

***First Quarter Report***

**Three Months Ended  
January 31, 2005**



**ARBOR**  
**MEMORIAL**  
SERVICES INC.



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## **MANAGEMENT'S DISCUSSION AND ANALYSIS**

Management's Discussion and Analysis has been prepared for the three months ended January 31, 2005. The financial data provided has been prepared in accordance with Canadian generally accepted accounting principles and all figures provided are in Canadian dollars. Management's Discussion and Analysis herewith provided is the responsibility of the Company's management. The Board of Directors is responsible for reviewing and approving Management's Discussion and Analysis. Additional information relating to Arbor Memorial Services Inc., including the Company's 2004 Annual Information Form and the 2004 Annual Report, can be found on SEDAR at [www.sedar.com](http://www.sedar.com).

Certain statements contained in this Quarter Report, including but not limited to, information regarding the status and progress of the Company's operating and capital activities, the plans and objectives of the Company and assumptions regarding the Company's future performance and plans are forward-looking statements. The words "believe", "may", "estimate", "continues", "anticipate", "intend", "expect" and similar expressions identify these forward-looking statements. These forward-looking statements are made subject to certain risks and uncertainties that could cause actual results to differ materially from those stated. Risks and uncertainties that could cause or contribute to such differences include, but are not limited to, those discussed in the 2004 Annual Report, particularly under "Risks, Events and Uncertainties". The Company undertakes no obligation to publicly release any revisions to these forward-looking statements to reflect events or circumstances after the date hereof or to reflect the occurrence of unanticipated events.

Arbor Memorial Services Inc. is a Canadian company incorporated in Ontario which, through wholly owned subsidiaries, is a market leader in providing interment rights, cremations, funerals and associated merchandise and services to customers across Canada. The Company owns 41 cemeteries, 27 crematoria, 2 reception centres and 87 funeral homes in communities in eight provinces of Canada.

### **CHANGES IN ACCOUNTING POLICIES**

#### ***Consolidation of Variable Interest Entities***

In the first quarter of 2005, the Company implemented Accounting Guideline 15 "Consolidation of Variable Interest Entities" (AcG-15). This Guideline was re-issued by the Canadian Accounting Standards Board in September 2004 and requires implementation for annual and interim periods beginning on or after November 1, 2004. Restatement of prior periods is encouraged. AcG-15 substantially harmonizes Canadian generally accepted accounting principles with similar accounting principles applicable in the United States.

The Guideline outlines consolidation principles for certain entities in which equity investors do not have the characteristics of a controlling financial interest or do not have sufficient equity at risk for the entity to finance its activities without additional subordinated financial support from other parties. As a result of the Guideline, the Company has consolidated its pre-need cemetery trust funds, pre-need funeral trust funds, pre-need funeral group annuity funds for which the Company is the policyholder and cemetery care funds. Previously, the Company presented its pre-need trust and annuity funds under the title "Pre-need receivables" and did not consolidate its cemetery care funds. The pre-need funds and care funds are considered variable interest entities because as a group, the equity investors (if any) do not have sufficient equity at risk and do not have the direct or indirect ability through voting or similar rights to make decisions about the funds' activities that have a significant effect on the success of the funds. The Guideline requires the Company to consolidate any funds for which the Company is the primary beneficiary. The Company is the primary beneficiary of all of its pre-need funds (other than pre-need funeral group annuity funds where the Company is not the policyholder) and care funds in that the Company absorbs the majority of the funds' expected losses.

The Company has also recognized non-controlling financial interests of third parties in the pre-need funds and care funds to the extent that the Company's customers are the legal beneficiaries of the pre-need funds and the Company does not have a legal right to access the principal amount of the cemetery care funds. The Company

has not recognized non-controlling financial interests in non-legislated pre-need trust funds since the Company's customers are not the legal beneficiaries of these funds.

Another change required as a result of AcG-15 is that the Company now recognizes realized earnings of its pre-need funds and care funds in "Investment and other income" in the statements of earnings. The Company also recognizes expenses within Investment and other income equal to the realized earnings of these funds attributable to the non-controlling interest holders and defers the realized earnings of the funds attributable to the Company when such earnings have not been earned by the Company through the performance of services or delivery of merchandise. The Company continues to recognize as sales, amounts removed from the pre-need funds upon the performance of services and delivery of merchandise including realized earnings accumulated in the funds.

The accounting changes associated with this Guideline principally affect classifications within the financial statements and do not affect cash flow or the manner in which the Company recognizes and reports revenue or net income. The Guideline also does not change the legal relationships among the funds, the Company and its customers. Prior period restatement was made for all of the changes effected.

### ***Pre-need Funeral Group Annuity Contracts***

Consistent with the change in accounting adopted by public companies in the same industry in the United States, the Company has changed its method of accounting for certain pre-need funeral group annuity funds. In the first quarter of 2005, the Company removed all group annuity funds for which the Company was not the policyholder from its balance sheet as the Company concluded that these funds are not assets and liabilities of the Company. Previously these funds were presented as "Amounts due from third-party insurers" under "Pre-need receivables" and an offsetting liability was included under "Deferred revenue". The removal of these amounts did not have an impact on the Company's shareholders' equity, results of operations or cash flows. The balance sheet at October 31, 2004 was restated for this change.

## **RESULTS OF OPERATIONS FOR THE THREE MONTHS ENDED JANUARY 31, 2005 COMPARED TO THE THREE MONTHS ENDED JANUARY 31, 2004**

### ***TOTAL COMPANY RESULTS***

The data set forth should be read in conjunction with the Company's consolidated financial statements and accompanying notes to the consolidated financial statements included in this Quarter Report. The historical information provided is not necessarily indicative of the results to be expected in the future.

**Revenue** for the three months ended January 31, 2005 was \$48.3 million. This represented a \$1.3 million or 2.8% increase over 2004. Sales accounted for \$1.1 million of the increase, while investment and other income accounted for \$0.2 million.

