

First Quarter Report

**Three Months Ended
January 31, 2004**



**ARBOR
MEMORIAL
SERVICES INC.**

Arbor Memorial Services Inc.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Three Months Ended January 31, 2004 Compared to Three Months Ended January 31, 2003

Results of Operations

Net earnings for the three months ended January 31, 2004, were \$4.7 million or \$0.45 per share. This represented an increase of \$1.0 million or 27.7% from net earnings of \$3.7 million or \$0.35 per share for the same period last year. The main reason for the increase was an improvement of \$1.3 million in earnings from operations in the funeral division.

Cemetery Segment

Cemetery sales for the first quarter increased by \$0.6 million or 2.9% to \$19.5 million over 2003. The increase was largely due to an increase in sales of crypts, deliveries of upright monuments sold on a pre-need basis and deliveries of services sold on an at-need basis.

Investment income increased by \$0.2 million or 8.0% to \$2.2 million, largely due to higher income on the care funds. The average balance of care funds for the first quarter of 2004 increased \$8.0 million or 6.8% from the same period last year, while the annualized return increased by 0.1 of a percentage point to 5.7%.

Cost of sales increased by \$0.3 million or 3.0%, largely due to the increase in sales. The gross margin percentage on cemetery sales for the quarter was consistent with the percentage in the first quarter of 2003. Selling expenses increased by \$0.1 million or 1.4% over the first quarter of 2003, mostly as a result of higher labour costs and employee benefits due to regular annual increases. Care and maintenance expenses increased by \$0.2 million or 4.5%, mostly due to higher labour costs including employee benefits. Earnings from cemetery operations increased marginally by 1.4% from the comparable prior year period.

In the first quarter of 2004, the number of interments performed by the Company increased by 278 or 6.9% to 4,280, the number of cremations increased by 282 or 8.0% to 3,791 and the amount of pre-need contracts written increased by \$0.8 million or 5.5% to \$14.6 million.

Funeral Segment

Funeral home sales for the first quarter of 2004 increased over the first quarter of 2003 by \$2.1 million or 9.6%. The increase in sales was the result of an improvement in the number of calls of 309 or 6.5% as well as an improvement in the average sale per funeral service performed of \$123 or 2.7%.

Investment income increased by \$0.1 million over the first quarter of 2003 to \$1.0 million. The increase was largely due to higher fees received from the deposit of pre-need funds under the Company's group annuity program.

Cost of sales increased by \$0.2 million or 5.4% in the quarter, largely due to the increase in sales. The gross margin on funeral sales for the quarter increased by 0.6 of a percentage point due to a change in the mix of sales and lower casket costs compared to last year. Other operating expenses increased by \$0.8 million or 6.1% due largely to an increase in services and administration costs. The majority of the increase in these expenses was due to higher bonus accruals as a result of the significantly improved earnings for the quarter.

Earnings from funeral operations increased by \$1.3 million or 17.7% to \$8.3 million. The increase was largely due to the growth in sales.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Corporate

Corporate revenue, which comprised rental income from leasing a portion of the Company's head office building for office or retail space and interest income on cash holdings and mortgages receivable, increased by \$0.2 million. This was due largely to interest received on a mortgage receivable that was established in the third quarter of 2003 as a result of the sale of land.

Corporate expenses increased by \$0.2 million or 7.6% to \$3.1 million. The increase was mostly attributable to the receipt of \$0.2 million from Service Corporation International in 2003 due to the settlement in the Company's favour of the costs of defending itself in a prior year's lawsuit. As a percentage of total Company revenue, corporate expenses increased from 6.4% for the first quarter of 2003 to 6.5% for the first quarter of 2004.

Interest Expense

Interest expense for the quarter ended January 31, 2004 decreased by \$0.2 million to \$1.1 million over the same quarter of 2003. The increase was due to a reduction in the average long-term debt balance outstanding for the period of \$13.6 million or 14.1% as a result of principal repayments on the bank term terms in the second half of 2003. The repayments were made possible by the sale of land in Markham, Ontario and the receipt of income taxes receivable related to prior years' reassessments. The average rate of interest on long-term debt for the quarter was 5.1%, which was the same percentage for the first quarter of 2003.

Income Taxes

The Company's effective tax rate decreased 1.2 percentage points, from 38.2% in the first quarter of 2003 to 37.0% in the same period of 2004. The decrease was mostly due to a reduction in the federal income tax rate.

