

STONEMOR PARTNERS LP  
Form 10-Q  
August 09, 2006  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

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**FORM 10-Q**

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(Mark One)

**x** **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**  
**FOR THE QUARTERLY PERIOD ENDED June 30, 2006**

**OR**

**“** **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES ACT OF 1934**  
**FOR THE TRANSITION PERIOD FROM \_\_\_\_ TO \_\_\_\_ .**

Commission File Number: 000-50910

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**STONEMOR PARTNERS L.P.**

(Exact name of registrant as specified in its charter)

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

**155 Rittenhouse Circle**

**Bristol, Pennsylvania**

**80-0103159**  
(I.R.S. Employer

Identification No.)

**19007**

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(Address of principal executive offices)

(Zip Code)

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(215) 826-2800

(Registrant's telephone number, including area code)

Not Applicable

(Former name or former address, if changed since last report)

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

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

Large accelerated filer ☐ Accelerated filer ☒ Non-accelerated filer ☐

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

The number of the registrant's outstanding common units at August 9, 2006 was 4,520,734.

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**Table of Contents****Part I Financial Information****Item 1. Financial Statements****StoneMor Partners L.P.****Condensed Consolidated Balance Sheets**

(in thousands)

(unaudited)

|                                                            | December 31,<br>2005 | June 30,<br>2006 |
|------------------------------------------------------------|----------------------|------------------|
| <b>ASSETS</b>                                              |                      |                  |
| CURRENT ASSETS:                                            |                      |                  |
| Cash and cash equivalents                                  | \$ 6,925             | \$ 4,824         |
| Accounts receivable, net of allowance                      | 29,991               | 30,770           |
| Prepaid expenses                                           | 2,420                | 2,740            |
| Other current assets                                       | 1,316                | 2,220            |
| Total current assets                                       | 40,652               | 40,554           |
| LONG-TERM ACCOUNTS RECEIVABLE - net of allowance           | 33,672               | 31,988           |
| CEMETERY PROPERTY                                          | 164,772              | 163,736          |
| PROPERTY AND EQUIPMENT, net of accumulated depreciation    | 27,091               | 26,303           |
| MERCHANDISE TRUSTS, restricted, at fair value              | 113,432              | 114,156          |
| PERPETUAL CARE TRUSTS, restricted, at fair value           | 136,719              | 140,862          |
| DEFERRED FINANCING COSTS - net of accumulated amortization | 1,985                | 1,614            |
| DEFERRED SELLING AND OBTAINING COSTS                       | 30,554               | 32,240           |
| OTHER ASSETS                                               | 1,958                | 2,017            |
| TOTAL ASSETS                                               | \$ 550,835           | \$ 553,470       |
| <b>LIABILITIES AND PARTNERS' EQUITY</b>                    |                      |                  |
| CURRENT LIABILITIES:                                       |                      |                  |
| Accounts payable and accrued liabilities                   | \$ 7,461             | \$ 5,521         |
| Accrued interest                                           | 260                  | 315              |
| Current portion, long-term debt                            | 641                  | 505              |
| Total current liabilities                                  | 8,362                | 6,341            |
| LONG-TERM DEBT                                             | 86,304               | 90,205           |
| DEFERRED CEMETERY REVENUES, net                            | 167,844              | 174,160          |
| MERCHANDISE LIABILITY                                      | 42,621               | 39,434           |
| TOTAL LIABILITIES                                          | 305,131              | 310,140          |
| <b>COMMITMENTS AND CONTINGENCIES</b>                       |                      |                  |
| NON-CONTROLLING INTEREST IN PERPETUAL CARE TRUSTS          | 136,719              | 140,862          |
| <b>PARTNERS' EQUITY</b>                                    |                      |                  |
| General partner                                            | 1,537                | 1,406            |
| Limited partners:                                          |                      |                  |
| Common                                                     | 72,750               | 69,453           |

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|                                               |                   |                   |
|-----------------------------------------------|-------------------|-------------------|
| Subordinated                                  | 34,698            | 31,609            |
| Total partners' equity                        | 108,985           | 102,468           |
| <b>TOTAL LIABILITIES AND PARTNERS' EQUITY</b> | <b>\$ 550,835</b> | <b>\$ 553,470</b> |

See Accompanying Notes to the Condensed Consolidated Financial Statements.

**Table of Contents****StoneMor Partners L.P.****Condensed Consolidated Statement of Operations**

(in thousands, except unit data)

(unaudited)

|                                                                                    | Three months ended June 30, |           | Six months ended June 30, |           |
|------------------------------------------------------------------------------------|-----------------------------|-----------|---------------------------|-----------|
|                                                                                    | 2005                        | 2006      | 2005                      | 2006      |
| <b>Revenues:</b>                                                                   |                             |           |                           |           |
| Cemetery                                                                           | \$ 24,699                   | \$ 27,163 | \$ 45,044                 | \$ 52,355 |
| Funeral home                                                                       | 529                         | 1,129     | 1,150                     | 2,589     |
| Total revenues                                                                     | 25,228                      | 28,292    | 46,194                    | 54,944    |
| <b>Costs and Expenses:</b>                                                         |                             |           |                           |           |
| Cost of goods sold (exclusive of depreciation shown separately below):             |                             |           |                           |           |
| Land and crypts                                                                    | 1,625                       | 1,416     | 2,588                     | 2,863     |
| Perpetual care                                                                     | 792                         | 847       | 1,407                     | 1,583     |
| Merchandise                                                                        | 1,171                       | 1,416     | 2,450                     | 2,689     |
| Cemetery expense                                                                   | 5,611                       | 6,366     | 10,328                    | 12,002    |
| Selling expense                                                                    | 5,270                       | 5,772     | 9,461                     | 11,419    |
| General and administrative expense                                                 | 2,544                       | 3,086     | 4,922                     | 6,150     |
| Corporate overhead                                                                 | 3,517                       | 4,426     | 6,592                     | 8,234     |
| Depreciation and amortization                                                      | 1,023                       | 925       | 1,868                     | 1,746     |
| Funeral home expense                                                               | 436                         | 961       | 870                       | 2,054     |
| Total cost and expenses                                                            | 21,989                      | 25,215    | 40,486                    | 48,740    |
| OPERATING PROFIT                                                                   | 3,239                       | 3,077     | 5,708                     | 6,204     |
| INTEREST EXPENSE                                                                   | 1,588                       | 1,782     | 3,169                     | 3,515     |
| INCOME BEFORE INCOME TAXES                                                         | 1,651                       | 1,295     | 2,539                     | 2,689     |
| INCOME TAXES:                                                                      |                             |           |                           |           |
| State                                                                              | 204                         | 112       | 244                       | 255       |
| Federal                                                                            | 95                          | 103       | 275                       | 413       |
| Total income taxes                                                                 | 299                         | 215       | 519                       | 668       |
| NET INCOME                                                                         | \$ 1,352                    | \$ 1,080  | \$ 2,020                  | \$ 2,021  |
| General partner's interest in net income for the period                            | \$ 27                       | \$ 22     | \$ 40                     | \$ 40     |
| Limited partners' interest in net income for the period                            |                             |           |                           |           |
| Common                                                                             | \$ 662                      | \$ 546    | \$ 990                    | \$ 1,023  |
| Subordinated                                                                       | \$ 662                      | \$ 512    | \$ 990                    | \$ 958    |
| Net income per limited partner unit (basic and diluted)                            | \$ .16                      | \$ .12    | \$ .23                    | \$ .23    |
| Weighted average number of limited partners' units outstanding (basic and diluted) | 8,480                       | 8,760     | 8,480                     | 8,760     |

See Accompanying Notes to the Condensed Consolidated Financial Statements.

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**StoneMor Partners L.P.**

**Condensed Consolidated Statement of**

**Partners' Equity**

(in thousands)

(unaudited)

|                            | <b>Partners' Capital<br/>Limited Partners</b> |                     |              | <b>General</b> |              |
|----------------------------|-----------------------------------------------|---------------------|--------------|----------------|--------------|
|                            | <b>Common</b>                                 | <b>Subordinated</b> | <b>Total</b> | <b>Partner</b> | <b>Total</b> |
| Balance, December 31, 2005 | \$ 72,750                                     | \$ 34,698           | \$ 107,448   | \$ 1,537       | 108,985      |
| Net Income                 | 476                                           | 446                 | 922          | 19             | 941          |
| Cash distribution          | (2,148)                                       | (2,013)             | (4,161)      | (86)           | (4,247)      |
| Balance, March 31, 2006    | \$ 71,078                                     | \$ 33,131           | \$ 104,209   | \$ 1,470       | \$ 105,679   |
| Net Income                 | 546                                           | 512                 | 1,058        | 22             | 1,080        |
| Cash distribution          | (2,171)                                       | (2,034)             | (4,205)      | (86)           | (4,291)      |
| Balance, June 30, 2006     | \$ 69,453                                     | \$ 31,609           | \$ 101,062   | \$ 1,406       | \$ 102,468   |

See Accompanying Notes to the Condensed Consolidated Financial Statements.

**Table of Contents****StoneMor Partners L.P.****Condensed Consolidated Statement of Cash Flows**

(in thousands)

(unaudited)

|                                                                                 | <b>Six months ended June 30,</b> |                 |
|---------------------------------------------------------------------------------|----------------------------------|-----------------|
|                                                                                 | <b>2005</b>                      | <b>2006</b>     |
| <b>OPERATING ACTIVITIES:</b>                                                    |                                  |                 |
| Net income                                                                      | \$ 2,020                         | \$ 2,021        |
| Adjustments to reconcile net income to net cash provided by operating activity: |                                  |                 |
| Cost of lots sold                                                               | 2,018                            | 2,210           |
| Depreciation and amortization                                                   | 1,868                            | 1,746           |
| Other                                                                           |                                  | 303             |
| Changes in assets and liabilities that provided (used) cash:                    |                                  |                 |
| Accounts receivable                                                             | 185                              | 125             |
| Allowance for doubtful accounts                                                 | (282)                            | 784             |
| Merchandise trust fund                                                          | 3,751                            | (869)           |
| Prepaid expenses                                                                | (1,007)                          | (320)           |
| Other current assets                                                            | (242)                            | (14)            |
| Other assets                                                                    | (18)                             | (57)            |
| Accounts payable and accrued and other liabilities                              | (607)                            | (1,940)         |
| Deferred selling and obtaining costs                                            | (1,184)                          | (1,686)         |
| Deferred cemetery revenue                                                       | 4,631                            | 6,399           |
| Merchandise liability                                                           | (3,956)                          | (3,243)         |
| Net cash provided by operating activities                                       | 7,177                            | 5,459           |
| <b>INVESTING ACTIVITIES:</b>                                                    |                                  |                 |
| Cost associated with potential acquisitions                                     | (673)                            | (884)           |
| Additions to cemetery property                                                  | (1,485)                          | (2,468)         |
| Divestiture of funeral home                                                     |                                  | 2,091           |
| Additions to property and equipment                                             | (1,628)                          | (1,527)         |
| Net cash used in investing activities                                           | (3,786)                          | (2,788)         |
| <b>FINANCING ACTIVITIES:</b>                                                    |                                  |                 |
| Cash distribution                                                               | (8,439)                          | (8,538)         |
| Additional borrowings on long-term debt                                         | 1,600                            | 4,376           |
| Repayments of long-term debt                                                    |                                  | (610)           |
| Cost of financing activities                                                    | (178)                            |                 |
| Net cash used in financing activities                                           | (7,017)                          | (4,772)         |
| <b>NET DECREASE IN CASH AND CASH EQUIVALENTS</b>                                | <b>(3,626)</b>                   | <b>(2,101)</b>  |
| <b>CASH AND CASH EQUIVALENTS - Beginning of period</b>                          | <b>14,474</b>                    | <b>6,925</b>    |
| <b>CASH AND CASH EQUIVALENTS - End of period</b>                                | <b>\$ 10,848</b>                 | <b>\$ 4,824</b> |
| <b>SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION</b>                         |                                  |                 |
| Cash paid during the period for interest                                        | \$ 3,151                         | \$ 3,460        |

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|                                              |    |     |    |       |
|----------------------------------------------|----|-----|----|-------|
| Cash paid during the period for income taxes | \$ | 728 | \$ | 3,024 |
|----------------------------------------------|----|-----|----|-------|

See Accompanying Notes to the Condensed Consolidated Financial Statements.

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### **1. NATURE OF OPERATIONS, BASIS OF PRESENTATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

**Basis of Presentation.** StoneMor Partners L.P. ( StoneMor , the Partnership or the Company) headquartered in Bristol, Pennsylvania, is an owner and operator of cemeteries in the United States, with 154 cemeteries and 13 funeral homes in 13 states. StoneMor is the only publicly traded deathcare company structured as a partnership.

**Interim Financial Data** The interim financial data are unaudited. However, in the opinion of management, the interim financial data as of June 30, 2006 and for the three and six months ended June 30, 2006 and 2005 include all adjustments, consisting only of normal recurring adjustments, necessary for a fair statement of the results for the interim. The results of operations for interim periods are not necessarily indicative of the results of operations to be expected for a full year.

**Summary of Significant Accounting Policies** Significant accounting policies followed by the Company, as summarized below, are in conformity with accounting principles generally accepted in the United States of America.

**Principles of Consolidation** The condensed consolidated financial statements include the accounts of each of the Company's subsidiaries. These statements also include the accounts of the merchandise and perpetual care trusts in which the Company has a variable interest and is the primary beneficiary. The operations of the 7 managed cemeteries that the Company operates under long-term management contracts are also consolidated in accordance with the provisions of Financial Accounting Standards Board (FASB) Interpretation (FIN) No. 46 revised (FIN 46R), Consolidation of Variable Interest Entities: an Interpretation of Accounting Research Bulletin (ARB) No. 51.

Total revenues derived from the cemeteries under long term management contracts totaled approximately \$9.4 million and \$4.8 million for the three months ended June 30, 2005 and 2006, respectively and \$14.5 million and \$10.7 million for the six months ended June 30, 2005 and 2006, respectively.