**Earnings from operations before other income** were \$7.9 million, which represented a decrease of \$0.6 million or 7.4% from 2004. The decrease was mostly attributable to cost increases in excess of revenue increases in both the cemetery and funeral divisions. In comparison, the first quarter of 2004 had an unusually high increase in earnings from operations before other income, rising by \$1.2 million or 17.0% over the first quarter of 2003. The first quarter results for 2004 were significantly impacted by a large increase in the number of funeral calls.

**Other income** in both 2005 and 2004 was minimal and represented the net gain on sale of various fixed assets.

**Interest expense**, which included interest rate swap costs, decreased marginally from 2004 due to a lower average long-term debt balance outstanding, and despite higher floating interest rates in the period and a higher ratio of fixed to floating rate debt. Swap costs caused the Company's interest expense to be higher in the first quarter of 2005 by \$0.4 million (2004 - \$0.3 million) than would otherwise have been the case if the Company had maintained all floating-rate debt. The weighted-average rate of interest on long-term debt for the period was 5.3%

compared to 5.1% in the first quarter of 2004 and excluding swap costs, the average rate was 3.4% (2004 – 3.5%). The proportion of fixed rate debt at the end of 2005 was 70% compared to 53% at the end of the first quarter of 2004.

**Income taxes** for the first quarter of 2005 resulted in an effective tax rate of 34.1%, compared to 37.0% for the same period of 2004. The 2.9 percentage point reduction in the effective tax rate was largely due to a 2.2 percentage point decrease in the combined federal and provincial statutory tax rate due to a lower federal rate and a corporate reorganization at the end of the first quarter of 2004.

**Net earnings and earnings per share** for the three months ended January 31, 2005 were \$4.5 million and \$0.43 per share compared to \$4.7 million or \$0.45 per share for the same period of 2004, a decrease of \$0.2 million or \$0.02 per share. The decrease in net earnings was due to lower earnings from operations primarily due to a decline in the number of funeral services performed.

## **CEMETERY DIVISION**

**Cemetery sales** in the first three months of 2005 increased by \$1.1 million or 5.7% over the first three months of 2004 to \$20.6 million. Following is a breakdown of the \$1.1 million increase (in \$millions):

<u>Pre-Need</u>	
Interment rights	0.2
Merchandise	0.5
Services	-
	<u>0.7</u>
<u>At-Need</u>	
Interment rights	0.2
Merchandise	0.3
Services	(0.1)
	<u>0.4</u>
	<u>1.1</u>

The increase in pre-need merchandise sales was largely due to an increase of \$0.4 million in the delivery of bronze memorials in the period compared to 2004. Deliveries of memorials were unusually low in the first quarter of 2004 and had decreased by \$0.4 million compared to 2003. The increase in at-need merchandise sales was due to higher deliveries of both bronze memorials and upright monuments in the period.

Total pre-need cemetery sales contracts written in the period were \$15.2 million, compared to \$14.6 million in 2004. This represented an increase of \$0.6 million or 4.0%. While pre-need merchandise and services sales and certain interment right sales that do not meet minimum deposit requirements are not included immediately in the Company's reported sales until delivery or installation, they do contribute to building future market share and future reported sales.

In the first quarter of 2005, the number of interments performed by the Company decreased by 4.3% to 4,096 and the number of cremations decreased by 6.5% to 3,546. This compared to increases of 6.9% and 8.0% respectively in the first quarter of 2004, which were higher than usual. From 2000 to 2004, interments on average increased by 1.8%, while cremations increased on average by 4.5%.

**Cemetery investment income** increased by \$0.1 million or 5.6% over 2004 to \$2.3 million. Growth in care fund income as a result of higher average funds in trust was the main reason for the increase. The average balance of care funds increased by \$9.4 million or 7.4%. The rate of return on the funds decreased from 5.7% for the first quarter of 2004 to 5.5% for the first quarter of 2005.

Realized earnings on pre-need cemetery funds increased by \$0.2 million or 12.2% to \$1.8 million in the first quarter of 2005 due to an increase in the average balance of the funds. The average balance of the funds increased by \$20.2 million or 14.5%, while the average rate of return on the funds decreased by 0.2 of a

percentage point to 4.4%. Realized earnings are retained in the funds until the underlying merchandise and services are delivered or performed, at which time the original deposits as well as all accumulated realized earnings attributable to the merchandise and/or services contract are withdrawn from the funds.

**Cemetery expenses** for the quarter increased by \$1.4 million or 7.3% as follows (in \$millions):

Cost of sales	0.6
Selling	0.4
Care and maintenance	0.1
Administrative and other	0.2
Depreciation	<u>0.1</u>
	<u>1.4</u>

The increase in cost of sales expense of \$0.6 million or 6.4% over 2004 was mostly related to the increase in sales of 5.7%. The cost of sales percentage was marginally higher by 0.3 of a percentage point in 2005 compared to 2004. The increase in selling expenses was mostly due to higher employee costs including benefits, higher managerial commissions, and timing of postal and promotional costs.

**Earnings from cemetery operations** decreased by \$0.1 million or 4.4% in the first quarter of 2005, due to cost increases in excess of the increase in revenue.

### **FUNERAL DIVISION**

**Funeral sales** in the first quarter of 2005 increased by 0.1% to \$23.9 million. The improvement was attributable to a 3.1% increase in the average sale per funeral service. The number of calls in the period decreased by 2.8% over 2004. The decrease in the number of calls was due to higher than normal calls in the first quarter of 2004 and management believes that the increase in 2004 was partially due to a higher death rate in Canada. In the first quarter of 2004, total calls increased by 6.5% over the same period of 2003. The comparative average annual increase in the number of calls for 2000 to 2003 was 1.3%. Statistics Canada has also reported that the number of deaths for the twelve months ended June 30, 2004 had increased by 3.7% over the prior year.

The increase in the average sale per funeral service was the result of the Company's continued efforts to provide customers with value-added merchandise and services and regular price increases. The increase of 3.1% exceeded the average annual increase from 2000 to 2004 of 2.3% by 0.8 of a percentage point.

