following additional redundant, compensating and monitoring controls at a consolidated level to monitor the control activities performed at the funeral and cemetery locations.

Review of preneed and atneed funeral and cemetery contracts to verify location management approval.

Review of manual contract control logs at funeral and cemetery locations to verify completeness of contracts issued.

Review of manual contracts to verify the accuracy of data entered into the point-of-sale system.

Review of daily cash receipts and cash report reconciliations at the funeral and cemetery locations to verify accuracy and performance.

Review of revenue recognition transactions at cemetery locations to verify accuracy of the delivery and performance of cemetery goods and services which were previously sold on a preneed basis.

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Verification of approvals of accounts receivable adjustments at funeral and cemetery locations.

Verification of reviews of cash disbursement reports at funeral and cemetery locations.

These additional controls and procedures will provide us with greater visibility over the performance of the controls in the funeral and cemetery locations. We will continue with formal training at the funeral and cemetery locations and continually assess the effectiveness of controls. Additionally, we are also planning for longer-term improvements in key business processes with an emphasis on preventative controls (versus detective controls), and system-based controls (versus manual controls) wherever possible.

We believe our consolidated financial statements present fairly the financial position of the Company and do not contain any material misstatements. The above described material weaknesses in internal control over financial reporting if left unremediated increase the likelihood of misstatements occurring in future periods and not being detected in a timely manner.

Changes in Internal Control Over Financial Reporting

The Company previously disclosed that as of June 30, 2005, the material weakness described above related to its controls over the application and monitoring of the appropriate accounting policies related to certain lease accounting had been remediated. There have been no changes in the Company's internal control over financial reporting during the most recently completed fiscal quarter that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

PART II. OTHER INFORMATION

(All share amounts and dollar values in whole numbers, except where indicated)

Item 1. Legal Proceedings

Information regarding legal proceedings is set forth in note nine to the unaudited consolidated financial statements in Item 1 of Part I of this Form 10-Q, which information is hereby incorporated by reference herein.

Item 2. Changes in Securities, Use of Proceeds and Issuer Purchases of Equity Securities

On July 29, 2005, we issued 319 deferred common stock equivalents or units pursuant to provisions regarding dividends under the Director Fee Plan to four non-employee directors. We did not receive any monetary consideration for the issuances. These issuances were unregistered because they did not constitute a sale within the meaning of Section 2(3) of the Securities Act of 1933, as amended.

In October 1999, we suspended payment of regular quarterly cash dividends on our outstanding common stock in order to focus on improving cash flow and reducing existing debt. On February 10, 2005, our Board of Directors approved the initiation of a quarterly cash dividend of \$.025 per common share. On October 31, 2005, we paid a dividend totaling \$7.5 million to shareholders of record at October 14, 2005. While we intend to pay regular quarterly cash dividends for the foreseeable future, all subsequent dividends are subject to final determination by the Board of Directors of SCI each quarter after its review of our financial performance.

On August 16, 2004, we announced a share repurchase program authorizing the investment of up to \$100 million to repurchase our common stock. On November 10, 2004, February 10, 2005, and June 23, 2005, we announced three increases in the share repurchase program each authorizing the investment of up to an additional \$100 million to repurchase our common stock for an aggregate of \$400 million. Pursuant to the program, we have repurchased shares of our common stock as set forth in the table below. As of September 30, 2005, the purchases totaled \$301.5 million.

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| | Issuer purchases of equity securities | | | |
|--|---|---|--|--|
| | (a) | (b) | (c) | (d) |
| Period | Total number of shares purchased | Average price paid per share | Total number of shares purchased as part of publicly announced programs | Dollar value of shares that may yet be purchased under the programs |
| July 1, 2005 – July 31, 2005 | | \$ | | \$99,933,222 |
| August 1, 2005 – August 31, 2005 | 170,000 | \$8.29 | 170,000 | \$98,521,321 |
| September 1, 2005 – September 30, 2005 | | \$ | | \$98,521,321 |

As of September 30, 2005, the remaining dollar value of shares that may yet be purchased under our share repurchase programs was approximately \$98.5 million. From October 1, 2005 to October 31, 2005, we purchased 1.6 million shares for a total cost of \$13.3 million. As of October 31, 2005, the remaining dollar value of share that may yet be purchased under our share repurchase program was approximately \$85.2 million.

Item 6. Exhibits

- 12.1 Ratio of earnings to fixed charges for the nine months ended September 30, 2005 and 2004 (Restated).
- 23.1 Consent of Independent Registered Public Accounting Firm.
- 31.1 Certification of Thomas L. Ryan as Principal Executive Officer in satisfaction of Section 302 of the Sarbanes-Oxley Act of 2002.
- 31.2 Certification of Eric D. Tanzberger as Principal Financial Officer in satisfaction of Section 302 of the Sarbanes-Oxley Act of 2002.
- 32.1 Certification of Periodic Financial Reports by Thomas L. Ryan as Principal Executive Officer in satisfaction of Section 906 of the Sarbanes-Oxley Act of 2002.
- 32.2 Certification of Periodic Financial Reports by Eric D. Tanzberger as Principal Financial Officer in satisfaction of Section 906 of the Sarbanes-Oxley Act of 2002.

Undertaking

We hereby undertake, pursuant to Regulation S-K, Item 601(b), paragraph (4) (iii), to furnish to the U.S. Securities and Exchange Commission, upon request, all constituent instruments defining the rights of holders of our long-term debt not filed herewith for the reason that the total amount of securities authorized under any of such instruments does not exceed 10 percent of our total consolidated assets.

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SIGNATURE

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

August 11, 2006

SERVICE CORPORATION
INTERNATIONAL

By: /s/ Jeffrey I. Beason

Jeffrey I. Beason
Vice President and Controller
(Chief Accounting Officer)

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