**Cemetery Operations** Sales of at-need cemetery interment rights, merchandise and services are recognized when the service is performed or merchandise is delivered. In accordance with Securities and Exchange Commission Staff Accounting Bulletin No. 104, Revenue Recognition in Financial Statements (SAB No. 104), and the retail land sales provisions of Statement of Financial Accounting Standards No. 66, Accounting for the Sale of Real Estate (SFAS No. 66), revenues from pre-need sales of burial lots and constructed mausoleum crypts and lawn crypts are deferred until at least 10% of the sales price has been collected. At the time of the sale, an allowance for customer cancellations is established, which reduces the amount of accounts receivable, net and deferred cemetery revenues, net or cemetery revenue recognized, based on management's estimates of expected cancellations and historical experiences. Historically, the cancelled contracts represent approximately 10% of the pre-need sales (based on contract dollar amounts). Revenues from the pre-need sale of unconstructed mausoleum and lawn crypts are deferred until at least 10% of the sales price has been collected, at which point revenues are recognized using the percentage-of-completion method of accounting, also in accordance with SFAS No. 66. Revenues related to the pre-need sale of merchandise and services are deferred until such merchandise is delivered (title has transferred to the customer and the merchandise is either installed or stored, at the direction of the customer, at the vendor's warehouse or a third-party warehouse at no additional cost to us) or such services are performed.

The Company also defers certain pre-need cemetery and prearranged funeral direct obtaining costs that vary with and are primarily related to the acquisition of new pre-need cemetery and prearranged funeral business. Such costs are accounted for under the provisions of SFAS No. 60, Accounting and Reporting by Insurance Enterprises (SFAS No. 60), and are expensed as revenues are recognized.

Costs related to the sales of interment rights include property and other costs related to cemetery development activities that are specifically identified by project. At the completion of a project, costs are charged to operations as revenues are recognized. Costs related to merchandise and services are based on actual costs incurred or estimates of future costs necessary, including provisions for inflation when required.

The Company records a merchandise liability at the time it enters into a pre-need contract with a customer at the estimated cost to purchase the merchandise or provide the service. The merchandise liability is reduced when payment for the merchandise is made by the Company and title to the merchandise is transferred to the customer. The merchandise liability is also reduced when the contracted service is performed by the Company. Allowances for customer cancellations arising from non-payment are provided at the date of sale based upon management's estimates of expected cancellations and historical experience. Actual cancellation rates in the future may result in a change in estimate. Actual cancellations did not vary significantly from the estimates of expected cancellations at June 30, 2005 and June 30, 2006.

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Pursuant to state law, a portion of the proceeds from cemetery merchandise or services sold on a pre-need basis is required to be paid into merchandise trusts. The Company defers investment earnings generated by the assets in these merchandise trusts (including realized gains and losses) until the associated merchandise is delivered or the services are performed. The fair value of the funds held in merchandise trusts at December 31, 2005 and June 30, 2006 was approximately \$113.4 million and \$114.2 million, respectively (see Note 5). A portion of the proceeds from the sale of cemetery property is required by state law to be paid into perpetual care trusts. Earnings from the perpetual care trusts are recognized in current cemetery revenues and are used to defray cemetery maintenance costs, which are expensed as incurred. Funds held in perpetual care trusts at December 31, 2005 and June 30, 2006 were \$136.7 million and \$141.0 million, respectively (see Note 6).

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

**Concentration of Credit Risk** The Company's revenues and accounts receivable relate to the sale of products and services to a customer base that is almost entirely concentrated in the states where the Company has cemeteries and funeral homes. The Company retains a security interest in any merchandise sold pursuant to the pre-need contracts. The condensed consolidated balance sheets contain a provision for cancellations arising from non-payment in amounts determined based on historical experience and the judgment of Company's management.

**Inventories** Inventories, classified as other current assets on the Company's condensed consolidated balance sheets, include cemetery and funeral home merchandise and are valued at the lower of cost or net realizable value. Cost is determined primarily on a specific identification basis on a first-in, first-out basis. Inventories were approximately \$1.0 million and \$1.1 million at December 31, 2005 and June 30, 2006, respectively.

**Cemetery Property** Cemetery property consists of developed and undeveloped cemetery property and constructed mausoleum crypts and lawn crypts and is valued at cost, which is not in excess of market value.

**Property and Equipment** Property and equipment is recorded at cost and depreciated on a straight-line basis. Maintenance and repairs are charged to expense as incurred, whereas additions and major replacements are capitalized and depreciation is recorded over their estimated useful lives as follows:

|                            |                            |
|----------------------------|----------------------------|
| Buildings and improvements | 10 to 40 years             |
| Furniture and equipment    | 5 to 10 years              |
| Leasehold improvements     | over the term of the lease |

For the six months ended June 30, 2005 and 2006, depreciation expense was \$1.5 million and \$1.3 million, respectively. For the six months ended June 30, 2005 and 2006, depreciation expense was \$2.3 million and \$2.1 million, respectively.

**Deferred Cemetery Revenues, Net** Revenues and all costs associated with pre-need sales of cemetery merchandise and services are deferred until the merchandise is delivered or the services are performed. In addition, investment earnings generated by the assets included in the merchandise trusts are deferred until the associated merchandise is delivered or the services are performed. Deferred cemetery revenues, net, also includes deferred revenues from pre-need sales that were entered into by entities prior to the acquisition of those entities by the Company, including entities that were acquired by Cornerstone Family Services, Inc., the predecessor to the Company (Cornerstone) upon its formation in 1999. The Company provides for a reasonable profit margin for these deferred revenues (deferred margin) to account for the future costs of delivering products and providing services on pre-need contracts that the Company acquired through acquisition. Deferred margin amounts are deferred until the merchandise is delivered or services are performed.

**Merchandise Liability** Merchandise liability accounts for merchandise and services that have been contracted for but not yet delivered or performed. This liability is recorded at the estimated cost and is expensed to cost of goods sold as merchandise is delivered and services are performed.

**Impairment of Long-Lived Assets** The Company monitors the recoverability of long-lived assets, including cemetery property, property and equipment and other assets, based on estimates using factors such as current market value, future asset utilization, business and regulatory climate and future undiscounted cash flow expected to result from the use of the related assets. The Company's policy is to evaluate an asset for impairment when events or circumstances indicate that a long-lived asset's carrying value may not be recovered. An impairment charge is recorded to write-down the asset to its fair value if the sum of future undiscounted cash flows is less than the carrying value of the asset.



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**Income Taxes** The Company accounts for income taxes in accordance with SFAS No. 109, Accounting for Income Taxes. The tax effects of temporary differences between income for financial statement and income tax purposes are recognized in the financial statements. The differences arise primarily from receivables and depreciation.

### ***New Accounting Pronouncements***

In March 2004, the FASB issued Emerging Issues Task Force ( EITF ) 03-1, Impairment and Its Application to Certain Investments. EITF 03-1 includes new guidance for evaluating and recording impairment losses on debt and equity investments, as well as new disclosure requirements for investments that are deemed to be temporarily impaired. In September 2004, the FASB issued Staff Position EITF 03-1-1, which delays the effective date until additional guidance is issued for the application of the recognition and measurement provisions of EITF 03-1 to investments and securities that are impaired. 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. 03-01* , as final. 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 reference to existing other-than-temporary impairment guidance. FSP FAS 115-1 is effective for other-than-temporary analyses conducted in periods beginning after December 15, 2005. This pronouncement as it relates to the Company's trusts did not have a current impact on the condensed consolidated financial statements of the Company.

In May 2005, the Financial Accounting Standards Board ( FASB ) released Statement of Financial Accounting Standard ( SFAS ) No. 154, Accounting Changes and Error Corrections-a replacement of APB Opinion No. 20 and FASB Statement No. 3, ( FAS 154 ). FAS 154 requires retrospective application to prior periods' financial statements for any changes in accounting principle, unless it is impracticable to determine either the period-specific effects or the cumulative effect of the change. This statement is effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005. The impact of FAS 154 will depend on the nature and extent of any voluntary accounting changes or error corrections after the effective date. At June 30, 2006 this statement did not have an impact on the Company's condensed consolidated financial statements.

At its March 28, 2006 meeting, the FASB approved the issuance of a draft abstract EITF Issue No. 06-3, *How Taxes Collected from Customers and Remitted to Governmental Authorities Should Be Presented in the Income Statement (That Is, Gross versus Net Presentation)* , which addresses the income statement disclosure on taxes assessed by a governmental authority that is directly imposed on a revenue-producing transaction between a seller and a customer, and may include, but are not limited to, sales, use, value added, and some excise taxes. The presentation of taxes on either a gross (included in revenues and costs) or a net (excluded from revenues) basis is an accounting policy decision that should be disclosed pursuant to Opinion 22. In addition, for any such taxes that are reported on a gross basis, a company should disclose the amounts of those taxes in interim and annual financial statements for each period for which an income statement is presented if those amounts are significant and can be done on an aggregate basis. When issued, EITF Issue No. 06-3 would be effective for financial reports for interim and annual reporting periods beginning after December 15, 2006. The Company currently accounts for taxes on a net basis; therefore EITF 06-3 should not have any significant impact on the Company's financial condition or results of operations.

In July 2006, the Financial Accounting Standards Board (FASB) issued FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes - an interpretation of FASB Statement No. 109 (FIN 48), which clarifies the accounting for uncertainty in tax positions. This Interpretation requires that the Company recognize in its financial statements, the impact of a tax position, if that position is more likely than not of being sustained on audit, based on the technical merits of the position. The provisions of FIN 48 are effective as of the beginning of the Company's 2007 fiscal year, with the cumulative effect of the change in accounting principle recorded as an adjustment to opening retained earnings. The Company is currently evaluating the impact of adopting FIN 48 on its financial statements.

**Use of Estimates** Preparation of these condensed consolidated financial statements requires that management make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities as of the date of the condensed consolidated financial statements and the reported amounts of revenue and expense during the reporting periods. As a result, actual results could differ from those estimates. The most significant estimates in the financial statements are the allowance for cancellations, merchandise liability, deferred margin, deferred merchandise trust investment earnings, deferred obtaining costs and income taxes. Deferred margin and deferred merchandise trust investment earnings are included in deferred cemetery revenues, net, on the condensed consolidated balance sheets.

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**Segment Reporting and Related Information** The Company has one reportable segment, death care services.

Disclosure of reported segment revenue:

|                                                                              | Three Months Ended |           | Six Months Ended |           |
|------------------------------------------------------------------------------|--------------------|-----------|------------------|-----------|
|                                                                              | June 30,           |           | June 30,         |           |
|                                                                              | 2005               | 2006      | 2005             | 2006      |
|                                                                              | (in thousands)     |           | (in thousands)   |           |
| Revenues:                                                                    |                    |           |                  |           |
| Cemetery:                                                                    |                    |           |                  |           |
| Sales                                                                        | \$ 14,606          | \$ 15,854 | \$ 25,883        | \$ 30,857 |
| Services and other                                                           | 5,437              | 6,704     | 10,768           | 13,625    |
| Investment, including realized gains from merchandise trusts and receivables | 3,663              | 3,813     | 6,445            | 6,645     |
| Deferred margin, recognized                                                  | 993                | 792       | 1,948            | 1,228     |
|                                                                              | 24,699             | 27,163    | 45,044           | 52,355    |
| Funeral home revenues                                                        | 529                | 1,129     | 1,150            | 2,589     |
| Total revenues                                                               | \$ 25,228          | \$ 28,292 | \$ 46,194        | \$ 54,944 |

## 2. LONG-TERM ACCOUNTS RECEIVABLE, NET OF ALLOWANCE

Long-term accounts receivable, net, consist of the following:

|                                          | December 31,   | June 30,  |
|------------------------------------------|----------------|-----------|
|                                          | 2005           | 2006      |
|                                          | (in thousands) |           |
| Customer receivables                     | \$ 80,755      | \$ 82,348 |
| Unearned finance income                  | (7,831)        | (8,715)   |
| Allowance for contract cancellations     | (9,261)        | (10,875)  |
|                                          | 63,663         | 62,758    |
| Less: current portion - net of allowance | 29,991         | 30,770    |
| Long-term portion - net of allowance     | \$ 33,672      | \$ 31,988 |

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Activity in the allowance for contract cancellations is as follows:

|                               | December 31,   | June 30,  |
|-------------------------------|----------------|-----------|
|                               | 2005           | 2006      |
|                               | (in thousands) |           |
| Balance - Beginning of period | \$ 8,948       | \$ 9,261  |
| Provision for cancellations   | 6,490          | 4,372     |
| Charge-offs - net             | (6,177)        | (2,758)   |
| Balance - End of period       | \$ 9,261       | \$ 10,875 |

**3. CEMETERY PROPERTY**

Cemetery property consists of the following:

|                                  | December 31,   | June 30,   |
|----------------------------------|----------------|------------|
|                                  | 2005           | 2006       |
|                                  | (in thousands) |            |
| Developed land                   | \$ 21,165      | \$ 20,246  |
| Undeveloped land                 | 110,556        | 109,583    |
| Mausoleum crypts and lawn crypts | 33,051         | 33,907     |
| Total                            | \$ 164,772     | \$ 163,736 |

**4. PROPERTY AND EQUIPMENT**

Major classes of property and equipment follow:

|                                | December 31,   | June 30,  |
|--------------------------------|----------------|-----------|
|                                | 2005           | 2006      |
|                                | (in thousands) |           |
| Building and improvements      | \$ 26,242      | \$ 26,080 |
| Furniture and equipment        | 20,784         | 21,318    |
|                                | 47,026         | 47,398    |
| Less: accumulated depreciation | (19,935)       | (21,095)  |
| Property and equipment net     | \$ 27,091      | \$ 26,303 |

**5. PRE-NEED MERCHANDISE AND SERVICES AND MERCHANDISE TRUSTS.**

**Cemetery** In connection with the pre-need sale of cemetery interment rights, merchandise and services, the customer typically enters into an installment contract with the Company. The contract is usually for a period not to exceed 60 months with payments of principal and interest required. Interest is imputed for contracts that do not bear a market rate of interest (at a rate of 6.75% during the year ended December 31, 2005 and 8.75% during the six months ended June 30, 2006). The Company establishes an allowance for cancellations due to non-payment at the date of sale based on historic experience and management's estimates. The allowance is reviewed quarterly and changes in estimates are reflected for

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current and prior contracts as a result of recent cancellation experience. Actual cancellation rates in the future may result in a change in estimate.