Sales in the period consisted of:

- \$17.0 million (2004 - \$17.2 million) of at-need sales of funeral merchandise and services, which represented a decrease of 1.1%;
- \$6.9 million (2004 - \$6.7 million) from the fulfilment of merchandise and services sales that were arranged on a pre-need basis, which represented an increase of 3.0%; and
- \$0.1 million (2004 - \$0.1 million) of flower shop sales.

Pre-need contracts written in 2005 totalled \$9.9 million compared to \$9.8 million in 2004, an increase of 0.8%.

**Investment and other income** in the funeral division increased by 4.2% to \$1.1 million in 2005. The improvement was attributable to an increase in the fees received from the deposit of pre-need funeral funds under the group annuity program, offset by a decrease in the share of net earnings of an equity-held investment. The last equity-held investment of the Company's was sold in the second quarter of 2004.

**Funeral expenses** in the first three months of 2005 increased by \$0.4 million or 2.6% largely due to increases of \$0.2 million in each of cost of sales and facilities expenses. The increase in cost of sales expense was mostly related to a change in the mix of sales and higher pre-need obtaining costs expensed in the period. The increase in facilities costs was mostly due to higher utilities and maintenance expenses.

**Earnings from funeral operations** decreased by \$0.4 million or 4.4%, to \$7.9 million in the first three months of 2005. The decrease was attributable to growth in expenses combined with only a minimal increase in sales.

## **CORPORATE DIVISION**

**Corporate revenue**, consisting of rental income from leasing a portion of the Company's head office building and interest on the Company's bank accounts, short-term investments and mortgages receivable, was \$0.3 million in both the first quarter of 2005 and the same period of 2004.

**Corporate expenses** increased by \$0.1 million or 4.4%, to \$3.2 million in 2005, largely due to higher employee costs.

As a percentage of total Company revenue, general and administrative expenses increased to 6.6% for the first quarter of 2005 from 6.5% for the same period of 2004.

## **CONSOLIDATED BALANCE SHEETS**

**Key financial indicators** were as follows:

	<b>January 31 2005</b>	October 31 2004
Current ratio	<b>2.75:1</b>	2.20:1
Working capital (in \$millions)	<b>43.1</b>	41.6
Long-term debt to equity ratio	<b>0.48:1</b>	0.50:1
Long-term debt to EBITDA <sup>(1)(2)</sup>	<b>2.02:1</b>	2.00:1
Interest coverage ratio <sup>(1)</sup>	<b>5.33:1</b>	5.42:1

<sup>(1)</sup> Bank covenant. Long-term debt to EBITDA must be less than or equal to 3.5 and interest coverage ratio must equal or exceed 3.25.

<sup>(2)</sup> EBITDA is a non-GAAP measure and is defined as earnings from operations before other income (expense), less share of net earnings in equity-held investments, plus dividends from equity-held investments plus depreciation.

The current ratio increased by 0.55 from October 31, 2004 due to a larger proportional decrease in current liabilities of \$10.0 million or 28.9% compared to a decrease of \$8.5 million or 11.2% in current assets. The main reason for the decrease in current liabilities was a \$13.2 million reduction in accounts payable and accrued liabilities, which was mostly the result of payment of year-end payables and accruals in the period, principally related to construction activity in the fourth quarter of 2004. The main reason for the reduction in current assets was a decrease in cash from \$10.4 million at the end of fiscal 2004 to bank indebtedness of \$2.0 million at the end of the first quarter due mostly to payment of year-end payables and accruals in the period.

**Accounts receivable** arising from at-need cemetery sales were paid on average within 52 days at January 31, 2005 (October 31, 2004 – 47 days). Accounts receivable arising from at-need funeral sales were paid on average within 35 days at January 31, 2005 (October 31, 2004 – 30 days).

**Pre-need receivables and funds**, including the current portion of pre-need receivables, increased by \$2.3 million or 0.5% to \$440.9 million at the end of the first quarter of 2005. The increase was due to contributions to the funds at a higher rate than deliveries of contracts in the period.

As described in note 2 to the financial statements, the Company changed its accounting policy with respect to certain amounts due from third-party insurers in the first quarter of 2005. Previously, the Company included the accumulated benefit of all pre-need funeral group annuity contracts in pre-need receivables. However, effective for the first quarter of 2005, only those group annuity contracts or funds for which the Company is the policyholder were included on the balance sheet under pre-need receivables and funds. Pre-need receivables for the comparative period have been restated. At October 31, 2004, the amount of funeral group annuity funds that were excluded from the balance sheet was \$47.2 million, compared to \$52.9 million at January 31, 2005, an increase of \$5.7 million or 12.1%.

**Cemetery care funds** of \$137.4 million were consolidated on the Company's balance sheet in the first quarter of 2005 as described in note 2 to the financial statements and the prior period was restated. Previously, these funds

were disclosed in the notes to the financial statements. At the end of fiscal 2004, the amount of these funds was \$134.5 million. Therefore, the funds increased by \$2.9 million or 2.2% in the period. The annualized rate of return on the funds decreased by 0.2 of a percentage point to 5.5%.

**Crypt and niche** additions in the first 3 months of 2005 were \$1.7 million including: \$0.4 million for a mausoleum addition at Pleasantview Memorial Gardens (Fonthill, Ontario); \$0.3 million for a mausoleum addition at Rideau Memorial Gardens (Montreal, Québec); and \$1.0 million for other crypt and niche projects. Also in the period, crypt and niche inventory was reduced by \$1.9 million for inventory sold.

**Cemetery land** decreased by \$0.1 million to \$28.7 million at the end of January 2005. The decrease was due to cost of sales in the period in excess of additions. The Company spent less than \$0.1 million on the development of land for burial gardens during the three months ended January 31, 2005 and the same period of 2004.