Consolidated Balance Sheet

Key Financial Indicators

Changes to the key financial indicators since the end of the 2003 fiscal year follow:

- the current ratio increased to 3.08 from 2.35, largely due to a reduction of \$9.0 million in accounts payable and accrued liabilities;
- the debt to equity ratio decreased to 0.57:1 from 0.59:1;
- the long-term debt to EBITDA ratio decreased to 2.27 from 2.35; and
- the interest coverage ratio relative to earnings from operations before other income (expense) increased to 4.72 times from 4.35 times.

Accounts Receivable

Accounts receivable arising from at-need cemetery sales at January 31, 2004 represented 55 days of 2004 sales, compared to 60 days for the same period of 2003 and 51 days at October 31, 2003. Accounts receivable arising from at-need funeral sales at January 31, 2004 represented 33 days of 2004 sales, which was the same number of days for the accounts receivable balance at January 31, 2003. The comparable number at October 31, 2003 was 31.

Income Taxes Receivable

Income taxes receivable decreased by \$1.3 million to \$1.2 million at the end of the quarter as a result of the receipt of certain amounts related to prior years' income tax reassessments with respect to reserves claimed on the sale of interment rights.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Pre-Need Receivables and Deferred Revenue

Pre-need receivables increased by \$7.6 million since the end of fiscal 2003, while deferred revenue increased by \$6.8 million. The increase in both balances was largely due to contributions at a higher rate than the delivery of contracts at the time of need.

Accounts Payable and Accrued Liabilities

Accounts payable and accrued liabilities decreased by \$9.0 million from October 31, 2003 to January 31, 2004 due largely to higher trade payables, income taxes payable, accrued bonuses, accrued vacation pay and dividends at the end of the 2003 fiscal year.

Long-Term Debt

Long-term debt at the end of the period decreased by \$0.1 million from October 31, 2003, due to repayments on notes payable and the obligation under capital lease. The Company's long-term debt at January 31, 2004 consisted of \$81.1 million under the banks' revolving term loans and \$2.0 million of notes payable and the obligation under capital lease.

Consolidated Cash Flows

The Company had negative cash flow from operating activities for the first quarter of 2004 of \$0.7 million compared to negative cash flow of \$6.4 million for the same period of 2003. The \$5.7 million improvement was due to the following:

- an improvement in the net change in other operating balance sheet items of \$3.2 million;
- lower additions to developed land, crypts and niches of \$1.3 million; and
- higher net earnings after adjusting for non-cash items of \$1.2 million.

Of the \$3.2 million improvement in net change in other operating balance sheet items, \$1.3 million was due to the receipt of certain income tax balances owing from prior years and \$1.4 million was due to a decrease in merchandise inventories of \$0.5 million compared to an increase of \$0.9 million in the first quarter of 2003.

Cash used for investing activities was \$2.2 million in the first quarter of 2004, compared to \$1.4 million in the first quarter of 2003. The main reason for the increase was \$2.3 million in additions to fixed assets in 2004 compared to \$1.2 million in 2003. In the first quarter of 2004, the Company expended \$1.0 million to replace an existing funeral home in Richmond, British Columbia, \$0.5 million for the development of a reception centre at a cemetery in Oakville, Ontario and \$0.2 million for the development of a computer operating system.

Cash used for financing activities was \$0.8 million in both periods.

Arbor Memorial Services Inc.

UNAUDITED CONSOLIDATED STATEMENTS OF EARNINGS

	<i>Three Months Ended January 31</i>	
	2004	2003
	(\$000)	
Revenue		
Sales	43,673	41,005
Investment and other income	3,396	2,981
	47,069	43,986
Expenses		
Operating	35,500	33,872
General and administrative	3,051	2,835
	38,551	36,707
Earnings from operations before other income	8,518	7,279
Other income		
Gain on disposal of assets	23	4
	23	4
Earnings from operations	8,541	7,283
Interest expense	1,050	1,298
Earnings before income taxes	7,491	5,985
Income taxes (note 2)	2,770	2,289
Net earnings	4,721	3,696
Weighted average number of shares outstanding (in thousands)	10,595	10,595
Earnings per share - basic	\$ 0.45	\$ 0.35
Earnings per share - fully diluted	\$ 0.45	\$ 0.35

UNAUDITED CONSOLIDATED STATEMENTS OF RETAINED EARNINGS

	<i>Three Months Ended January 31</i>	
	2004	2003
Retained earnings - beginning of period	68,838	44,212
Net earnings for the period	4,721	3,696
Retained earnings - end of period	73,559	47,908

Arbor Memorial Services Inc.