The Company evaluates the collectibility of the assets held in merchandise trusts for impairment when the fair values of the assets are below the recorded asset balance. Assets are deemed to be impaired when, based on current information and events, it is probable that the Company will be unable to collect all amounts from the merchandise trust at the time such amounts are due. In those instances when the amount is deemed to be impaired, the merchandise trust is reduced to the currently estimated recoverable amount with a corresponding reduction to the associated deferred cemetery revenues balance. There is no income statement impact as long as deferred revenues are not below the estimated costs to deliver the underlying products or services. If the deferred revenue were to decrease below the estimated cost to deliver the underlying products or services, the Company would record a charge to earnings for the difference.

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At December 31, 2005, the cost and market value associated with the assets held in merchandise trusts follows:

|                                        | Cost       | Gross<br>Unrealized<br>Gains<br>(In Thousands) | Gross<br>Unrealized<br>Losses | Market     |
|----------------------------------------|------------|------------------------------------------------|-------------------------------|------------|
| Short-term investment                  | \$ 11,651  | \$                                             | \$                            | \$ 11,651  |
| Fixed maturities:                      |            |                                                |                               |            |
| U.S. Government and federal agency     | 2,408      | 1                                              | (48)                          | 2,361      |
| U.S. State and local government agency | 1,946      | 1                                              | (10)                          | 1,937      |
| Corporate debt securities              | 4,113      | 10                                             | (133)                         | 3,990      |
| Other debt securities                  | 47,212     | 59                                             | (759)                         | 46,512     |
| Total fixed maturities                 | 55,679     | 71                                             | (950)                         | 54,800     |
| Equity securities                      | 47,944     | 1,192                                          | (2,155)                       | 46,981     |
| Total                                  | \$ 115,274 | \$ 1,263                                       | \$ (3,105)                    | \$ 113,432 |

At June 30, 2006, the cost and market value associated with the assets held in merchandise trusts follows:

|                                        | Cost       | Gross<br>Unrealized<br>Gains<br>(In Thousands) | Gross<br>Unrealized<br>Losses | Market     |
|----------------------------------------|------------|------------------------------------------------|-------------------------------|------------|
| Short-term investment                  | \$ 11,297  | \$                                             | \$                            | 11,297     |
| Fixed maturities:                      |            |                                                |                               |            |
| U.S. Government and federal agency     | 3,375      |                                                | (105)                         | 3,270      |
| U.S. State and local government agency | 1,920      |                                                | (84)                          | 1,836      |
| Corporate debt securities              | 4,074      | 13                                             | (162)                         | 3,925      |
| Other debt securities                  | 42,762     |                                                | (1,569)                       | 41,193     |
| Total fixed maturities                 | 52,131     | 13                                             | (1,920)                       | 50,224     |
| Equity securities                      | 52,654     | 1,696                                          | (1,715)                       | 52,635     |
| Total                                  | \$ 116,082 | \$ 1,709                                       | \$ (3,635)                    | \$ 114,156 |

An aging of unrealized losses on the Company's investments in fixed maturities and equity securities at June 30, 2006 is presented below:

|                                        | Less than 12 months<br>Fair<br>Value | Unrealized<br>Losses | 12 Months or more<br>Fair<br>Value | Unrealized<br>Losses | Total<br>Fair<br>Value | Total<br>Unrealized<br>Losses |
|----------------------------------------|--------------------------------------|----------------------|------------------------------------|----------------------|------------------------|-------------------------------|
|                                        | (In Thousands)                       |                      |                                    |                      |                        |                               |
| Fixed maturities:                      |                                      |                      |                                    |                      |                        |                               |
| U.S. Government and federal agency     | \$ 1,811                             | \$ 29                | \$ 1,459                           | \$ 76                | \$ 3,270               | \$ 105                        |
| U.S. State and local government agency | 1,636                                | 70                   | 201                                | 14                   | 1,837                  | 84                            |
| Corporate debt securities              | 2,417                                | 124                  | 814                                | 38                   | 3,231                  | 162                           |
| Other debt securities                  | 8,866                                | 414                  | 23,879                             | 1,155                | 32,745                 | 1,569                         |

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|                        |           |          |           |          |           |          |
|------------------------|-----------|----------|-----------|----------|-----------|----------|
| Total fixed maturities | 14,730    | 637      | 26,353    | 1,283    | 41,083    | 1,920    |
| Equity securities      | 20,099    | 1,522    | 2,231     | 193      | 22,330    | 1,715    |
| Total                  | \$ 34,829 | \$ 2,159 | \$ 28,584 | \$ 1,476 | \$ 63,413 | \$ 3,635 |

The Company considers various factors when considering if a decline in fair value of an asset is other than temporary, including but not limited to the length of time and magnitude of the unrealized loss; the volatility of the investment; the credit ratings of the issuers of the investments; and the Company's intentions to sell or ability to hold the investments. At June 30, 2006, the Company has concluded that the declines in the fair values of the Company's investments in fixed maturities and equity securities held by the merchandise trusts are temporary.

The company deposited \$4,528 and \$3,078 and withdrew \$7,698 and \$4,592 from the trusts during the three month period ended June 30, 2005 and 2006, respectively. During the three months ended June 30, 2005, purchase and sales of securities available for sale included in trust investments were \$25,211 and \$29,113, respectively. During the three months ended June 30, 2006, purchase and sales of securities available for sale included in trust investments were \$17,605 and \$17,330, respectively.

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**Funeral Home** Prearranged funeral home services provide for future funeral home services generally determined by prices prevailing at the time that the contract is signed. A portion of the payments made under funeral home pre-need contracts is placed in funeral trusts. Amounts used to defray the initial cost of administration are not placed in trust. The balance of the amounts in the trusts totaled approximately \$1.6 million at December 31, 2005 and approximately \$1.6 million at June 30, 2006 and are included within the merchandise trusts above. Funeral trust principal, together with investment earnings retained in trust, are deferred until the service is performed. Upon performance of the contracted funeral home service, the Company recognizes the funeral trust principal amount together with the accumulated trust earnings as funeral home revenues.

**6. PERPETUAL CARE TRUSTS.**

At December 31, 2005, the cost and market value associated with the assets held in perpetual care trust follows:

|                                        | Cost       | Gross<br>Unrealized<br>Gains<br>(In Thousands) | Gross<br>Unrealized<br>Losses<br>(In Thousands) | Market     |
|----------------------------------------|------------|------------------------------------------------|-------------------------------------------------|------------|
| Short-term investment                  | \$ 13,400  | \$                                             | \$                                              | \$ 13,400  |
| Fixed maturities:                      |            |                                                |                                                 |            |
| U.S. Government and federal agency     | 3,988      | 9                                              | (69)                                            | 3,928      |
| U.S. State and local government agency | 1,673      | 11                                             | (13)                                            | 1,671      |
| Corporate debt securities              | 14,609     | 212                                            | (271)                                           | 14,550     |
| Other debt securities                  | 66,392     | 535                                            | (300)                                           | 66,627     |
| Total fixed maturities                 | 86,662     | 767                                            | (653)                                           | 86,776     |
| Equity Securities                      | 34,993     | 1,882                                          | (332)                                           | 36,543     |
| Total                                  | \$ 135,055 | \$ 2,649                                       | \$ (985)                                        | \$ 136,719 |

At June 30, 2006, the cost and market value associated with the assets held in perpetual care trust follows:

|                                        | Cost       | Gross<br>Unrealized<br>Gains<br>(In Thousands) | Gross<br>Unrealized<br>Losses<br>(In Thousands) | Market     |
|----------------------------------------|------------|------------------------------------------------|-------------------------------------------------|------------|
| Short-term investment                  | \$ 16,310  | \$                                             | \$                                              | \$ 16,310  |
| Fixed maturities:                      |            |                                                |                                                 |            |
| U.S. Government and federal agency     | 4,010      | 4                                              | (116)                                           | 3,898      |
| U.S. State and local government agency | 1,675      | 7                                              | (33)                                            | 1,649      |
| Corporate debt securities              | 14,923     | 148                                            | (407)                                           | 14,664     |
| Other debt securities                  | 60,965     | 1,935                                          | (461)                                           | 62,439     |
| Total fixed maturities                 | 81,573     | 2,094                                          | (1,017)                                         | 82,650     |
| Equity Securities                      | 38,926     | 3,443                                          | (467)                                           | 41,902     |
| Total                                  | \$ 136,809 | \$ 5,537                                       | \$ (1,484)                                      | \$ 140,862 |

An aging of unrealized losses on the Company's investments in fixed maturities and equity securities at June 30, 2006 held in perpetual care trusts is presented below:

|                                        | Less than 12 months |                   | 12 Months or more |                   | Total      |                   |
|----------------------------------------|---------------------|-------------------|-------------------|-------------------|------------|-------------------|
|                                        | Fair Value          | Unrealized Losses | Fair Value        | Unrealized Losses | Fair Value | Unrealized Losses |
| (In Thousands)                         |                     |                   |                   |                   |            |                   |
| Fixed maturities:                      |                     |                   |                   |                   |            |                   |
| U.S. Government and federal agency     | \$ 2,878            | \$ 81             | \$ 827            | \$ 35             | \$ 3,705   | \$ 116            |
| U.S. State and local government agency | 980                 | 20                | 304               | 13                | 1,284      | 33                |
| Corporate debt securities              | 7,372               | 286               | 3,309             | 121               | 10,681     | 407               |
| Other debt securities                  | 9,814               | 461               |                   |                   | 9,814      | 461               |
| Total fixed maturities                 | 21,044              | 848               | 4,440             | 169               | 25,484     | 1,017             |
| Equity Securities                      | 7,028               | 267               | 4,952             | 200               | 11,980     | 467               |
| Total                                  | \$ 28,072           | \$ 1,115          | \$ 9,392          | \$ 369            | \$ 37,464  | \$ 1,484          |

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The Company considers various factors when considering if a decline in fair value of an asset is other than temporary, including but not limited to the length of time and magnitude of the unrealized loss; the volatility of the investment; the credit ratings of the issuers of the investments; and the Company's intentions to sell or ability to hold the investments. At June 30, 2006, the Company has concluded that the declines in the fair values of the Company's investments in fixed maturities and equity securities held in perpetual care trusts are temporary.

The company deposited \$1,095 and \$1,126 and withdrew \$1,442 and \$1,435 from the trusts during the three months ended June 30, 2005 and 2006, respectively. During the three months ended June 30, 2005, purchase and sales of securities available for sale included in trust investments were \$14,146 and \$10,717, respectively. During the three months ended June 30, 2006, purchase and sales of securities available for sale included in trust investments were \$22,767 and \$17,756, respectively.

The Company recorded income from perpetual care trusts of \$ 1.7 million and \$3.4 million for the three and six months ended June 30, 2005, respectively and \$2.5 million and \$4.4 million during the same period of 2006. This income is classified as cemetery revenues in the consolidated statements of operations.

**7. LONG-TERM DEBT**

The following is a summary of debt outstanding at:

|                                                                                 | December 31,<br>2005 | June 30,<br>2006 |
|---------------------------------------------------------------------------------|----------------------|------------------|
|                                                                                 | (In Thousands)       |                  |
| Insurance premium financing, due in installments through September 2006 (4.75%) | 437                  | 355              |
| Covenants not to compete due through August 2007 (non-interest bearing)         | 258                  | 144              |
| Vehicle Financing                                                               |                      | 61               |
| Acquisition Credit Line, due September 2008 (interest rate - Libor + 3.5%)      | 5,250                | 5,250            |
| Revolving Credit Line, due September 2007 (interest rate - Libor + 3.5%)        | 1,000                | 4,900            |
| Senior secured notes, due 2009 (interest rate 7.66%)                            | 80,000               | 80,000           |
| <b>Total</b>                                                                    | <b>86,945</b>        | <b>90,710</b>    |
| Less current portion                                                            | 641                  | 505              |
| <b>Long-term portion</b>                                                        | <b>\$ 86,304</b>     | <b>\$ 90,205</b> |

On September 20, 2004, concurrent with the closing of the Partnership's initial public offering, StoneMor Operating LLC and its subsidiaries issued and sold \$80.0 million aggregate principal amount of senior secured notes. The senior secured notes rank pari passu with all of our other senior secured debt, including the revolving credit facility and the acquisition facility, subject to the description of the collateral securing the senior secured notes described below. The senior secured notes are guaranteed by the Partnership, the general partner of the Partnership and any future subsidiaries of StoneMor Operating LLC. Obligations under the senior secured notes are secured by a first priority lien and security interest covering substantially all of the assets of the issuers of the senior secured notes, whether then owned or thereafter acquired, other than specified receivable rights and a second priority lien and security interest covering those specified receivable rights, each as described above, of such issuers, whether then owned or thereafter acquired.

On September 20, 2004, concurrent with the closing of the Partnership's initial public offering, StoneMor Operating LLC and its subsidiaries entered into a new \$35.0 million credit facility with a group of banks. This credit facility consists of a \$12.5 million revolving credit line and a \$22.5 million acquisition line of credit. Borrowings under the revolving credit line are due and payable on September 20, 2007, and borrowings under the acquisition line of credit are due and payable on September 20, 2008. Depending on the type of loan, this credit facility bears interest at the Base Rate or the Eurodollar Rate, plus applicable margins ranging from 0.00% to 1% and 2.5% to 3.5% per annum, respectively, depending on our ratio of total debt to consolidated EBITDA, as defined. The Base Rate is the higher of the federal funds rate plus 0.05% or the prime rate announced by Fleet National Bank, a Bank of America Company. The Eurodollar Rate is to be determined by the administrative agent according to the credit facility. As of June 30, 2006, we had outstanding borrowings of \$4.9 million under our revolving credit line. As of June 30, 2006, we had \$5.25 million outstanding under our acquisition line of credit which we borrowed for the acquisition of 22 cemeteries and 6 funeral homes from Service Corporation International in November 2005.