**Fixed assets:** During the quarter, the Company expended \$3.3 million on fixed assets compared to \$2.3 million in 2004. Details of capital expenditures by segment follow (in \$millions):

	<u>2005</u>	<u>2004</u>
Cemetery division	1.0	1.1
Funeral division	1.9	1.0
Corporate division	<u>0.4</u>	<u>0.2</u>
	<u>3.3</u>	<u>2.3</u>

Cemetery division expenditures in 2005 included: \$0.2 million for new road and drainage development at Highland Hills Memorial Gardens in Gormley, Ontario; \$0.3 million for partial development of a new combination reception centre and sales and administration office at Mount Lawn Memorial Gardens in Whitby, Ontario; \$0.2 million for partial completion of an administration office expansion at Pine Ridge Memorial Gardens in Ajax/Pickering, Ontario; and \$0.3 million for other capital expenditures.

Funeral division expenditures in 2005 included: \$0.7 million on construction of a new funeral home in Markham, Ontario; \$0.7 million to purchase the land and building of an existing funeral home in Toronto, Ontario; \$0.2 million to complete a replacement funeral home in Cap-de-la-Madeleine, Québec; and \$0.3 million for other capital expenditures.

Corporate division expenditures included \$0.1 million for further development of a new computer system for cemetery and funeral operations, \$0.1 million for new elevators at the Company's head office location and \$0.2 for other projects.

**Deferred obtaining costs and stored merchandise** at January 31, 2005 represented commissions incurred to sell pre-need cemetery and funeral arrangements as well as cemetery merchandise purchased on behalf of customers under pre-need cemetery contracts and stored by the Company until the merchandise is delivered, and the related revenue is recognized. Prior to the first quarter of 2005, these costs were presented as an offset to deferred revenue. Deferred obtaining costs and stored merchandise at January 31, 2005 increased by \$0.7 million or 1.1%.

**Accounts payable and accrued liabilities** decreased by \$13.2 million as follows (in \$millions):

Trade accounts payables	4.9
Accrued liabilities	4.7
Income taxes payable	2.8
Dividends payable	0.7
Other accounts payable	<u>0.1</u>
	<u>13.2</u>

Trade accounts payable were higher at October 31, 2004 partially due to increased construction and development activity at that time. Accrued liabilities at the end of fiscal 2004 included bonuses, vacation pay, payroll, audit and other accruals. Income taxes payable at the end of fiscal 2004 included \$2.4 million that was related to a new Quebec subsidiary.

**Long-term debt** at the end of the first quarter of 2005 was \$77.5 million, which was consistent with the balance owing at the end of fiscal 2004. Total unused credit facilities as of January 31, 2005 were \$58.5 million (October 31, 2004 - \$62.5 million). The Company has satisfied all of the debt covenants as defined in its bank loan agreements and is in good standing.

**Deferred revenue** decreased by \$1.2 million or 0.6% from the end of fiscal 2004 to \$177.7 million at the end of the quarter. As described in note 2 to the financial statements, the Company adopted AcG-15 "Variable Interest Entities" in the first quarter of 2005. AcG-15 required the establishment of non-controlling interests in the pre-need cemetery and funeral trust and annuity funds where previously these amounts were classified as deferred revenue. In addition, in the first quarter of 2005, the Company changed its method of accounting for certain pre-need funeral group annuity funds where the Company was not the policyholder and removed these funds and the corresponding deferred revenue from its balance sheet. The amount of pre-need funeral group annuity funds for which the Company is not the policyholder is now presented in note 5 to the financial statements. Deferred revenue at October 31, 2004 was restated for both of these changes. As at January 31, 2005, deferred revenue represented the portion of pre-need cemetery and funeral merchandise and services sales that had not yet been recognized in sales in accordance with the Company's revenue recognition policies and that were not required to be deposited to trust funds by provincial regulation.

Deferred revenue at January 31, 2005 plus the non-controlling interests in pre-need trust and annuity funds plus the accumulated benefit of the pre-need funeral group annuity funds excluded from the balance sheet was \$597.6 million compared to \$589.7 at the end of fiscal 2004, an increase of \$7.9 million or 5.4% on an annualized basis. This accumulation was equivalent to 3.3 years of 2004 annual cemetery and funeral sales (October 31, 2004 – 3.3 years).

**Non-controlling interests in pre-need funds** were established in the first quarter of 2005 as described in note 2 to the financial statements as a result of the adoption of AcG-15. Non-controlling interests were established where the Company's customers are the legal beneficiaries of the funds. Previously, these amounts were included under deferred revenue. Non-controlling interests in pre-need funds increased by \$3.5 million or 0.9% in the quarter.

**Non-controlling interests in cemetery care funds** were established in the first quarter of 2005 as described in note 2 to the financial statements as a result of the adoption of AcG-15. The non-controlling interests were established since the Company does not have a legal right to access the principal amount of the care funds.

## **CONSOLIDATED STATEMENTS OF CASH FLOWS**

**Net cash used by operating activities** in the first quarter of 2005 was \$8.4 million compared to \$0.6 million in the same period of 2004, an increase of \$7.8 million. The main reasons for the increase in cash used were a higher net change in other operating balance sheet items of \$6.5 million and higher net additions to developed land, crypts and niches after deducting cost of sales of \$0.9 million.

The \$6.5 million increase in net change in other operating balance sheet items was mostly due to the following: a \$4.2 million increase in cash used as a result of payment of accounts payable and accrued liabilities in the period and \$1.3 million of income taxes receivable collected in 2004 compared to none in 2005. Accounts payable and accrued liabilities were particularly high at the end of fiscal 2004 due to a higher than normal level of construction and development activity.

**Net cash used for investing activities** increased by \$1.0 million in the first quarter of 2005 compared to the same period of 2004 due to higher additions to fixed assets. The main reason for the increase in additions to fixed assets was higher spending on new and replacement funeral homes and cemetery fixed assets.

**Cash used for financing activities** did not change significantly from the first quarter of 2004 to the first quarter of 2005.

## CAPITAL AND CEMETERY BURIAL SPACE INVENTORY PROJECTS

Following are projects on which the Company had expended significant funds prior to January 31, 2005 but that had not yet generated operating revenue as of January 31, 2005.