UNAUDITED CONSOLIDATED BALANCE SHEETS

	<i>As at</i>	
	<i>January 31</i>	<i>October 31</i>
	<i>2004</i>	<i>2003</i>
	<i>(\$000)</i>	
Assets		
Current assets		
Cash	4,610	8,279
Accounts receivable	17,086	16,042
Merchandise inventories	9,685	10,136
Income taxes receivable	1,179	2,512
Pre-need receivables, current portion	37,909	38,325
	70,469	75,294
Pre-need receivables	416,112	408,132
Crypts and niches	29,617	30,653
Cemetery land	30,065	30,211
Fixed assets	149,262	148,997
Goodwill	44,765	44,765
Future income taxes	153	707
Mortgage receivable	13,753	13,761
Other assets	6,519	5,681
	760,715	758,201
Liabilities		
Current liabilities		
Accounts payable and accrued liabilities	20,145	29,186
Long-term debt, current portion	2,744	2,797
	22,889	31,983
Deferred revenue	504,474	497,627
Long-term debt	80,363	80,367
Other liabilities	6,931	6,887
	614,657	616,864
Shareholders' equity		
Share capital (note 4)	72,499	72,499
Retained earnings	73,559	68,838
	146,058	141,337
	760,715	758,201

Arbor Memorial Services Inc.

UNAUDITED CONSOLIDATED STATEMENTS OF CASH FLOWS

	<i>Three Months Ended</i>	
	<i>January 31</i>	
	<i>2004</i>	<i>2003</i>
	<i>(\$000)</i>	
Cash provided by (used for)		
Operating activities		
Net earnings	4,721	3,696
Add (deduct) items not affecting cash from operating activities:		
Depreciation and amortization	1,966	1,890
Gain on disposal of assets	(23)	(4)
Future income taxes	554	571
Additions to developed land, crypts and niches	(895)	(2,198)
Developed land, crypt and niche cost of sales	2,084	1,885
Net change in other operating balance sheet items	(9,061)	(12,231)
	(654)	(6,391)
Investing activities		
Additions to fixed assets	(2,276)	(1,247)
Additions to cemetery land held for future development	(8)	(18)
Acquisition (note 3)	-	(180)
Proceeds on disposal of assets	68	4
	(2,216)	(1,441)
Financing activities		
Repayments of long-term debt	(57)	(61)
Dividends	(742)	(742)
	(799)	(803)
Decrease in cash	(3,669)	(8,635)
Cash, beginning of period	8,279	7,609
Cash (bank indebtedness), end of period	4,610	(1,026)
Supplementary information		
Income taxes paid	6,270	1,746
Interest paid	1,064	1,309

UNAUDITED NOTES TO INTERIM CONSOLIDATED FINANCIAL RESULTS
Three Months Ended January 31, 2004

1. Basis of Preparation

The accompanying unaudited quarterly consolidated financial statements have been prepared in accordance with Canadian generally accepted accounting principles and consistent with the accounting policies used to prepare the 2003 annual consolidated financial statements. While management considers the interim disclosures presented to be adequate, these consolidated financial statements and notes should be read in conjunction with the Company's 2003 annual consolidated financial statements.

2. Income Taxes

The Company follows the asset and liability method of accounting for income taxes, whereby future income tax assets and liabilities are recognized for temporary differences between their accounting and tax bases. Future income tax assets and liabilities are measured using substantively enacted income tax rates expected to apply to taxable income in the years in which the temporary differences are expected to be recovered or settled. The effect on future income tax assets and liabilities of a change in tax rates is included in income in the period of substantive enactment.

The Company's income tax expense consisted of the following:

	January 31	
	2004	2003
	(\$000)	
Current tax expense	2,216	1,718
Future income tax expense relating to the origination and reversal of temporary differences	554	571
Income tax expense	2,770	2,289

The reconciliation of the Company's effective income tax rate follows:

	January 31	
	2004	2003
	%	%
Combined basic federal and provincial income tax rate	36.2	37.9
Increase (decrease) in the basic tax rate resulting from:		
Non-deductible amortization of excess of acquisition cost over book value	0.3	0.4
Large corporations tax	1.1	2.3
Non-deductible meals and entertainment expenses	0.5	0.5
Net earnings of associated corporations	(0.6)	(0.5)
Non-taxable dividends	(0.9)	(1.2)
Settlement of litigation costs ⁽¹⁾	-	(1.5)
Other items	0.4	0.3
Effective income tax rate	37.0	38.2

⁽¹⁾ For tax purposes, these costs were non-deductible in the year they were incurred.