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Borrowings under the credit facility rank pari passu with all of our other senior secured debt, including the senior secured notes, subject to the description of the collateral securing the credit facility described below. Borrowings under the credit facility are guaranteed by the Partnership and the general partner of the Partnership.

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Our obligations under the revolving facility are secured by a first priority lien and security interest in specified receivable rights, whether then owned or thereafter acquired, of the borrower and the guarantors and by a second priority lien and security interest in substantially all assets other than those receivable rights of the borrower and the guarantors, excluding trust accounts and certain proceeds required by law to be placed into such trust accounts and funds held in trust accounts, our general partner's interest in the Partnership and our general partner's incentive distribution rights under the Partnership's partnership agreement. These assets secure the acquisition facility and our senior secured notes. The specified receivable rights include all accounts and other rights to payment arising under customer contracts or agreements (other than amounts required to be deposited into merchandise and perpetual care trusts) or management agreements, and all inventory, general intangibles and other rights reasonably related to the collection and performance of these accounts and rights to payment.

Our obligations under the acquisition facility are secured by a first priority lien and security interest in substantially all assets, whether then owned or thereafter acquired, other than specified receivable rights of the borrower and the guarantors, excluding trust accounts and certain proceeds required by law to be placed into such trust accounts and funds held in trust accounts, our general partner's interest in the Partnership and our general partner's incentive distribution rights under the Partnership's partnership agreement, and a secondary priority lien and security interest in those specified receivable rights of the borrower and the guarantors. The senior secured notes will share *pari passu* in the collateral securing the acquisition facility.

The agreements governing the revolving credit facility, the acquisition line of credit and the senior secured notes contain restrictive covenants that, among other things, prohibit distributions upon defined events of default, restrict investments and sales of assets and require us to maintain certain financial covenants, including specified financial ratios. As of June 30, 2006, the Company was in compliance with all debt covenants.

Deferred financing costs as of June 30, 2006 consisted of approximately \$2.9 million of debt issuance costs, less accumulated amortization of approximately \$1.3 million. These costs were incurred in connection with the issuance of the Company's senior secured notes during September 2004.

## **8. INCOME TAXES**

As of December 31, 2005, the Company's taxable corporate subsidiaries had a federal net operating loss carryover of approximately \$35.4 million, which will begin to expire in 2019. As of December 31, 2005, the Company also had a state net operating loss carry-forward of approximately \$46.0 million, a portion of which expires annually.

Effective with the closing of the Partnership's initial public offering on September 20, 2004, the Company was no longer a taxable entity for federal and state income tax purposes; rather, the Partnership's tax attributes (except those of its corporate subsidiaries) are to be included in the individual tax returns of its partners. Neither the Partnership's financial reporting income, nor the cash distributions to unitholders, can be used as a substitute for the detailed tax calculations that the Partnership must perform annually for its partners. Net income from the Partnership is not treated as *passive income* for federal income tax purposes. As a result, partners subject to the passive activity loss rules are not permitted to offset income from the Partnership with passive losses from other sources.

The tax returns of the Partnership are subject to examination by state and federal tax authorities. If such examinations result in changes to taxable income, the tax liability of the partners could be changed accordingly.

The Partnership's corporate subsidiaries account for their income taxes under the asset and liability method. Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases and operating loss and tax credit carry forwards. These assets are fully reserved as they are more likely than not to be recognized.

Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date.

The provision for income taxes for the three months ended June 30, 2005 and 2006 is based upon the estimated annual effective tax rates expected to be applicable to the Company for 2005 and 2006, respectively.

## **9. DEFERRED CEMETERY REVENUES - NET**

In accordance with SAB No. 104, the Company defers the revenues and all direct costs associated with the sale of pre-need cemetery merchandise and services until the merchandise is delivered or the services are performed. The Company also defers the costs to obtain new

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pre-need cemetery and new prearranged funeral business as well as the investment earnings on the prearranged services and merchandise trusts (see Note 1). At December 31, 2005 and June 30, 2006, deferred cemetery revenues, net, consisted of the following:

|                                      | December 31,<br>2005 | June 30,<br>2006 |
|--------------------------------------|----------------------|------------------|
|                                      | (In Thousands)       |                  |
| Deferred cemetery revenue            | \$ 136,299           | \$ 143,867       |
| Deferred merchandise trust revenue   | 20,166               | 21,250           |
| Deferred pre-acquisition margin      | 32,151               | 30,924           |
| Deferred cost of good sold           | (20,772)             | (21,881)         |
| Deferred cemetery revenues, net      | \$ 167,844           | \$ 174,160       |
| Deferred selling and obtaining costs | \$ 30,554            | \$ 32,240        |

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Deferred selling and obtaining costs are carried as an asset on the condensed consolidated balance sheet in accordance with FAS 60.

**10. COMMITMENTS AND CONTINGENCIES**

**Legal** The Company is party to legal proceedings in the ordinary course of its business but does not expect the outcome of any proceedings, individually or in the aggregate, to have a material adverse effect on the Company's financial position, results of operations or liquidity.

**Leases** At June 30, 2006, the Company was committed to operating lease payments for premises, automobiles and office equipment under various operating leases with initial terms ranging from one to five years and options to renew at varying terms. Expenses under operating leases were \$0.3 million for the six months ended June 30, 2006 and \$0.4 million for the six months ended June 30, 2005.

At June 30, 2006, operating leases will result in future payments in the following approximate amounts:

|              | (in thousands)  |
|--------------|-----------------|
| 2006         | \$ 276          |
| 2007         | 475             |
| 2008         | 469             |
| 2009         | 447             |
| 2010         | 365             |
| Thereafter   | 1,124           |
| <b>Total</b> | <b>\$ 3,156</b> |

**Tax Indemnification** CFSI LLC (formerly Cornerstone Family Services, Inc., the Company's predecessor) has agreed to indemnify the Company for all federal, state and local income tax liabilities attributable to the operation of the assets contributed by CFSI LLC to us prior to September 20, 2004. CFSI LLC has also agreed to indemnify us against additional income tax liabilities, if any, that arise from the consummation of the transactions related to our formation in excess of those believed to result at the time of the closing of our initial public offering. CFSI LLC has also agreed to indemnify us against the increase in income tax liabilities of our corporate subsidiaries resulting from any reduction or elimination of our net operating losses to the extent those net operating losses are used to offset any income tax gain or income resulting from the prior operation of the assets of CFSI LLC contributed to us, or from our formation transactions in excess of such gain or income believed to result at September 20, 2004.

**Management Contract-** As of June 30, 2006, one of the management contracts under which we operate one of our locations is in negotiation for renewal. The Company consolidates this location in accordance with FIN 46R (see Note 1.). We are continuing to operate under the terms and conditions of the old agreement. In the event that we do not negotiate a new contract we will discontinue consolidating this entity and our investment will be evaluated for recoverability. If it is determined to be impaired, we would record a non-cash charge of approximately \$0.3 million.

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For the years ended December 31, 2003, 2004 and 2005 we received \$154,000, \$190,527 and \$164,930 in net management fees from this location. Additionally, we will be required to evaluate the collectibility of an intercompany receivable in the amount of approximately \$0.7 million, which may increase the amount of the non-cash charge.

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

The words "we," "us," "our," "Company" and similar words, when used in a historical context prior to the closing of the initial public offering of StoneMor Partners L.P. on September 20, 2004, refer to Cornerstone Family Services, Inc. (and, after its conversion, CFSI LLC) and its subsidiaries and thereafter refer to StoneMor Partners L.P. and its subsidiaries.

This discussion and analysis should be read in conjunction with our unaudited condensed consolidated financial statements included in Item 1 of this Quarterly Report on Form 10-Q (including the notes thereto).

## **Forward-Looking Statements**

Certain statements contained in this Quarterly Report on Form 10-Q, including, but not limited to, information regarding the status and progress of StoneMor's operating activities, the plans and objectives of StoneMor's management, assumptions regarding StoneMor's future performance and plans, and any financial guidance provided, as well as certain information in other filings with the SEC and elsewhere, are forward-looking statements within the meaning of Section 27A(i) of the Securities Act of 1933 and Section 21E(i) of the Securities Exchange Act of 1934. The words "believe," "may," "will," "estimate," "continues," "anticipate," "intend," "project," "expect," "predict," and similar expressions identify these statements. These forward-looking statements are made subject to certain risks and uncertainties that could cause actual results to differ materially from those stated, including, but not limited to, the following: future revenue and revenue growth; the impact of StoneMor's significant leverage on its operating plans; the ability of StoneMor to service its debt; StoneMor's ability to attract, train and retain an adequate number of sales people; uncertainties associated with the volume and timing of pre-need sales of cemetery services and products; variances in death rates; variances in the use of cremation; changes in the political or regulatory environments, including potential changes in tax accounting and trusting policies; StoneMor's ability to successfully implement a strategic plan relating to producing operating improvement, strong cash flows and further deleveraging; uncertainties associated with the integration or the anticipated benefits of the acquisition of assets in November 2005; information disclosed within this Quarterly Report on Form 10-Q; and various other uncertainties associated with the deathcare industry and StoneMor's operations in particular.

When considering forward-looking statements, you should keep in mind the risk factors and other cautionary statements set forth in our Annual Report on Form 10-K for the fiscal year ended December 31, 2005 and this Quarterly Report on Form 10-Q. 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.

## **Overview**

On April 2, 2004, StoneMor Partners L.P. ("StoneMor," the "Partnership," or the "Company") was created to own and operate the cemetery and funeral home business conducted by Cornerstone Family Services, Inc. ("Cornerstone") and its subsidiaries. On September 20, 2004, in connection with the initial public offering by the Partnership of common units representing limited partner interests, Cornerstone contributed to the Partnership substantially all of the assets, liabilities and businesses owned and operated by it, and then converted into CFSI LLC, a limited liability company. This transfer represented a reorganization of entities under common control and was recorded at historical cost. In exchange for these assets, liabilities and businesses, CFSI LLC received 564,782 common units and 4,239,782 subordinated units representing limited partner interests in the Partnership.

Cornerstone was founded in 1999 by members of our management team and a private equity investment firm, which we refer to as McCown De Leeuw, in order to acquire a group of 123 cemetery properties and 4 funeral homes. Since that time, Cornerstone acquired 32 additional cemeteries and eight funeral homes, built two funeral homes and sold one cemetery and one funeral home.

**Initial Public Offering.** On September 20, 2004, StoneMor completed its initial public offering of 3,675,000 common units at a price of \$20.50 per unit representing a 42.5% interest in us. On September 23, 2004, StoneMor sold an additional 551,250 common units to the underwriters in connection with the exercise of their

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over-allotment option and redeemed an equal number of common units from CFSI LLC at a cost of \$5.3 million, making a total of 4,239,782 common units outstanding. Total gross proceeds from these sales were \$86.6 million, before offering costs and underwriting discounts. The net proceeds to the Partnership, after deducting underwriting discounts but before paying offering costs, from these sales of common units was \$80.8 million. Concurrent with the initial public offering, the Partnership's wholly owned subsidiary, StoneMor Operating LLC, and its subsidiaries, all as borrowers, issued and sold \$80.0 million in aggregate principal amount of senior secured notes in a private placement and entered into a \$12.5 million revolving credit facility and a \$22.5 million acquisition facility with a group of banks. The net proceeds of the initial public offering and the sale of senior secured notes were used to repay the debt and associated accrued interest of approximately \$135.1 million of CFSI LLC and \$15.7 million of fees and expenses associated with the initial public offering and the sale of senior secured notes. The remaining funds have been used for general partnership purposes, including the construction of mausoleum crypts and lawn crypts, the purchases of equipment needed to install burial vaults and the acquisition of cemetery and funeral home locations.

We are an owner and operator of cemeteries in the United States of America. As of June 30, 2006, the Company operated 154 cemeteries in 13 states, located primarily in the eastern United States of America. The Company owns 147 of these cemeteries and operates the remaining 7 under long-term management agreements with cemetery associations that own the cemeteries. As a result of the agreements and other control arrangements, StoneMor consolidates the results of the 7 managed cemeteries in our historical consolidated financial statements.

StoneMor sells cemetery products and services both at the time of death, which the Company refers to as at-need, and prior to the time of death, which the Company refers to as pre-need. During the first six months of 2006, StoneMor performed over 12,500 burials and sold more than 7,800 interment rights (net of cancellations) compared to 11,300 and 7,500, respectively, for the same period of 2005.

### **Cemetery Operations**

*Sources of Revenues.* Our results of operations are determined primarily by the volume of sales of products and services and the timing of product delivery and performance of services. We derive our revenues primarily from:

at-need sales of cemetery interment rights, merchandise and services, which we recognize as revenues at the time of sale;

pre-need sales of cemetery interment rights, which we generally recognize as revenues when we have collected 10% of the sales price from the customer;

pre-need sales of cemetery merchandise, which we recognize as revenues when we satisfy the criteria specified below for delivery of the merchandise to the customer;

pre-need sales of cemetery services, other than perpetual care services, which we recognize as revenues when we perform the services for the customer;

accumulated merchandise trust earnings related to the delivery of pre-need cemetery merchandise and the performance of pre-need cemetery services, which we recognize as revenues when we deliver the merchandise or perform the services;

income from perpetual care trusts, which we recognize as revenues as the income is earned in the trust; and

other items, such as interest income on pre-need installment contracts and sales of land.

Revenues from pre-need sales of cemetery merchandise and the related accumulated merchandise trust earnings are deferred until the merchandise is delivered to the customer, which generally means that:

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the merchandise is complete and ready for installation or, in the case of merchandise other than burial vaults, storage on third-party premises;

the merchandise is either installed or stored at an off-site location, at no additional cost to us, and specifically identified with a particular customer, except as described below; and

the risks and rewards of ownership have passed to the customer.

We generally satisfy these delivery criteria by purchasing the merchandise and either installing it on our cemetery property or storing it, at the customer's request, in third-party warehouses, at no additional cost to us, until the time of need. With respect to burial vaults, we install the vaults rather than storing them to satisfy the delivery criteria. When merchandise is stored for a customer, we may issue a certificate of ownership to the customer to evidence the transfer to the customer of the risks and rewards of ownership.