**Highland Funeral Home (Markham Chapel):** As at January 31, 2005, the Company had spent \$4.3 million on this project. The Company expects to spend an additional \$1.6 million to complete the project and expects to have it substantially completed by the end of the second quarter of 2005.

**Pleasantview Mausoleum:** Total spent to January 31, 2005 was \$1.1 million. The Company expects to spend an additional \$0.8 million in 2005 to complete this project and to have the project substantially completed in the second quarter of 2005.

**Computer Operating System - Focus:** Total spent on this project to January 31, 2005 was \$5.3 million. The Company expects to spend an additional \$0.2 million in 2005 to complete this project and expects to have the system fully implemented by the end of fiscal 2005.

The Company had committed to the following expenditures for capital and cemetery burial space inventory at January 31, 2005 (in \$millions):

New funeral homes	3.9
Combination reception centre and cemetery sales office	1.3
Cemetery burial space inventory	2.9
Cemetery maintenance capital expenditures	1.5
Funeral maintenance capital expenditures	<u>0.4</u>
	<u>10.0</u>

In addition, at January 31, 2005, the Company was committed to funeral casket purchases of \$6.0 million, of which approximately \$5.0 million is to be purchased in fiscal 2005 and \$1.0 million in 2006.

Following is the Company's expected capital and cemetery burial space inventory spending for the remainder of fiscal 2005 (in \$millions):

Maintenance capital expenditures	11.8
New cemetery and funeral initiatives	10.8
Cemetery burial space inventory	<u>3.9</u>
	<u>26.5</u>

At January 31, 2005, the Company was in the process of locating a purchaser for one funeral home in Toronto, Ontario. Revenues and net earnings attributable to this operation in the first quarter of 2005 and 2004 were minimal as disclosed in note 11 to the financial statements. The Company anticipates that the selling price for this operation will approximate its net book value.

## LIQUIDITY AND CAPITAL RESOURCES

The Company anticipates that it can generate sufficient amounts of cash, in the short and the long term to maintain the Company's capacity and to meet planned growth and development activities. The Company also had access to unused operating facilities of \$9.0 million and unused floating rate debt facilities of \$49.5 million at January 31, 2005.

## OUTSTANDING SHARES

The Company has an unlimited number of Preferred Shares, Class A Voting Shares and Class B Non-Voting Shares authorized for issue. The Class A and Class B shares have identical rights and privileges, except that the Class A shares are voting. In certain circumstances, if an offer is made by the Company or a third party to purchase Class A shares from each holder in Ontario, each Class B share is convertible into one Class A share. At January 31, 2005 and October 31, 2004, the Company had issued 2,525,497 Class A shares and 8,069,746 Class B shares for \$1.7 million and \$70.8 million respectively.

## **EVENTS AND UNCERTAINTIES**

### ***SEASONALITY***

While the death care industry is fairly stable and predictable, the Company's at-need business and pre-need deliveries of some merchandise and services can be affected by seasonal fluctuations in the death rate. Death rates are generally higher in the winter months. The Company's pre-need cemetery sales of interment rights can also have seasonal fluctuations, whereby sales are generally lower in the winter and summer months.

### ***FUTURE ACCOUNTING POLICY CHANGE***

In 2003, the AcSB issued three exposure drafts concerning financial instruments: Financial Instruments – Recognition and Measurement (Section 3855); Hedges (Section 3865); and Comprehensive Income (Section 1530). In 2004, the AcSB issued re-exposure drafts of Sections 3855 and 3865 and delayed the implementation date for all three standards by one year. According to the re-exposure drafts, the sections will now apply for interim and annual financial statements relating to fiscal years beginning on or after October 1, 2006. Implementation is required on a prospective basis.

Under these standards, the Company will be required to measure its interest rate swaps, which are accounted for as hedges, at fair value with gains and losses recognized in a new account entitled "Other comprehensive income". The Company expects to implement these standards in the first quarter of fiscal 2007.

Another change under these standards is that the Company will be required to measure its cemetery and funeral pre-need trust funds and cemetery care trust funds at fair value and present them on this basis in its financial statements. Any gains and losses recorded as a result of the measurement of the funds at fair value will be offset by a corresponding charge to non-controlling interests in pre-need funds and recognized in other comprehensive income.

***March 10, 2005***

**Arbor Memorial Services Inc.**

**UNAUDITED CONSOLIDATED STATEMENTS OF EARNINGS**

	<i>Three Months Ended January 31</i>	
	<b>2005</b>	<b>2004</b>
	<i>Restated<sup>(1)</sup> (\$000)</i>	
<b>Revenue</b>		
Sales	44,711	43,562
Investment and other income (note 3)	3,554	3,396
	<b>48,265</b>	46,958
<b>Expenses</b>		
Operating	37,207	35,405
General and administrative	3,184	3,051
	<b>40,391</b>	38,456
<b>Earnings from operations before other income</b>	<b>7,874</b>	8,502
<b>Other income</b>		
Gain on disposal of assets	19	23
<b>Earnings from operations</b>	<b>7,893</b>	8,525
Interest expense	1,023	1,050
Earnings before income taxes	6,870	7,475
Income taxes (note 10)	2,346	2,764
<b>Net earnings from continuing operations</b>	<b>4,524</b>	4,711
<b>Net earnings from discontinued operations (note 11)</b>	<b>13</b>	10
<b>Net earnings</b>	<b>4,537</b>	4,721
<b>Weighted average number of shares outstanding (in thousands)</b>	<b>10,595</b>	10,595
<b>Earnings per share - basic and diluted (in \$)</b>		
Earnings per share from continuing operations	0.43	0.45
Earnings per share from discontinued operations	-	-
<b>Earnings per share - basic and diluted (in \$)</b>	<b>0.43</b>	0.45

<sup>(1)</sup> See note 11 to the financial statements.