3. Acquisitions and Dispositions

In the first three months of 2003, the Company acquired a flower shop for cash consideration of \$0.2 million. There were no acquisitions or dispositions in the first quarter of 2004 and no dispositions in the first quarter of 2003.

4. Share Capital

The Company's issued and outstanding share capital is as follows:

	January 31	
	2004	2003
Number of Class A Voting Shares	2,525,497	2,525,497
Number of Class B Non-Voting Shares	8,069,746	8,069,746
Shares issued and outstanding	10,595,243	10,595,243

There were no dilutive options outstanding during the current and prior periods.

Arbor Memorial Services Inc.

UNAUDITED NOTES TO INTERIM CONSOLIDATED FINANCIAL RESULTS
Three Months Ended January 31, 2004

5. Derivative Financial Instruments

Derivative financial instruments are utilized by the Company in the management of its interest rate exposure on long-term debt. The company does not enter into financial instruments for trading or speculative purposes. Interest rate swap agreements are used as part of the Company's program to manage the fixed and floating interest rate mix of the Company's total debt portfolio and overall cost of borrowing. The interest rate swap agreements involve the periodic exchange of payments without the exchange of the notional principal amount upon which the payments are based and are recorded as an adjustment of interest expense on the debt instrument. The related amount payable to or receivable from counter-parties is included as an adjustment to accrued interest.

As of January 31, 2004, the Company's use of interest rate swap agreements was limited to five (2003 - four) interest rate swaps with a Canadian chartered bank, whereby the Company has fixed a portion of its term loan financing at interest rates ranging from 4.6% to 6.2% plus a bank margin. At January 31, these swaps had a total notional amount of \$42.5 million (October 31, 2003 - \$43.8 million). Two of the swaps amortize quarterly on a straight-line basis and will be fully amortized in 2008, while the remaining swaps expire in 2006, 2007 and 2008. The swaps and other fixed rate debt represented 53% (October 31, 2003 - 55%) of the total amount of long-term debt outstanding.

The fair value of the swaps is estimated as the discounted unrealized gain or loss calculated based on the market price at January 31, 2003, which generally reflects the estimated amount that the Company would receive or pay to terminate the contracts at the balance sheet date. The estimated fair value of the interest rate swaps was a loss of \$2.5 million (October 31, 2003 - loss of \$2.1 million). Losses due to non-performance by the counter-party are not anticipated due to their high credit standing. Swap costs in the first quarter of 2004 were \$0.3 million (first quarter of 2003 - \$0.3 million).

All of the Company's interest rate swaps are designated as cash flow hedges. At January 31, 2004, the critical terms of the swaps did not match the terms of the underlying floating rate debt. Therefore, the hypothetical derivative method was used to perform a quantitative, retrospective assessment of the effectiveness of the swaps. This methodology involved regression analysis of historical interest rates for the floating rate portion of the swaps and historical interest rates for the underlying debt. The result of the analysis was that the fair value of the cash flows from the interest rates of the swaps were highly effective at offsetting the variability in cash flows from the interest rates of the underlying debt. Therefore, hedge accounting was afforded.

6. Segment Disclosure

	<i>Three Months Ended January 31 (\$'000)</i>							
	<i>Cemetery</i>		<i>Funeral</i>		<i>Corporate</i>		<i>Consolidated</i>	
	<i>2004</i>	<i>2003</i>	<i>2004</i>	<i>2003</i>	<i>2004</i>	<i>2003</i>	<i>2004</i>	<i>2003</i>
Sales	19,518	18,960	24,010	21,915	145	130	43,673	41,005
Investment and other income	2,169	2,009	1,037	947	190	25	3,396	2,981
	21,687	20,969	25,047	22,862	335	155	47,069	43,986
Interest expense	-	-	-	-	1,050	1,298	1,050	1,298
Depreciation	673	630	1,087	1,038	206	222	1,966	1,890
Earnings (loss) from operations before other income	2,928	2,891	8,306	7,068	(2,716)	(2,680)	8,518	7,279
Other income	8	4	15	-	-	-	23	4
Earnings from operations	2,936	2,895	8,321	7,068	(2,716)	(2,680)	8,541	7,283
Identifiable assets ⁽¹⁾	309,311	280,909	425,633	409,793	25,771	22,880	760,715	713,582
Capital expenditures	1,135	919	934	268	207	240	2,276	1,427
Cemetery land and crypt and niche additions	903	2,216	-	-	-	-	903	2,216
Pre-need contracts written	14,630	13,873	10,111	9,634	-	-	24,741	23,507

⁽¹⁾ Identifiable assets for 2003 were restated to conform with the current year's presentation.