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*Deferred Cemetery Revenues, Net.* Deferred revenues from pre-need sales and related merchandise trust earnings are reflected on our balance sheet in deferred cemetery revenues, net, until we recognize the amounts as revenues. Deferred cemetery revenues, net, also includes deferred revenues from pre-need sales that were entered into by entities we acquired prior to the time we acquired them. These entities include those that we acquired at the time of the formation of Cornerstone and other entities we subsequently acquired. We recognize revenues from these acquired pre-need sales in the manner described above that is, when we deliver the merchandise to, or perform the services for, the customer. Our profit margin on these pre-need sales is generally less than our profit margin on other pre-need sales because, in accordance with industry practice at the time these acquired pre-need sales were made, none of the selling expenses were recognized at the time of sale. As a result, we are required to recognize all of the expenses (including deferred selling expenses) associated with these acquired pre-need sale when we recognize the revenues from that sale. We recognize certain expenses, such as indirect selling costs, maintenance costs and general and administrative costs, at the time the pre-need sale is made and defer other expenses, such as direct selling costs and costs of goods sold, until we recognize revenues on the sale. As a result, our profit margin on current pre-need sales is generally higher than on the pre-need sales we acquired.

## **Funeral Home Operations**

We also derive revenues from the sale of funeral home merchandise, including caskets and related funeral merchandise, and services, including removal and preparation of remains, the use of our facilities for visitation, worship and performance of funeral services and transportation services. These services and merchandise are sold by us almost exclusively at the time of need by salaried licensed funeral directors.

We generally include revenues from pre-need casket sales in the results of our cemetery operations. However, some states require that caskets be sold by funeral homes, and revenues from casket sales in those states are included in our funeral home results. We do not report the results of our funeral home operations as a separate business segment.

Eight of our 13 funeral homes are located on the grounds of cemeteries that we own. As a result, we are able to combine certain general and administrative expenses that relate to both the cemetery and the funeral home at the same location. Our other funeral home operating expenses consist primarily of compensation to our funeral directors and the cost of caskets.

## **Critical Accounting Policies and Estimates**

Our discussion and analysis of our financial condition and results of operations are based on the historical consolidated financial statements of StoneMor. We prepared these financial statements in conformity with Accounting Principles Generally Accepted in the United States of America. The preparation of these financial statements required us to make estimates, judgments and assumptions that affected the reported amounts of assets and liabilities at the dates of the financial statements and the reported amounts of revenues and expenses during the reporting periods. We based our estimates, judgments and assumptions on historical experience and known facts and other assumptions that we believed to be reasonable under the circumstances. In future periods, we expect to make similar estimates, judgments and assumptions on the same basis as we have historically. Our actual results in future periods may differ from these estimates under different assumptions and conditions. We believe that the following accounting policies or estimates had or will have the greatest potential impact on our consolidated financial statements for the periods discussed and for future periods.

*Revenue Recognition.* At-need sales of cemetery interment rights, merchandise and services and at-need sales of funeral home merchandise and services are recognized as revenues when the interment rights or merchandise is delivered or the services are performed.

Revenues from pre-need sales of cemetery interment rights in constructed burial property are deferred until at least 10% of the sales price has been collected. Revenues from pre-need sales of cemetery interment rights in unconstructed burial property, such as mausoleum crypts and lawn crypts, are deferred until at least 10% of the sales price has been collected, at which time revenues are recognized using the percentage-of-completion method of accounting. The percentage-of-completion method of accounting requires us to estimate the percentage of completion as of the balance sheet date and future costs (including estimates for future inflation). Changes to our estimates of the percentage of completion or the related future costs would impact the amount of recognized and deferred revenues.

Revenues from pre-need sales of cemetery merchandise and services are deferred until the merchandise is delivered or the services are performed. Investment earnings generated by funds required to be deposited into merchandise trusts, including realized gains and losses, in connection with pre-need sales of cemetery merchandise and services are deferred until the associated merchandise is delivered or the services are performed.

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We defer recognition of the direct costs associated with pre-need sales of cemetery products and services. Direct costs are those costs that vary with and are directly related to obtaining new pre-need cemetery business and the actual cost of the products and services we sell. Direct costs are expensed when the related revenues are recognized. Until that time, direct costs are reflected on our balance sheet in deferred cemetery revenues, net.

*Allowance for Cancellations.* Allowances for cancellations arising from non-payment of pre-need contracts are estimated at the date of sale based upon our historical cancellation experience. Due to the number of estimates and projections used in determining an expected cancellation rate and the possibility of changes in collection patterns resulting from modifications to our collection policies or contract terms, actual collections could differ from these estimates.

*Impairment of Long-Lived Assets.* We monitor the recoverability of long-lived assets, including cemetery property, property and equipment, merchandise and perpetual care trusts, and other assets, based on estimates using factors such as current market value, future asset utilization, business and regulatory climate and future undiscounted cash flows expected to result from the use of the related assets. Our policy is to record an impairment loss in the period when it is determined that the sum of future undiscounted cash flows is less than the carrying value of the asset. Modifications to our estimates could result in our recording impairment charges in future periods.

*Property and Equipment.* Property and equipment is recorded at cost and depreciated on a straight-line basis. Maintenance and repairs are charged to expense as incurred, whereas additions and major replacements are capitalized and depreciated over the estimated useful life of the asset. We estimate that the useful lives of our buildings and improvements are 10 to 40 years, that the useful lives of our furniture and equipment are 5 to 10 years and that the useful lives of our leasehold improvements are the respective terms of the leases. These estimates could be impacted in the future by changes in market conditions or other factors.

*Income Taxes.* We make estimates and judgments to calculate some of our tax liabilities and determine the recoverability of some of our deferred tax assets, which arise from temporary differences between the tax and financial statement recognition of revenues and expenses. We also estimate a reserve for deferred tax assets if, based on the available evidence, it is more likely than not that some portion or all of the recorded deferred tax assets will not be realized in future periods.

In evaluating our ability to recover deferred tax assets, we consider all available positive and negative evidence, including our past operating results, recent cumulative losses and our forecast of future taxable income. In determining future taxable income, we make assumptions for the amount of taxable income, the reversal of temporary differences and the implementation of feasible and prudent tax planning strategies. These assumptions require us to make judgments about our future taxable income and are consistent with the plans and estimates we use to manage our business. Any reduction in estimated future taxable income may require us to record an additional valuation allowance against our deferred tax assets. An increase in the valuation allowance would result in additional income tax expense in the period and could have a significant impact on our future earnings.

We expect to reduce the amount of our taxable income as a result of our treatment as a partnership for U.S. federal tax purposes. However, some of our operations will be continue to be conducted through corporate subsidiaries that will be subject to applicable U.S. federal and state income taxes. Accordingly, changes in our income tax plans and estimates may impact our earnings in future periods.

As of December 31, 2005, Stonemor Partners L.P., and its affiliated group of corporate subsidiaries had a consolidated federal net operating loss carryover of approximately \$35.4 million and state net operating losses of approximately \$46.0 million. These federal and state net operating losses will begin to expire in 2019 and expire annually, respectively, and are available to reduce future taxable income of our taxable subsidiaries that would otherwise be subject to federal income taxes. Our ability to use such federal net operating losses may be limited by changes in the ownership of our units deemed to result in an ownership change under the applicable provisions of the Internal Revenue Code.

For additional information about, among other things, our pre-need sales, at-need sales, trusting requirements, cash flow, expenses and operations, please see Management's Discussion and Analysis of Financial Condition and Results of Operations included in our annual report on Form 10-K for the fiscal year ended December 31, 2005 and our other reports and statements filed with the SEC.

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### **Recent Accounting Pronouncements**

In March 2004, the FASB issued Emerging Issues Task Force ( EITF ) 03-1, *Impairment and Its Application to Certain Investments*. EITF 03-1 includes new guidance for evaluating and recording impairment losses on debt and equity investments, as well as new disclosure requirements for investments that are deemed to be temporarily impaired. In September 2004, the FASB issued Staff Position EITF 03-1-1, which delays the effective date until additional guidance is issued for the application of the recognition and measurement provisions of EITF 03-1 to investments and securities that are impaired. 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. 03-01*, as final. 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 reference to existing other-than-temporary impairment guidance. FSP FAS 115-1 is effective for other-than-temporary analyses conducted in periods beginning after December 15, 2005. This pronouncement as it relates to the Company's trusts did not have current impact on net earnings.

In May 2005, the Financial Accounting Standards Board ( FASB ) released Statement of Financial Accounting Standard ( SFAS ) No. 154, *Accounting Changes and Error Corrections*-a replacement of APB Opinion No. 20 and FASB Statement No. 3, ( FAS 154 ). FAS 154 requires retrospective application to prior periods' financial statements for any changes in accounting principle, unless it is impracticable to determine either the period-specific effects or the cumulative effect of the change. This statement is effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005. The impact of FAS 154 will depend on the nature and extent of any voluntary accounting changes or error corrections after the effective date. At June 30, 2006 this statement did not have an impact on the Company's condensed consolidated financial statements.

At its March 28, 2006 meeting, the FASB approved the issuance of a draft abstract EITF Issue No. 06-3, *How Taxes Collected from Customers and Remitted to Governmental Authorities Should Be Presented in the Income Statement (That Is, Gross versus Net Presentation)*, which addresses the income statement disclosure on taxes assessed by a governmental authority that is directly imposed on a revenue-producing transaction between a seller and a customer, and may include, but are not limited to, sales, use, value added, and some excise taxes. The presentation of taxes on either a gross (included in revenues and costs) or a net (excluded from revenues) basis is an accounting policy decision that should be disclosed pursuant to Opinion 22. In addition, for any such taxes that are reported on a gross basis, a company should disclose the amounts of those taxes in interim and annual financial statements for each period for which an income statement is presented if those amounts are significant and can be done on an aggregate basis. When issued, EITF Issue No. 06-3 would be effective for financial reports for interim and annual reporting periods beginning after December 15, 2006. The Company currently accounts for taxes on a net basis; therefore EITF 06-3 should not have any significant impact on its financial condition or results of operations.

In July 2006, the Financial Accounting Standards Board (FASB) issued FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* - an interpretation of FASB Statement No. 109 (FIN 48), which clarifies the accounting for uncertainty in tax positions. This Interpretation requires that the Company recognize in its financial statements, the impact of a tax position, if that position is more likely than not of being sustained on audit, based on the technical merits of the position. The provisions of FIN 48 are effective as of the beginning of the Company's 2007 fiscal year, with the cumulative effect of the change in accounting principle recorded as an adjustment to opening retained earnings. The Company is currently evaluating the impact of adopting FIN 48 on its financial statements.

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The following table summarizes our results of operations for the periods presented:

|                                    | Three months ended |                  | Six months ended |                  |
|------------------------------------|--------------------|------------------|------------------|------------------|
|                                    | June 30,<br>2005   | June 30,<br>2006 | June 30,<br>2005 | June 30,<br>2006 |
| (in thousands)                     |                    |                  |                  |                  |
| Statement of Operations Data:      |                    |                  |                  |                  |
| Revenues:                          |                    |                  |                  |                  |
| Cemetery                           | \$ 24,699          | \$ 27,163        | \$ 45,044        | \$ 52,355        |
| Funeral home                       | 529                | 1,129            | 1,150            | 2,589            |
| Total                              | 25,228             | 28,292           | 46,194           | 54,944           |
| Costs and Expenses:                |                    |                  |                  |                  |
| Cost of goods sold:                |                    |                  |                  |                  |
| Land and crypts                    | 1,625              | 1,416            | 2,588            | 2,863            |
| Perpetual care                     | 792                | 847              | 1,407            | 1,583            |
| Merchandise                        | 1,171              | 1,416            | 2,450            | 2,689            |
| Cemetery expense                   | 5,611              | 6,366            | 10,328           | 12,002           |
| Selling expense                    | 5,270              | 5,772            | 9,461            | 11,419           |
| General and administrative expense | 2,544              | 3,086            | 4,922            | 6,150            |
| Corporate overhead                 | 3,517              | 4,426            | 6,592            | 8,234            |
| Depreciation and amortization      | 1,023              | 925              | 1,868            | 1,746            |
| Funeral home expense               | 436                | 961              | 870              | 2,054            |
| Interest expense                   | 1,588              | 1,782            | 3,169            | 3,515            |
| Income taxes (benefit)             | 299                | 215              | 519              | 668              |
| Net income (loss)                  | \$ 1,352           | \$ 1,080         | \$ 2,020         | \$ 2,021         |

The following table presents supplemental operating data as of the periods presented:

|                                                              | Three months ended |           | Six months ended |           |
|--------------------------------------------------------------|--------------------|-----------|------------------|-----------|
|                                                              | June 30,           |           | June 30,         |           |
|                                                              | 2005               | 2006      | 2005             | 2006      |
| <b>Operating Data:</b>                                       |                    |           |                  |           |
| Interments Performed                                         | 5,403              | 6,216     | 11,381           | 12,588    |
| Cemetery revenues per interment performed                    | \$ 4,571           | \$ 4,370  | \$ 3,958         | \$ 4,159  |
| Interment rights sold (1):                                   |                    |           |                  |           |
| Lots                                                         | 4,036              | 4,341     | 6,243            | 6,476     |
| Mausoleum crypts (including pre-construction)                | 657                | 618       | 1,078            | 1,184     |
| Niches                                                       | 110                | 113       | 214              | 229       |
| Total interment rights sold                                  | 4,803              | 5,072     | 7,535            | 7,889     |
| Number of contracts written                                  | 12,638             | 14,078    | 23,420           | 27,309    |
| Aggregate contract amount, in thousands (excluding interest) | \$ 25,853          | \$ 30,136 | \$ 47,282        | \$ 58,264 |
| Average amount per contract (excluding interest)             | \$ 2,046           | \$ 2,141  | \$ 2,019         | \$ 2,134  |

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|                                                                       |           |           |           |           |
|-----------------------------------------------------------------------|-----------|-----------|-----------|-----------|
| Number of pre-need contracts written                                  | 5,937     | 6,555     | 10,432    | 12,797    |
| Aggregate pre-need contract amount, in thousands (excluding interest) | \$ 17,269 | \$ 19,450 | \$ 30,606 | \$ 37,704 |
| Average amount per pre-need contract (excluding interest)             | \$ 2,909  | \$ 2,967  | \$ 2,934  | \$ 2,946  |
| Number of at-need contracts written                                   | 6,701     | 7,523     | 12,988    | 14,512    |
| Aggregate at-need contract amount, in thousands                       | \$ 8,584  | \$ 10,686 | \$ 16,676 | \$ 20,560 |
| Average amount per at-need contract                                   | \$ 1,281  | \$ 1,420  | \$ 1,284  | \$ 1,417  |

(1) Net of cancellations. Counts the sale of a double-depth burial lot as the sale of two interment rights.