**UNAUDITED CONSOLIDATED STATEMENTS OF RETAINED EARNINGS**

	<i>Three Months Ended January 31</i>	
	<b>2005</b>	<b>2004</b>
	<i>(\$000)</i>	
<b>Retained earnings, beginning of period</b>	<b>83,679</b>	65,137
Net earnings for the period	4,537	4,721
<b>Retained earnings, end of period</b>	<b>88,216</b>	69,858

**Arbor Memorial Services Inc.**  
**UNAUDITED CONSOLIDATED BALANCE SHEET**

	<i>As at</i>	
	<i>January 31</i>	<i>October 31</i>
	<i>2005</i>	<i>2004</i>
		<i>Restated<sup>(1)</sup></i>
		<i>(\$000)</i>
<b>Assets</b>		
Current assets		
Cash	-	10,396
Accounts receivable	18,102	16,514
Merchandise inventories	9,550	9,713
Prepaid insurance	980	-
Assets held for sale, current portion (note 11)	183	182
Pre-need receivables, current portion (note 4)	38,788	39,309
	<b>67,603</b>	76,114
Pre-need receivables and funds (note 4)	402,136	399,315
Cemetery care funds	137,384	134,523
Crypts and niches	30,570	30,779
Cemetery land	28,663	28,789
Fixed assets	160,647	159,454
Goodwill	44,461	44,461
Mortgages receivable	13,669	13,501
Deferred obtaining costs and stored merchandise (note 6)	65,866	65,131
Assets held for sale (note 11)	1,730	1,737
Other assets	705	986
	<b>953,434</b>	954,790
<b>Liabilities</b>		
Current liabilities		
Bank indebtedness	2,013	-
Accounts payable and accrued liabilities	18,810	32,052
Long-term debt, current portion	3,721	2,485
	<b>24,544</b>	34,537
Deferred revenue (note 8)	177,745	178,953
Non-controlling interests in pre-need funds	366,959	363,488
Long-term debt	73,746	74,986
Future income taxes	3,904	3,677
Liabilities associated with assets held for sale (note 11)	476	481
Other liabilities	7,961	7,967
	<b>655,335</b>	664,089
Non-controlling interests in cemetery care funds	137,384	134,523
<b>Shareholders' equity</b>		
Share capital (note 9)	72,499	72,499
Retained earnings	88,216	83,679
	<b>160,715</b>	156,178
	<b>953,434</b>	954,790

<sup>(1)</sup> See notes 2 and 6 to the financial statements.

Arbor Memorial Services Inc.

**UNAUDITED CONSOLIDATED STATEMENTS OF CASH FLOWS**

	<i>Three Months Ended</i>	
	<i>January 31</i>	
	<b>2005</b>	<b>2004</b>
		<i>Restated<sup>(1)</sup></i>
	<i>(\$000)</i>	
<b>Cash provided by (used for)</b>		
<b>Operating activities</b>		
Net earnings	4,537	4,721
Net earnings from discontinued operations (note 11)	(13)	(10)
Add (deduct) items not affecting cash from operating activities:		
Depreciation	2,071	1,966
Gain on disposal of assets	(19)	(23)
Future income taxes	227	554
Additions to developed land, crypts and niches	(1,778)	(895)
Developed land, crypt and niche cost of sales	2,125	2,084
Net change in other operating balance sheet items (note 13)	(15,570)	(9,044)
<b>Net cash used for continuing operations</b>	<b>(8,420)</b>	<b>(647)</b>
<b>Net cash provided by (used for) discontinued operations</b>	<b>14</b>	<b>(7)</b>
<b>Investing activities</b>		
Additions to fixed assets	(3,266)	(2,276)
Additions to cemetery land held for future development	(12)	(8)
Proceeds on disposal of assets	21	68
<b>Net cash used for continuing operations</b>	<b>(3,257)</b>	<b>(2,216)</b>
<b>Financing activities</b>		
Repayments of long-term debt	(4)	(57)
Dividends	(742)	(742)
<b>Net cash used for continuing operations</b>	<b>(746)</b>	<b>(799)</b>
<b>Decrease in cash</b>	<b>(12,409)</b>	<b>(3,669)</b>
Cash, beginning of period	10,396	8,279
<b>(Bank indebtedness) cash, end of period</b>	<b>(2,013)</b>	<b>4,610</b>
<b>Supplementary information</b>		
Income taxes paid	5,433	6,270
Interest paid	1,069	1,064

<sup>(1)</sup> See note 11 to the financial statements.

**ARBOR MEMORIAL SERVICES INC.**  
**UNAUDITED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**Three Months Ended January 31, 2005 and 2004**

**1. BASIS OF PREPARATION**

The accompanying unaudited quarterly consolidated financial statements have been prepared in accordance with Canadian generally accepted accounting principles and are consistent with the accounting policies used to prepare the 2004 annual consolidated financial statements, except as otherwise noted herein. While management considers the interim disclosures presented to be adequate, these consolidated financial statements do not include all of the disclosures required for annual financial statements and should be read in conjunction with the Company's 2004 annual consolidated financial statements.

**2. ACCOUNTING CHANGES**

***Consolidation of Variable Interest Entities***

In the first quarter of 2005, the Company implemented Accounting Guideline 15 "Consolidation of Variable Interest Entities" (AcG-15). This Guideline was re-issued by the Accounting Standards Board in September 2004 and requires implementation for annual and interim periods beginning on or after November 1, 2004. Restatement of prior periods is encouraged. AcG-15 substantially harmonizes Canadian generally accepted accounting principles with similar accounting principles applicable in the United States.

The Guideline outlines consolidation principles for certain entities in which equity investors do not have the characteristics of a controlling financial interest or do not have sufficient equity at risk for the entity to finance its activities without additional subordinated financial support from other parties. As a result of the Guideline, the Company has consolidated its pre-need cemetery trust funds, pre-need funeral trust funds, pre-need funeral group annuity funds for which the Company is the policyholder and cemetery care funds. Previously, the Company presented its pre-need trust and annuity funds under the title "Pre-need receivables" and did not consolidate its cemetery care funds. The pre-need funds and care funds are considered variable interest entities because as a group, the equity investors (if any) do not have sufficient equity at risk and do not have the direct or indirect ability through voting or similar rights to make decisions about the funds' activities that have a significant effect on the success of the funds. The Guideline requires the Company to consolidate any funds for which the Company is the primary beneficiary. The Company is the primary beneficiary of all of its pre-need funds (other than pre-need funeral group annuity funds where the Company is not the policyholder) and care funds in that the Company absorbs the majority of the funds' expected losses.