### **Three Months Ended June 30, 2006 Compared to Three Months Ended June 30, 2005**

*Cemetery Revenues.* Cemetery revenues were \$27.2 million in the second quarter of 2006, an increase of \$2.9 million, or 24.1%, as compared to \$24.7 million in second quarter of 2005. Cemetery revenues from pre-need sales, including interest income from pre-need installment contracts and investment income from trusts, were \$17.2 million in the second quarter of 2006, an increase of

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\$0.8 million, or 4.9%, as compared to \$16.4 million in the second quarter of 2005. The increase primarily resulted from increased marker and marker base deliveries (\$0.5 million), additional vault deliveries and installation (\$0.8 million), and increased document and installation fees (\$0.5 million), partially offset by a decrease in casket deliveries of \$1.1 million. Total revenues from merchandise and perpetual care trusts for the second quarter of 2006 were \$3.8 million an increase of \$0.2 million or 5.6%, as compared to \$3.6 million during same period in 2005.

Cemetery revenues from at-need sales in the second quarter of 2006 were \$9.4 million, an increase of \$1.6 million, or 20.5%, as compared to \$7.8 million in the second quarter of 2005. The increase in cemetery revenues from at-need sales was primarily attributable to higher sales of monument bases and markers of \$0.5 million, higher sales of openings and closings of \$0.8 million and higher sales of at-need lot spaces of \$0.3 million.

Other cemetery revenues were \$0.5 million in the second quarter of 2006, essentially unchanged from the second quarter of 2005.

The second quarter increases in all revenue and expense components are primarily related to our November 2005 acquisition.

*Costs of Goods Sold.* Cost of goods sold was \$3.7 million in the second quarter of 2006, an increase of \$0.1 million, or 2.8%, as compared to \$3.6 million in the second quarter of 2005. As a percentage of cemetery revenues, cost of goods sold was 13.6% in the second quarter of 2006 a decrease of 0.9% from 14.5% in the second quarter of 2005.

*Selling Expense.* Total selling expense was \$5.8 million in the second quarter of 2006, an increase of \$0.5 million, or 9.4%, as compared to \$5.3 million in the second quarter of 2005. Sales commissions and other compensation expenses contributed \$4.4 million to total selling expense during the second quarter of 2006, an increase of \$0.3 million, or 7.3%, compared to \$4.1 million in the second quarter of 2005. As a percentage of pre-need sales, sales commissions and other compensation expenses were 34.8% in the second quarter of 2006, essentially unchanged from the second of 2005.

*Cemetery Expense.* Cemetery expense was \$6.4 million in the second quarter of 2006, an increase of \$0.8 million, or 14.3%, as compared to \$5.6 million in the second quarter of 2005. This increase was primarily due to an increase in cemetery labor costs of \$0.4 million and an increase in cemetery maintenance and supplies of \$0.2 million.

*General and Administrative Expense.* General and administrative expense was \$3.1 million in the second quarter of 2006, an increase of \$0.6 million, or 24.0%, as compared to \$2.5 million in the second quarter of 2005. The increase was primarily attributable to an increase in office salaries of \$0.2 million and an increase in insurance costs of \$0.2 million.

*Funeral Home Revenues and Expense.* Funeral home revenues were \$1.1 million in the second quarter of 2006, an increase of \$0.6 million, or 120.0%, as compared to \$0.5 million in the second quarter of 2005. The primary reason for the increase was an increase in the number of services performed, 392 in the second quarter of 2006 compared to 153 in the second quarter of 2005. Funeral home expenses were \$1.0 million in the second quarter of 2006, an increase of \$0.6 million, or 150.0%, as compared to \$0.4 million in the second quarter of 2005. The majority of all increases in funeral home revenue and expenses are attributable to our November, 2005 acquisition of 6 funeral homes.

*Corporate Overhead.* Corporate overhead was \$4.4 million in the second quarter of 2006, an increase of \$0.9 million, or 25.7%, as compared to \$3.5 million in the second quarter of 2005. The increase is primarily related to \$0.9 million in increased professional fees related to the restatement of our 2005 quarterly reports and material weakness disclosed in our 2005 10-k.

*Depreciation and Amortization.* Depreciation and amortization was \$0.9 million in the second quarter of 2006, essentially unchanged from the second quarter of 2005.

*Interest Expense.* Interest expense was \$1.8 million in the second quarter of 2006, an increase of \$0.2 million, or 12.5%, as compared to \$1.6 million in the second quarter of 2005. This increase is attributable to \$10.2 million increase in debt outstanding at June 30, 2006.

*Provision (Benefit) for Income Taxes.* Provision for income taxes was \$0.2 million in the second quarter of 2006 as compared to a provision for income taxes of \$0.3 million during the second quarter of 2005. The change in provision for income taxes was primarily due to the decrease in operating profit attained during the second quarter of 2006.

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*Net Income(Loss).* Net income was \$1.1 million during the second quarter of 2006, an increase of \$0.2 million, as compared to net income of \$1.4 million during the second quarter of 2005. The increase in net income was primarily attributable to the \$0.9 million we spent on professional fees for the restatement of our 2005 quarterly financial statements, partially offset by the contribution of the new locations we added in our November, 2005 acquisition.

*Deferred Cemetery Revenue, net.* Deferred cemetery revenues, net, increased \$1.2 million, or 0.7% in the second quarter of 2006, from \$173.0 million as of March 31, 2006 to \$174.2 million at June 30, 2006. In the comparable period in 2005, deferred cemetery revenues, net, increased \$2.4 million, or 1.5%, from \$156.4 million as of March 31, 2005 to \$156.8 million as of June 30, 2005. The net increase in the quarter ended June 30, 2006 was primarily attributable to an increase in sales of pre-need cemetery products and services that were not delivered or performed in the quarter ended June 30, 2006. In the three months ended June 30, 2006, we added \$11.6 million in pre-need sales of cemetery merchandise and services, net of deferred costs and cancellations, to our pre-need sales backlog which was offset by revenues recognized, net of costs, of \$9.7 million, including accumulated merchandise trust earnings related to the delivery and performance of pre-need cemetery merchandise and services. In the three months ended June 30, 2005, we added \$11.4 million in pre-need sales of cemetery merchandise and services, net of deferred costs and cancellations, to our pre-need sales backlog which was offset by revenues recognized, net of costs, of \$8.2 million, including accumulated merchandise trust earnings related to the delivery and performance of pre-need cemetery merchandise and services.

### **Six Months Ended June 30, 2006 versus Six Months Ended June 30, 2005**

*Cemetery Revenues.* Cemetery revenues were \$52.4 million in the first half of 2006, an increase of \$7.4 million, or 16.4%, as compared to \$45.0 million in the first half of 2005. Of that increase, \$3.9 million or 52.7%, is related to our November 2005 acquisition of 22 cemeteries from Service Corporation International. Cemetery revenues from pre-need sales, including interest income from pre-need installment contracts and investment income from trusts, were \$32.4 million in the first half of 2006, an increase of \$3.9 million, or 13.6%, as compared to \$28.7 million in the first half of 2005. The increase primarily resulted from additional mausoleum deliveries (\$1.1 million), additional lot sales (\$1.0 million), additional vault deliveries (\$2.6 million), additional marker and marker base sales (\$0.7 million), and additional document fees (\$0.4 million). These increases were partially offset by a decrease in the delivery of caskets (\$2.2 million). An additional contribution to the increase in cemetery revenues from pre-need sales was higher accumulated earnings from merchandise trusts allocated to the pre-need products delivered during the first half of 2006. Total revenues from merchandise and perpetual care trusts for the first half of 2006 were higher by \$0.2 million than the same period in 2005.

Cemetery revenues from at-need sales in the first half of 2006 were \$18.6 million, an increase of \$2.9 million, or 18.5%, as compared to \$15.7 million in the first half of 2005. The increase in cemetery revenues from at-need sales was primarily attributable to higher sales of monument bases and markers of \$1.0 million and higher sales of at-need interment rights of \$1.7 million.

Other cemetery revenues were \$1.3 million in the first half of 2006, an increase of \$0.6 million, or 85.7%, from \$0.7 million in the first half of 2005. The increase in other cemetery revenues was primarily attributable to an increase in sales of undeveloped land for net proceeds of \$0.5 million.

*Costs of Goods Sold.* Cost of goods sold was \$7.1 million in the first half of 2006, an increase of \$0.7 million, or 10.9%, as compared to \$6.4 million in the first half of 2005. Of that increase, \$0.6 million or 85.7%, is related to our November 2005 acquisition of 22 cemeteries from Service Corporation International. As a percentage of cemetery revenues, cost of goods sold decreased to 13.5% in the first half of 2006 from 14.2% in the first half of 2005. The decrease in cost of goods sold as a percentage of cemetery revenue was attributable to the increase in mausoleum and interment sales in the first half of 2006 that produce an increased gross margin.

*Selling Expense.* Total selling expense was \$11.4 million in the first half of 2006, an increase of \$1.9 million or 20.0%, as compared to \$9.5 million in the first half of 2005. Of that increase, \$1.3 million, or 68.4%, is related to our November 2005 acquisition of 22 cemeteries from Service Corporation International. Sales commissions and other compensation expenses contributed \$8.7 million to total selling expense during the first half of 2006, an increase of \$1.3 million, or 17.6%, compared to \$7.4 million in the first half of 2005. As a percentage of pre-need sales, sales commissions and other compensation expenses were 36.9% in the first half of 2006, as compared to 38.9% in the first half of 2005.

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*Cemetery Expense.* Cemetery expense was \$12.0 million in the first half of 2006, an increase of \$1.7 million, or 16.5%, as compared to \$10.3 million in the first half of 2005. Of that increase, \$1.5 million, or 88.2%, is related to our November 2005 acquisition of 22 cemeteries from Service Corporation International.

*General and Administrative Expense.* General and administrative expense was \$6.2 million in the first half of 2006 an increase of \$1.3 million or 26.5%, as compared to \$4.9 million in the first half of 2005. Of that increase, \$1.2 million, or 100.0%, is related to our November 2005 acquisition of 22 cemeteries from Service Corporation International.

*Funeral Home Revenues and Expense.* Funeral home revenues were \$2.6 million in the first half of 2006, an increase of \$1.4 million, or 116.7%, as compared to \$1.2 million in the first half of 2005. The primary reason for the increase was an increase in the number of services performed, 734 in the first half of 2006 compared to 342 in the first half of 2005. Funeral home expenses were \$2.1 million in the first half of 2006, an increase of \$1.2 million or 133.3%, as compared to \$0.9 million in the first half of 2005. The majority of all increases in funeral home revenue and expenses are attributable to our November, 2005 acquisition of 6 funeral homes.

*Corporate Overhead.* Corporate overhead was \$8.2 million in the first half of 2006, an increase of \$1.6 million, or 24.2%, as compared to \$6.6 million in the first half of 2005. The increase is primarily related to \$0.9 million in increased professional fees related to the restatement of our 2005 quarterly reports and an increase of \$0.6 million in corporate salaries.

*Depreciation and Amortization.* Depreciation and amortization was \$1.8 million in the first half of 2006, a decrease of \$0.1 million, or 5.3%, as compared to \$1.9 million in the first half of 2005.

*Interest Expense.* Interest expense was \$3.5 million in the first half of 2006, an increase of \$0.3 million, or 9.4%, as compared to \$3.2 million in the first half of 2005. This increase is attributable to an increase in outstanding borrowings on our acquisition line of credit of \$5.3 million and an increase in borrowings on our revolving line of credit of \$4.9 million.

*Provision (Benefit) for Income Taxes.* Provision for income taxes was \$0.7 million in the first half of 2006 as compared to a provision for income taxes of \$0.5 million during the first half of 2005. The change in provision for income taxes was primarily due to the increase in operating profit attained during the first half of 2006.

*Net Income(Loss).* Net income was \$2.1 million during the first half of 2006, an increase of \$0.1 million, or 6.0%, as compared to net income of \$2.0 million during the first half of 2005. The increase in net income was primarily attributable to the contribution of the new locations we added in our November, 2005 acquisition, partially offset by the \$0.9 million we spent on professional fees for the restatement of our 2005 quarterly financial statements

*Deferred Cemetery Revenue.* Deferred cemetery revenues, net, increased \$6.4 million, or 3.8% in the first half of 2006, from \$167.8 million as of December 31, 2005 to \$174.2 million as of June 30, 2006. In the comparable period in 2005, deferred cemetery revenues, net, increased \$2.8 million, or 1.8% in the first half of 2005, from \$156.0 million as of December 31, 2004 to \$158.8 million as of June 30, 2005. The net increase in the first half of 2006 was primarily attributable to an increase in sales of pre-need cemetery products and services that were not delivered or performed in the first half of 2006. We added \$26.2 million in pre-need sales of cemetery merchandise and services, net of deferred costs and cancellations, to our pre-need sales backlog during the first half of 2006 as compared to \$21.7 million added during the first half of 2005. These increases were offset by revenues recognized, net of costs, of \$18.6 million, including accumulated merchandise trust earnings, during the first half of 2006 related to the delivery and performance of pre-need cemetery merchandise and services as compared to \$16.3 million of revenues recognized in the first half of 2005.

## **Liquidity and Capital Resources**

*Overview.* Our primary short-term operating liquidity needs are to fund general working capital requirements and maintenance capital expenditures. Our long-term operating liquidity needs are primarily associated with acquisitions of cemetery properties and the construction of mausoleum crypts and lawn crypts on the grounds of our cemetery properties. We may also construct funeral homes on the grounds of cemetery properties that we

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acquire in the future. Our primary source of funds for our short-term liquidity needs will be cash flow from operations and income from perpetual care trusts. Our primary source of funds for long-term liquidity needs will be long-term bank borrowings and the issuance of additional common units and other partnership securities, including debt, subject to the restrictions in our credit facility and under our senior secured notes.

We believe that cash generated from operations and our borrowing capacity under our credit facility, which is discussed below, will be sufficient to meet our working capital requirements, anticipated capital expenditures and scheduled debt payments for the foreseeable future. In 2006, we anticipate that we will spend \$2.8 million for the construction of mausoleums. Additionally, we anticipate ongoing annual capital expenditure requirements of between approximately \$1.7 million and \$2.9 million for the foreseeable future, of which between \$1.1 million and \$2.1 million is for maintenance of our existing cemeteries and between \$0.6 million and 0.8 million is for mausoleum and lawn crypt construction and other expansion after 2006, excluding acquisitions. The estimate for cemetery maintenance capital expenditures would increase if we were to acquire additional cemetery properties.

One of our goals is to grow through the acquisition of high-quality cemetery properties. On November 1, 2005, StoneMor acquired 22 cemeteries and six funeral homes from Service Corporation International (NYSE: SCI) for \$12.9 million. StoneMor paid \$7.0 million in cash and 280,952 StoneMor Limited Partner units, representing the additional \$5.9 million. In addition, StoneMor assumed the merchandise and service liabilities associated with certain pre-arranged bonded contracts related to the properties. We anticipate financing future acquisitions with the proceeds of borrowings under our credit facility or the issuance of additional common units and other partnership securities, including debt, to the extent permitted under our credit facility, the senior secured notes and our partnership agreement.

Our ability to satisfy our debt service obligations, fund planned capital expenditures, make acquisitions and pay distributions to partners will depend upon our future operating performance. Our operating performance is primarily dependent on the sales volume of customer contracts, the cost of purchasing cemetery merchandise that we have sold, the amount of funds withdrawn from merchandise trusts and perpetual care trusts and the timing and amount of collections on our pre-need installment contracts.

*Cash Flow from Operating Activities.* Cash flows provided by operating activities were \$5.5 million in the first half of 2006 compared to cash flows provided by operating activities of \$7.2 million during the first half of 2005. Cash flows provided by operating activities in the first half of 2006 decreased from the cash flows provided by operating activities in the first half of 2005 primarily due to cash distributed from and used to fund our merchandise trust funds. During the first half of the year, one of our cemetery merchandise suppliers was retooling its production facility and did not make shipments until June. This decreased the amount of cash flow we received as the result of servicing some of our pre-need products by approximately \$2.4 million. Additionally, we used approximately \$1.6 million in cash to reduce our outstanding accounts payable and accrued liabilities and paid approximately \$0.6 million in expenses related to the restatement of our 2005 quarterly financial statements. This decrease in cash flows from operating activities was partially offset by increased net income earned during the first half of 2006 and increases in merchandise liability related to the preceding factors.

*Cash Flow from Investing Activities.* Net cash used in investing activities was \$2.8 million in the first six months of 2006, a decrease of \$1.0 million, as compared to cash used in investing activities of \$3.8 million in the first six months of 2005. This decrease was primarily attributable to \$2.1 million provided from the divestiture of one of our funeral home locations, partially offset by increased capital expenditures related to mausoleum construction of \$1.0 million.

*Cash Flow from Financing Activities.* Net cash used in financing activities was \$4.8 million in the first six months of 2006 as compared to cash used in financing activities of \$7.0 million in the first six months of 2005. The cash flow used in financing activities in 2006 was primarily attributable to the February and May unit holder distributions of \$8.5 million partially offset by increased borrowings from our revolving credit facility of \$3.7 million. The cash flow used in financing activities in 2005 was primarily attributable to the February and May unit holder distributions of \$8.4 million partially offset by increased borrowings from our revolving credit facility of \$1.6 million.

*Credit Facility.* Concurrent with the closing of our initial public offering in September 2004, StoneMor Operating LLC, which is our operating company, and its present and future subsidiaries, all as borrowers, entered into a new \$35.0 million credit agreement. The credit agreement consists of a \$12.5 million revolving credit facility and a \$22.5 million acquisition line of credit. Borrowings under our revolving credit facility are due and payable three years after the date of the credit agreement, and borrowings under the acquisition facility are due and payable four years after the date of the credit agreement. We may prepay all loans under the credit agreement at any time without penalty, although our acquisition line may be subject to hedging arrangements with attendant termination fees. Any amounts repaid on the acquisition line cannot be reborrowed. We are required to reduce borrowings under

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our revolving credit facility that are designated for the purpose of funding a regularly scheduled quarterly distribution to the unitholders to not more than \$5.0 million for a period of at least 30 consecutive days at least once during each consecutive 12-month period prior to the maturity of the revolving credit facility. As of June 30, 2006, we had outstanding borrowings of \$4.9 million under our revolving credit line. As of June 30, 2006, we had \$5.25 million outstanding under our acquisition line of credit that we borrowed for the acquisition of 22 cemeteries and 6 funeral homes from Service Corporation International in November 2005.

The revolving credit facility is available for ongoing working capital needs, capital expenditures, distributions and general partnership purposes. Amounts borrowed and repaid under the revolving credit facility may be borrowed in an amount that does not exceed 80% of our eligible accounts receivable. Eligible accounts receivable are defined as gross accounts receivable represented by approved installment agreements for pre-need sales net of collection reserves, imputed interest earnings, funds due to perpetual care and merchandise trusts, unpaid sales commissions and other reserves as may be required by the agent for the lenders.

The acquisition facility is available to finance acquisitions of companies in our line of business that have been approved by our board of directors. We are required to obtain the approval of the requisite lenders for any acquisition exceeding \$2.5 million and for any series of acquisitions exceeding \$20.0 million in any consecutive 12 months, but this consent may not be unreasonably withheld. Interest under the acquisition facility is payable quarterly for the first 12 months after each borrowing. We will repay the then outstanding borrowings in equal quarterly installments based on a six-year amortization schedule, with the first quarterly principal payment beginning 15 months after each borrowing and subsequent quarterly principal payments continuing on each 3 month interval from the previous quarterly principal payment and with a balloon payment for any unpaid amount due at the maturity of the acquisition facility.

Borrowings under the credit agreement rank pari passu with all of our other senior secured debt, including the senior secured notes issued concurrently with our initial public offering, subject to the description of the collateral securing the credit agreement described below. Borrowings under the credit agreement are guaranteed by the partnership and our general partner.

Our obligations under the revolving facility are secured by a first priority lien and security interest in specified receivable rights, whether then owned or thereafter acquired, of the borrowers and the guarantors and by a second priority lien and security interest in substantially all assets other than those receivable rights of the borrowers and the guarantors, excluding trust accounts and certain proceeds required by law to be placed into such trust accounts and funds held in trust accounts, our general partner's general partner interest in the partnership and our general partner's incentive distribution rights under our partnership agreement. These assets will secure the acquisition facility and our senior secured notes, as described below and under Senior Secured Notes. The specified receivable rights include all accounts and other rights to payment arising under customer contracts or agreements (other than amounts required to be deposited into merchandise and perpetual care trusts) or management agreements, and all inventory, general intangibles and other rights reasonably related to the collection and performance of these accounts and rights to payment.

Our obligations under the acquisition facility are secured by a first priority lien and security interest in substantially all assets, whether then owned or thereafter acquired, other than specified receivable rights of the borrowers and the guarantors, excluding trust accounts and certain proceeds required by law to be placed into such trust accounts and funds held in trust accounts, our general partner's general partner interest in the partnership and our general partner's incentive distribution rights under our partnership agreement, and a secondary priority lien and security interest in those specified receivable rights of the borrowers and the guarantors. The senior secured notes will share pari passu in the collateral securing the acquisition facility.

Depending on the type of loan, indebtedness outstanding under the revolving credit facility bears interest at a rate based upon the Base Rate or the Eurodollar Rate plus an applicable margin ranging from 0.00% to 1.00% and 2.50% to 3.50% per annum, respectively, depending on our ratio of total debt to consolidated cash flow. The Base Rate is the higher of the federal funds rate plus .050% or the prime rate announced by Fleet National Bank, a Bank of America company. The Eurodollar Rate is to be determined by the administrative agent according to the new credit agreement. The interest will be determined and payable quarterly. We incur commitment fees ranging from 0.375% to 0.500% per annum, depending on our ratio of total debt to consolidated cash flow, determined and payable quarterly based on the unused amount of the credit facilities.

We are required to use the net cash proceeds from the sale of any assets, the incurrence of any indebtedness or the issuance of any equity interests in the partnership or any subsidiary of the partnership to repay amounts outstanding under the credit agreement and our senior secured notes, pro rata based on the percentage share of the aggregate amounts outstanding, provided that we may use the proceeds from the sale of any assets to purchase capital assets or fund permitted acquisitions within 180 days of such sale and we may use the proceeds from any

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issuance of equity interests by the partnership to fund permitted acquisitions to the extent such equity interests are issued in connection with a permitted acquisition that is completed within 180 days before or after the receipt of such proceeds.

The credit agreement prevents us from declaring dividends or distributions if any event of default, as defined in the new credit agreement, occurs or would result from such declaration. The following will be an event of default under the credit agreement:

failure to pay any principal, interest, fees, expenses or other amounts when due;

failure of any of our representations and warranties to be materially correct;

failure to observe any covenant included in the credit agreement beyond specified cure periods in specified cases;

the occurrence of a default under other indebtedness of the partnership, our general partner, our operating company or any of our other subsidiaries;

the occurrence of specified bankruptcy or insolvency events involving the partnership, our operating company, our general partner or our other subsidiaries;

a change of control; or

the entry of judgments against the partnership, our general partner, our operating company or any of our other subsidiaries in excess of certain allowances.

Change of control is defined in the credit agreement as the occurrence of any of the following events:

any two of our chairman, chief executive officer or chief financial officer on the date of the credit agreement cease to hold such positions unless approved by the lenders under the credit agreement;

any person or group that did not hold any equity interests in the general partner or the partnership on the date of the credit agreement acquires 20% or more of the equity interests in the partnership or the general partner;

the general partner ceases to be our sole general partner;

the partnership ceases to own 100% of the operating company; or

the operating company ceases to own 100% of the other borrowers.

The credit agreement contains financial covenants requiring us to maintain, on a rolling four-quarter basis:

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a ratio of consolidated cash flow, as defined in the credit agreement, to consolidated interest expense of not less than 3.5 to 1.0 for the four most recent quarters;

a ratio of total funded debt on the last day of each quarter to consolidated cash flow of not more than 3.5 to 1.0 for the four most recent quarters (except as described below); and

consolidated cash flow of at least \$21.0 million. Our minimum consolidated cash flow will be increased by 80% of any consolidated cash flow acquired in an acquisition.

The credit agreement was amended in November 2004 to amend the leverage ratio from 3.5 to 1 to 3.75 to 1 until September 30, 2005 at which time it reverted back to 3.5 to 1. In March 2006, we received a waiver which extended the time allowed to meet the requirement that we deliver 2005 annual audited financial statements within 95 days of 2005 fiscal year end to 155 days from 2005 fiscal year end. We delivered the 2005 audited financial statements on May 15, 2006, within the extended deadline. As of June 30, 2006, the Company was in compliance with all debt covenants.

For purposes of determining our compliance with the covenants described above, total funded debt includes all indebtedness for borrowed money (except that if we reduce borrowings under our revolving credit facility that are designated for the purpose of funding a regularly scheduled quarterly distribution to unitholders to not more than \$5.0 million for a period of at least 30 consecutive days at least once during each consecutive 12-month period prior to the maturity of the revolving credit facility, then the amount of outstanding revolving loans to be included in total funded debt will be an amount not to exceed \$5.0 million), purchase money indebtedness, obligations under letters of credit, capitalized leases, if any, and the deferred purchase price of any property or services. Consolidated cash flow is based on our adjusted EBITDA and is defined in the credit agreement as net income plus, among other things:

interest expense;

taxes;

depreciation and amortization;

non-cash cost of land and crypts;

extraordinary losses;

other non-cash items;

increase (decrease) in deferred cemetery revenues, net (excluding deferred margin);

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increase (decrease) in accounts receivable;

increase (decrease) in merchandise liability; and

increase (decrease) in merchandise trust (excluding any change in trust income receivable).

Consolidated cash flow is adjusted to exclude, among other things, extraordinary gains, gains from sales of assets outside the ordinary course of business and non-cash items.

The credit agreement limits the ability of the partnership, our general partner, our operating company and any of our other subsidiaries, among other things, to:

enter into a new line of business;

enter into any agreement of merger or acquisition;

sell, transfer, assign or convey assets;

grant certain liens;

incur or guarantee additional indebtedness;

make certain loans, advances and investments;

declare and pay dividends and distributions;

enter into certain leases;

enter into transactions with affiliates; and

make voluntary payments or modifications of indebtedness.

*Senior Secured Notes.* Concurrent with the closing of our initial public offering, StoneMor Operating LLC and its existing subsidiaries issued and sold \$80.0 million in aggregate principal amount of senior secured notes. The net proceeds of the senior secured notes were used to repay a portion of our then existing indebtedness.

The senior secured notes rank pari passu with all of our other senior secured debt, including the revolving credit facility and the acquisition facility, subject to the description of the collateral securing the senior secured notes described below. The senior secured notes are guaranteed by the partnership, our general partner and any future subsidiaries of our operating company. Obligations under the senior secured notes are secured by a first priority lien and security interest covering substantially all of the assets of the issuers, whether then owned or thereafter acquired, other than specified receivable rights, excluding trust accounts and certain proceeds required by law to be placed in such trust accounts and funds held

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in trust accounts, our general partner's general partner interest in the Partnership and our general partner's incentive distribution rights under our partnership agreement, and a second priority lien and security interest covering those specified receivable rights, each as described above, of the issuers and the guarantors, whether then owned or thereafter acquired.