The Company has also recognized non-controlling financial interests of third parties in the pre-need funds and care funds to the extent that the Company's customers are the legal beneficiaries of the pre-need funds and the Company does not have a legal right to access the principal amount of the cemetery care funds. The Company has not recognized non-controlling financial interests in non-legislated pre-need trust funds since the Company's customers are not the legal beneficiaries of these funds.

Another change required as a result of AcG-15 is that the Company now recognizes realized earnings of its pre-need funds and care funds in "Investment and other income" in the statements of earnings. The Company also recognizes expenses within Investment and other income equal to the realized earnings of these funds attributable to the non-controlling interest holders and defers the realized earnings of the funds attributable to the Company when such earnings have not been earned by the Company through the performance of services or delivery of merchandise. The Company continues to recognize as sales, amounts removed from the pre-need funds upon the performance of services and delivery of merchandise including realized earnings accumulated in the funds.

The accounting changes associated with this Guideline principally affect classifications within the financial statements and do not affect cash flow or the manner in which the Company recognizes and reports revenue or net income. The Guideline also does not change the legal relationships among the funds, the Company and its customers. Prior period restatement was made for all of the changes effected.

### **Pre-need Funeral Group Annuity Contracts**

Consistent with the change in accounting adopted by public companies in the same industry in the United States, the Company has changed its method of accounting for certain pre-need funeral group annuity funds. In the first quarter of 2005, the Company removed all group annuity funds for which the Company was not the policyholder from its balance sheet as the Company concluded that these funds are not assets and liabilities of the Company. Previously these funds were presented as “Amounts due from third-party insurers” under “Pre-need receivables” and an offsetting liability was included under “Deferred revenue”. The removal of these amounts did not have an impact on the Company’s shareholders’ equity, results of operations or cash flows. The balance sheet at October 31, 2004 was restated for this change.

### **3. INVESTMENT AND OTHER INCOME**

	<b>Three Months Ended January 31 (\$000)</b>									
	<b>Cemetery</b>		<b>Funeral</b>		<b>Care Funds</b>		<b>Other</b>		<b>Consolidated</b>	
	<b>2005</b>	<b>2004</b>	<b>2005</b>	<b>2004</b>	<b>2005</b>	<b>2004</b>	<b>2005</b>	<b>2004</b>	<b>2005</b>	<b>2004</b>
Realized earnings of funds:										
Interest and dividends	<b>1,743</b>	1,599	<b>2,267</b>	2,244	<b>1,887</b>	1,806	-	-	<b>5,897</b>	5,649
Realized gains	<b>118</b>	54	<b>284</b>	64	<b>177</b>	66	-	-	<b>579</b>	184
Realized losses	<b>(31)</b>	(20)	<b>(15)</b>	(13)	<b>(34)</b>	(3)	-	-	<b>(80)</b>	(36)
Trust expenses	<b>(33)</b>	(32)	<b>(33)</b>	(33)	<b>(58)</b>	(57)	-	-	<b>(124)</b>	(122)
	<b>1,797</b>	1,601	<b>2,503</b>	2,262	<b>1,972</b>	1,812	-	-	<b>6,272</b>	5,675
Deferred revenue	<b>(6)</b>	(49)	-	-	-	-	-	-	<b>(6)</b>	(49)
Non-controlling interests in funds	<b>(1,791)</b>	(1,552)	<b>(2,503)</b>	(2,262)	<b>(101)</b>	(24)	-	-	<b>(4,395)</b>	(3,838)
	-	-	-	-	<b>1,871</b>	1,788	-	-	<b>1,871</b>	1,788
Fee income	<b>420</b>	381	<b>1,081</b>	920	-	-	-	-	<b>1,501</b>	1,301
Other	-	-	-	-	-	-	<b>182</b>	307	<b>182</b>	307
	<b>420</b>	381	<b>1,081</b>	920	<b>1,871</b>	1,788	<b>182</b>	307	<b>3,554</b>	3,396

### **4. PRE-NEED RECEIVABLES AND FUNDS**

	<b>January 31 2005</b>	<b>October 31 2004</b>
	(\$000)	
Cemetery trust funds	<b>161,469</b>	158,812
Funeral trust funds	<b>180,419</b>	179,246
	<b>341,888</b>	338,058
Funeral group annuity funds	<b>31,522</b>	31,878
Instalment accounts receivable	<b>67,514</b>	68,688
	<b>440,924</b>	438,624
Less: current portion of instalment accounts receivable	<b>38,788</b>	39,309
	<b>402,136</b>	399,315

## 5. PRE-NEED FUNERAL GROUP ANNUITY FUNDS

The consolidated balance sheets do not include pre-need funeral contracts that will be funded by a third-party insurer under a group annuity program, upon delivery of pre-need merchandise and services, where the Company is not the policyholder (see note 2 to the financial statements). At January 31, 2005, the accumulated benefit of all such contracts was \$52.9 million (October 31, 2004 - \$47.2 million).

## 6. DEFERRED OBTAINING COSTS AND STORED MERCHANDISE

	<u>January 31</u> <u>2005</u>	<u>October 31</u> <u>2004</u>
	(\$000)	
Deferred obtaining costs	54,924	54,346
Stored merchandise	10,942	10,785
	<u>65,866</u>	<u>65,131</u>

In the 2004 annual financial statements, deferred obtaining costs and stored merchandise were netted against deferred revenue on the balance sheet.