The senior secured notes mature on September 20, 2009 and bear interest at a rate of 7.66% per annum. Interest on the senior secured notes is payable quarterly, commencing on December 20, 2004. There will be no principal amortization prior to the final maturity of the senior secured notes.

The senior secured notes are redeemable, at our option, at any time in whole or in part at a make-whole premium. The make-whole premium is calculated on the basis of a discount rate equal to the yield on the U.S. treasury notes having a constant maturity comparable to the remaining term of the senior secured notes, plus 100 basis points. The senior secured notes are not subject to any sinking fund provisions.

The senior secured notes limit the ability of the partnership, our general partner, our operating company and any of our other subsidiaries, among other things, to:

enter into a new line of business;

enter into any agreement of merger or acquisition;

sell, transfer, assign or convey assets;

grant certain liens;

incur or guarantee additional indebtedness;

make certain loans, advances and investments;

declare and pay dividends and distributions;

enter into certain leases;

enter into transactions with affiliates; and

make voluntary payments or modifications of indebtedness.

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The note purchase agreement also contains financial covenants requiring us to maintain, on a rolling four-quarter basis:

a ratio of consolidated cash flow, as defined in the note purchase agreement, to consolidated interest expense of not less than 3.5 to 1.0 for the four most recent quarters;

a ratio of total funded debt on the last day of each quarter to consolidated cash flow of not more than 3.5 to 1.0 for the four most recent quarters (except as described below); and

consolidated cash flow of at least \$21.0 million. Our minimum consolidated cash flow will be increased by 80% of any consolidated cash flow acquired in an acquisition.

The note purchase agreement was amended in November 2004 to amend the leverage ratio from 3.5 to 3.75 to 1 until September 30, 2005 at which time it reverted back to 3.5 to 1.

For purposes of determining our compliance with the covenants described above, total funded debt and consolidated cash flow are defined in the note purchase agreement in the same manner as they are defined in our new credit agreement.

Each of the following is an event of default under the note purchase agreement:

failure to pay any principal, interest, fees, expenses or other amounts when due;

failure of any of our representations and warranties to be materially correct;

failure to observe any covenant included in the note purchase agreement beyond specified cure periods in specified cases;

the occurrence of a default under other indebtedness of the partnership, our general partner, our operating company or any of our other subsidiaries;

the occurrence of specified bankruptcy or insolvency events involving the partnership, our operating company, our general partner or our other subsidiaries;

a change of control; or

the entry of judgments against the partnership, our general partner, our operating company or any of our other subsidiaries in excess of certain allowances.

Change of control is defined as the occurrence of any of the following events:

any two of our chairman, chief executive officer or chief financial officer on the closing date of the senior secured notes offering cease to hold such positions unless approved by the requisite noteholders;

any person or group that did not hold any equity interests in the general partner or the partnership on the closing date of the senior secured notes offering acquires 20% or more of the equity interests in the partnership or the general partner;

the general partner ceases to be our sole general partner;

the partnership ceases to own 100% of the operating company; or

the operating company ceases to own 100% of the other borrowers.

The initial offering of the senior secured notes was not registered under the Securities Act, and the senior secured notes may not be resold absent registration or an available exemption from the registration requirements of the Securities Act. The holders of the senior secured notes do not have registration rights. The senior secured notes are not listed or quoted on any national securities exchange or association.

*Intercreditor and Collateral Agency Agreement.* In connection with the closing of the credit facility and the private placement of the senior secured notes, our general partner, the partnership, our operating company, our other subsidiaries, the lenders under the new credit facility, the holders of the senior secured notes and Fleet National Bank, as collateral agent, entered into an intercreditor and collateral agency agreement setting forth the rights and obligations of the parties to the agreement as they relate to the collateral securing the new credit facility and the senior secured notes.

#### *Capital Expenditures*

The following table summarizes total maintenance capital expenditures and expansion capital expenditures, including for the construction of mausoleums and for acquisitions, for the periods presented (in thousands):

|                                  | Six Months Ended |          |
|----------------------------------|------------------|----------|
|                                  | 2005             | 2006     |
| Maintenance capital expenditures | \$ 1,628         | \$ 1,527 |
| Expansion capital expenditures   | 2,158            | 3,352    |
| Total capital expenditures       | \$ 3,786         | \$ 1,800 |

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Pursuant to our partnership agreement, in connection with determining operating cash flows available for distribution, costs to construct mausoleum crypts and lawn crypts may be considered to be a combination of maintenance capital expenditures and expansion capital expenditures depending on the purposes for construction. Our general partner, with the concurrence of its conflicts committee, has the discretion to determine how to allocate a capital expenditure for the construction of a mausoleum crypt or a lawn crypt between maintenance capital expenditures and expansion capital expenditures. In addition, maintenance capital expenditures for the construction of a mausoleum crypt or a lawn crypt are not subtracted from operating surplus in the quarter incurred but rather are subtracted from operating surplus ratably during the estimated number of years it will take to sell all of the available spaces in the mausoleum or lawn crypt. Estimated life is determined by our general partner, with the concurrence of its conflicts committee.

*Seasonality.* The death care business is relatively stable and predictable. Although we experience seasonal increases in deaths due to extreme weather conditions and winter flu, these increases have not historically had any significant impact on our results of operations. In addition, we perform fewer initial openings and closings in the winter when the ground is frozen.

### **Item 3. Quantitative and Qualitative Disclosure About Market Risk**

The information presented below should be read in conjunction with the notes to our unaudited condensed consolidated financial statements included under Item 1 Financial Statements.

The market risk inherent in our market risk sensitive instruments and positions is the potential change arising from increases or decreases in interest rates and the prices of marketable equity securities, as discussed below. Our exposure to market risk includes forward-looking statements and represents an estimate of possible changes in fair value or future earnings that would occur assuming hypothetical future movements in interest rates or equity markets. Our views on market risk are not necessarily indicative of actual results that may occur and do not represent the maximum possible gains and losses that may occur, since actual gains and losses will differ from those estimated, based on actual fluctuations in interest rates, equity markets and the timing of transactions. We classify our market risk sensitive instruments and positions as other than trading.

*Interest-bearing Investments.* Our fixed-income securities subject to market risk consist primarily of investments in merchandise trusts and perpetual care trusts. As of June 30, 2006, fixed-income securities represented 44.0% of the funds held in merchandise trusts and 58.7% of the funds held in perpetual care trusts. The aggregate quoted market value of these fixed-income securities was \$50.2 million and \$82.7 million in merchandise trusts and perpetual care trusts, respectively, as of June 30, 2006. Each 1% change in interest rates on these fixed-income securities would result in changes of approximately \$0.5 million and \$0.8 million in the fair market values of the securities held in merchandise trusts and perpetual care trusts, respectively, based on discounted expected future cash flows. If these securities are held to maturity, no change in fair market value will be realized.

Our money market and other short-term investments subject to market risk consist primarily of investments held in merchandise trusts and perpetual care trusts. As of June 30, 2006, these investments accounted for approximately 9.9% and 11.6% of the funds held in merchandise trusts and perpetual care trusts, respectively. The fair market value of these investments was \$11.3 million and \$16.3 million in merchandise trusts and perpetual care trusts, respectively, as of June 30, 2006. Each 10% change in average interest rates applicable to these investments would result in changes of approximately \$1.1 million and \$1.6 million, respectively; in the aggregate fair market values of the perpetual care investments and the merchandise trust investments.

*Marketable Equity Securities.* Our marketable equity securities subject to market risk consist primarily of investments held in merchandise trusts and in the case of perpetual care trusts, investments in real estate investment trusts, or REITs. As of June 30, 2006, marketable equity securities represented 46.1% of funds held in merchandise trusts and 29.7% of funds held in perpetual care trusts. The aggregate fair market value of these marketable equity securities was \$52.6 million and \$41.9 million in merchandise trusts and perpetual care trusts, respectively, as of June 30, 2006, based on final quoted sales prices. Each 10% change in the average market prices of the equity securities would result in a change of approximately \$5.3 million and \$4.2 million in the fair market value of securities held in merchandise trusts and perpetual care trusts, respectively.

*Investment Strategies and Objectives.* Our internal investment strategies and objectives for funds held in merchandise trusts and perpetual care trusts are specified in an Investment Policy Statement which requires us to do the following:

State in a written document our expectations, objectives, tolerances for risk and guidelines in the investment of our assets;



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Set forth a disciplined and consistent structure for managing all trust assets. This structure is based on a long-term asset allocation strategy, which is diversified across asset classes, investment styles and strategies. We believe this structure is likely to meet our stated objectives within our tolerances for risk and variability. This structure also includes ranges around the target allocations allowing for adjustments when appropriate to reduce risk or enhance returns. It further includes guidelines for the selection of investment managers and vehicles through which to implement the investment strategy;

Provide specific guidelines for each investment manager. These guidelines control the level of overall risk and liquidity assumed in their portfolio;

Appoint third-party investment advisors to oversee the specific investment managers and advise our Trust and Compliance Committee; and

Establish criteria to monitor, evaluate and compare the performance results achieved by the overall trust portfolios and by our investment managers. This allows us to compare the performance results of the trusts to our objectives and other benchmarks, including our peers, on a regular basis.

Our investment guidelines are based on relatively long investment horizons, which vary with the type of trust. Because of this, interim fluctuations should be viewed with appropriate perspective. The strategic asset allocation of the trust portfolios is also based on this longer-term perspective. However, in developing our investment policy, we have taken into account the potential negative impact on our operations and financial performance of significant short-term declines in market value.

We recognize the challenges we face in achieving our investment objectives in light of the uncertainties and complexities of contemporary investment markets. Furthermore, we recognize that, in order to achieve the stated long-term objectives, we may have short-term declines in market value. Given the need to maintain consistent values in the portfolio, we have attempted to develop a strategy which is likely to maximize returns and earnings without experiencing overall declines in value in excess of 3% over any 12-month period.

In order to consistently achieve the stated return objectives within our tolerance for risk, we use a strategy of allocating appropriate portions of our portfolio to a variety of asset classes with attractive risk and return characteristics, and low to moderate correlations of returns. See the notes to our unaudited condensed consolidated financial statements for a breakdown of the assets held in our merchandise trusts and perpetual care trusts by asset class.

*Debt Instruments.* Our credit facility bears interest at a floating rate, based on LIBOR, which is adjusted quarterly. This credit facility will subject us to increases in interest expense resulting from movements in interest rates. As of June 30, 2006, we had outstanding borrowings of \$4.9 million under our revolving credit line. On November 1, 2005, we borrowed \$5.25 million from our acquisition line of credit to facilitate the consummation of the acquisition of 22 cemeteries and 6 funeral homes from Service Corporation International.

## **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 reports that the Company files or submits under the Securities Exchange Act of 1934 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(b). Based upon, and as of the date of this evaluation, the Chief Executive Officer and the Chief Financial Officer concluded that the Company's disclosure controls and procedures were effective to provide reasonable assurance that information the Company is required to disclose in its reports under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported accurately including, without limitation, ensuring that such information is accumulated and communicated to the Company's management as appropriate to allow timely decisions regarding required disclosure.



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### **Changes in Internal Control over Financial Reporting**

There have been no changes in the Company's internal control over financial reporting that occurred during the Company's last fiscal quarter ended June 30, 2006 that have materially affected, or are reasonably likely to materially affect, its internal control over financial reporting.

## **Part II Other Information**

### **Item 1. Legal Proceedings**

We and certain of our subsidiaries may from time to time be parties to legal proceedings that have arisen in the ordinary course of business. While the outcome of these proceedings cannot be predicted with certainty, management does not expect these matters to have a material adverse effect on our consolidated financial position, results of operations or cash flows.

We carry insurance that we believe to be adequate. Although there can be no assurance that such insurance is sufficient to protect us against all contingencies, management believes that our insurance protection is reasonable in view of the nature and scope of our operations.

### **Item 1A. Risk Factors**

In addition to the other information set forth in this quarterly report on Form 10-Q, you should carefully consider the factors discussed in Part I, Item 1A. Risk Factors in our Annual Report on Form 10-K for the fiscal year ended December 31, 2005, which could materially affect our business, financial condition or future results. The risk factors in our Annual Report on Form 10-K have not materially changed. The risks described in our Annual Report on Form 10-K, are not the only risks we face. Additional risks and uncertainties not currently known to us or that we currently deem to be immaterial also may materially adversely affect our business, financial condition and/or operating results.

This Quarterly Report on Form 10-Q contains forward-looking statements that involve risks and uncertainties. Our actual results could differ materially from those anticipated in the forward-looking statements as a result of many factors, including the risks faced by us described below and in our Annual Report on Form 10-K.

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

None.

### **Item 3. Defaults Upon Senior Securities.**

None.

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

None.

### **Item 5. Other Information.**

None.

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**Item 6. Exhibits**

The following documents are filed as exhibits to this quarterly report on Form 10-Q.

**Exhibit**

| <b>Number</b> | <b>Description</b>                                                                                                                                                                                                                            |
|---------------|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| 31.1          | Certification pursuant to Exchange Act Rule 13a-14(a) of Lawrence Miller, Chief Executive Officer, President and Chairman of the Board of Directors                                                                                           |
| 31.2          | Certification pursuant to Exchange Act Rule 13a-14(a) of William R. Shane, Executive Vice President and Chief Financial Officer                                                                                                               |
| 32.1          | Certification pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (18 U.S.C. § 1350) and Exchange Act Rule 13a-14(b) of Lawrence Miller, Chief Executive Officer, President and Chairman of the Board of Directors (furnished herewith) |
| 32.2          | Certification pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (18 U.S.C. § 1350) and Exchange Act Rule 13a-14(b) of William R. Shane, Executive Vice President and Chief Financial Officer (furnished herewith)                     |

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**SIGNATURES**

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

**STONEMOR PARTNERS L.P.**

By: StoneMor GP LLC  
its general partner

August 9, 2006

/s/ Lawrence Miller

Lawrence Miller  
Chief Executive Officer, President and Chairman of the Board of  
Directors (Principal Executive Officer)

August 9, 2006

/s/ William R. Shane

William R. Shane  
Executive Vice President and Chief Financial Officer (Principal  
Financial Officer)

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