## 7. DERIVATIVE FINANCIAL INSTRUMENTS

As of January 31, 2005, the Company's use of interest rate swap agreements was limited to seven (October 31, 2004 – seven) interest rate swaps with a Canadian chartered bank. At the end of the period, these swaps had a total notional amount of \$52.5 million (October 31, 2004 - \$53.8 million) and the estimated fair value of the interest rate swaps was a loss of \$2.4 million (October 31, 2004 – loss of \$1.9 million). Total swaps and other fixed rate debt represented 70% (October 31, 2004 – 72%) of the total amount of long-term debt outstanding. Swap costs for the period were \$0.4 million compared to \$0.3 million in the first quarter of 2004.

## 8. DEFERRED REVENUE

	<u>January 31</u> <u>2005</u>	<u>October 31</u> <u>2004</u>
	(\$000)	
Deferred pre-need cemetery sales	140,375	140,390
Deferred pre-need funeral sales	37,370	38,563
	<u>177,745</u>	<u>178,953</u>

## 9. ISSUED AND OUTSTANDING SHARE CAPITAL

	<u>January 31</u>	
	<u>2005</u>	<u>2004</u>
	(000)	
Number of Class A voting shares	2,525	2,525
Number of Class B non-voting shares	8,070	8,070
Shares issued and outstanding	<u>10,595</u>	<u>10,595</u>

## 10. INCOME TAXES

### *Income tax expense*

	<i>January 31</i>	
	<u>2005</u>	<u>2004</u>
	<i>(\$000)</i>	
Current tax expense	2,119	2,210
Future income tax expense relating to the origination and reversal of temporary differences	<u>227</u>	<u>554</u>
Income tax expense	<u><u>2,346</u></u>	<u><u>2,764</u></u>

### *Effective income tax rate*

	<i>January 31</i>	
	<u>2005</u>	<u>2004</u>
	<i>%</i>	<i>%</i>
Combined basic federal and provincial income tax rate	34.0	36.2
Increase (decrease) in the basic tax rate resulting from:		
Large corporations tax	1.1	1.1
Non-deductible amortization of excess of acquisition cost over book value	0.5	0.3
Non-deductible meals and entertainment expenses	0.4	0.5
Net earnings of associated corporations	-	(0.6)
Non-taxable portion of capital gains	(0.9)	-
Dividends/RDTOH	(0.4)	(0.9)
Other items	<u>(0.6)</u>	<u>0.4</u>
Effective income tax rate	<u><u>34.1</u></u>	<u><u>37.0</u></u>

## 11. DISCONTINUED OPERATIONS

In the fourth quarter of 2004, the assets of one funeral branch operation met the criteria for being classified as "held for sale" according to the provisions of CICA Handbook Section 3475 "Disposal of Long-Lived Assets and Discontinued Operations". The Company anticipates completing the disposal by the end of fiscal 2005. Revenue associated with this branch for the first three months of 2005 was \$0.1 million (2004 - \$0.1 million) and net earnings for both the first three months of 2005 and 2004 were less than \$0.1 million.

## 12. CONTRACTUAL COMMITMENTS

The Company is contractually committed to capital and cemetery burial space inventory expenditures of \$10.0 million. The Company anticipates that all of these committed expenditures will be incurred in the remainder of 2005. The Company is also contractually committed to funeral inventory purchases of \$6.0 million. This commitment expires December 31, 2005.

### 13. NET CHANGE IN OTHER OPERATING BALANCE SHEET ITEMS

	<i>January 31</i>	
	<u>2005</u>	<u>2004</u>
	(\$000)	
Accounts receivable	(1,588)	(1,047)
Prepaid insurance	(980)	(902)
Income taxes receivable	-	1,333
Pre-need receivables and funds	(2,300)	(4,356)
Cemetery care funds	(2,861)	(2,161)
Deferred obtaining costs and stored merchandise	(735)	(903)
Accounts payable and accrued liabilities	(12,500)	(8,314)
Deferred revenue	(1,208)	(1,243)
Non-controlling interest in pre-need funds	3,471	5,902
Non-controlling interest in cemetery care funds	2,861	2,161
Other changes	270	486
	<u>(15,570)</u>	<u>(9,044)</u>

### 14. SEGMENT DISCLOSURE

#### *Industry segments (\$000)*

	<i>Three Months Ended January 31</i>							
	<i>Cemetery</i>		<i>Funeral</i>		<i>Corporate</i>		<i>Consolidated</i>	
	<u>2005</u>	<u>2004</u>	<u>2005</u>	<u>2004</u>	<u>2005</u>	<u>2004</u>	<u>2005</u>	<u>2004</u>
Sales	20,633	19,518	23,932	23,899	146	145	44,711	43,562
Investment and other income	2,291	2,169	1,081	1,037	182	190	3,554	3,396
Revenue	<u>22,924</u>	<u>21,687</u>	<u>25,013</u>	<u>24,936</u>	<u>328</u>	<u>335</u>	<u>48,265</u>	<u>46,958</u>
Depreciation	735	673	1,178	1,087	158	206	2,071	1,966
Earnings (loss) from operations before other income	2,794	2,928	7,936	8,290	(2,856)	(2,716)	7,874	8,502
Other income	13	8	6	15	-	-	19	23
Earnings (loss) from operations	2,807	2,936	7,942	8,305	(2,856)	(2,716)	7,893	8,525
Interest expense	-	-	-	-	1,023	1,050	1,023	1,050
Identifiable assets <sup>(1)</sup>	524,056	519,188	405,596	408,522	23,782	27,080	953,434	954,790
Capital expenditures	976	1,135	1,933	934	357	207	3,266	2,276
Developed land, crypt and niche additions	1,778	895	-	-	-	-	1,778	895
Cemetery land held for future development additions	12	8	-	-	-	-	12	8
Pre-need contracts written	15,215	14,630	9,920	9,838	-	-	25,135	24,468

<sup>(1)</sup> Identifiable assets shown for 2004 are as at October 31 and have been restated to conform with the current period's presentation.

### 15. SUBSEQUENT EVENTS

Subsequent to January 31, 2005, the Company purchased a parcel of land adjacent to the premises of an existing funeral operation for \$0.2 million and disposed of a parcel of land held for future development for cash proceeds of \$0.2 million. The gain on the sale of the land was \$0.1 million.



**ARBOR**  
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