Meritage Homes CORP
Form 10-Q/A
November 01, 2006

# UNITED STATES

# SECURITIES AND EXCHANGE COMMISSION

**WASHINGTON, D.C. 20549**

# FORM 10-Q/A

## Amendment No. 1

**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**

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

**Commission File Number 1-9977**

# MERITAGE HOMES CORPORATION

(Exact Name of Registrant as Specified in Its Charter)

| | |
|---|---|
| **Maryland**<br>(State or Other Jurisdiction<br>of Incorporation or Organization) | **86-0611231**<br>(I.R.S. Employer<br>Identification No.) |
| **17851 North 85th Street, Suite 300**<br>**Scottsdale, Arizona**<br>(Address of Principal Executive Offices) | **85255**<br>(Zip Code) |

**(480) 609-3330**

(Registrant s Telephone Number, Including Area Code)

**Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (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 x No o**

**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 x** **Accelerated Filer o** **Non-Accelerated Filer o**

**Indicate by a checkmark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).**

**Yes o No x**

**Common shares outstanding as of October 30, 2006: 26,121,016.**

**MERITAGE HOMES CORPORATION**

**FORM 10-Q/A FOR THE QUARTER ENDED JUNE 30, 2006**

**Explanatory Note**

This quarterly report on Form 10-Q/A is filed for the purpose of restating Note 13 in the Notes to Condensed Consolidated Financial Statements for the three and six months ended June 30, 2006 and 2005, which includes expanded reportable segment footnote disclosure related to our homebuilding operations. The restatement has no impact on our consolidated balance sheets as of June 30, 2006 and December 31, 2005, or our consolidated statements of earnings and related earnings per share amounts, consolidated statements of cash flows or our consolidated statements of stockholders equity for the three and six months ended June 30, 2006 and 2005. Conforming changes have been made to Management s Discussion and Analysis of Financial Condition and Results of Operations in Part I, Item 2 and our Controls and Procedures discussion in Part I, Item 4 of this Form 10-Q/A. See Note 13 in the Notes of Condensed Consolidated Financial Statements for further information relating to the restatement. This Form 10-Q/A has not been updated for events or information subsequent to the date of filing of the original Form 10-Q, except in connection with the foregoing.

**MERITAGE HOMES CORPORATION**

**FORM 10-Q/A FOR THE QUARTER ENDED JUNE 30, 2006**

**TABLE OF CONTENTS**

**PART I - FINANCIAL INFORMATION**

**Item 1. Financial Statements**

**MERITAGE HOMES CORPORATION AND SUBSIDIARIES**

**UNAUDITED CONDENSED CONSOLIDATED BALANCE SHEETS**

**(in thousands, except share amounts)**

| | June 30, 2006 | December 31, 2005 |
|---|---|---|
| **Assets:** | | |
| Real estate | $ 1,548,822 | $ 1,392,267 |
| Cash and cash equivalents | 47,465 | 65,812 |
| Deposits on real estate under option or contract | 172,636 | 167,040 |
| Receivables | 59,664 | 60,745 |
| Goodwill | 129,940 | 130,222 |
| Intangibles, net | 14,075 | 14,029 |
| Property and equipment, net | 41,639 | 36,239 |
| Prepaid expenses and other assets | 26,791 | 16,289 |
| Investments in unconsolidated entities | 87,320 | 88,714 |
| Total assets | $ 2,128,352 | $ 1,971,357 |
| **Liabilities:** | | |
| Accounts payable | $ 132,213 | $ 140,789 |
| Accrued liabilities | 253,465 | 290,275 |
| Home sale deposits | 68,075 | 76,299 |
| Deferred tax liability, net | 19,295 | 20,865 |
| Loans payable and other borrowings | 243,013 | 112,398 |
| Senior notes | 478,553 | 479,726 |
| Total liabilities | 1,194,614 | 1,120,352 |
| **Stockholders Equity:** | | |
| Common stock, par value $0.01. Authorized 125,000,000 shares at June 30, 2006, and 50,000,000 shares at December 31, 2005; issued and outstanding 33,865,684 and 33,112,358 shares at June 30, 2006 and December 31, 2005, respectively | 338 | 331 |
| Additional paid-in capital | 326,147 | 296,804 |
| Deferred stock compensation | (1,920 ) | |
| Retained earnings | 794,039 | 637,248 |
| Treasury stock at cost, 7,791,068 and 5,935,068 shares at June 30, 2006 and December 31, 2005, respectively | (184,866 ) | (83,378 ) |
| Total stockholders equity | 933,738 | 851,005 |
| Total liabilities and stockholders equity | $ 2,128,352 | $ 1,971,357 |

See accompanying notes to condensed consolidated financial statements

**MERITAGE HOMES CORPORATION AND SUBSIDIARIES**

***UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF EARNINGS***

**(in thousands, except per share amounts)**

| | **Three Months Ended June 30, 2006** | **2005** | **Six Months Ended June 30, 2006** | **2005** |
|---|---|---|---|---|
| Home closing revenue | $ 902,851 | $ 651,783 | $ 1,749,225 | $ 1,202,730 |
| Land closing revenue | 11,809 | 1,788 | 12,706 | 2,009 |
| Total closing revenue | 914,660 | 653,571 | 1,761,931 | 1,204,739 |
| | | | | |
| Cost of home closings | (683,384) | (499,080) | (1,315,695) | (930,702) |
| Cost of land closings | (10,658) | (1,326) | (11,577) | (1,538) |
| Total cost of closings | (694,042) | (500,406) | (1,327,272) | (932,240) |
| | | | | |
| Home closing gross profit | 219,467 | 152,703 | 433,530 | 272,028 |
| Land closing gross profit | 1,151 | 462 | 1,129 | 471 |
| Total closing gross profit | 220,618 | 153,165 | 434,659 | 272,499 |
| | | | | |
| Commissions and other sales costs | (52,849) | (35,869) | (100,876) | (67,340) |
| General and administrative expenses | (51,344) | (26,672) | (94,066) | (50,635) |
| Earnings from unconsolidated entities, net | 5,251 | 2,053 | 10,839 | 6,514 |
| Other income, net | 3,474 | 2,316 | 5,385 | 3,956 |
| Loss on extinguishment of debt | | (197) | | (31,477) |
| | | | | |
| Earnings before provision for income taxes | 125,150 | 94,796 | 255,941 | 133,517 |
| Provision for income taxes | (48,095) | (35,557) | (99,150) | (50,082) |
| | | | | |
| Net earnings | $ 77,055 | $ 59,239 | $ 156,791 | $ 83,435 |
| | | | | |
| Earnings per common share: | | | | |
| Basic | $ 2.90 | $ 2.19 | $ 5.85 | $ 3.13 |
| Diluted | $ 2.82 | $ 2.05 | $ 5.68 | $ 2.92 |
| | | | | |
| Weighted average number of shares: | | | | |
| Basic | 26,609 | 27,110 | 26,792 | 26,664 |
| Diluted | 27,362 | 28,906 | 27,619 | 28,545 |

See accompanying notes to condensed consolidated financial statements

**MERITAGE HOMES CORPORATION AND SUBSIDIARIES**

***UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS***

**(in thousands)**

| | Six Months Ended June 30, 2006 | 2005 |
|---|---|---|
| **Cash flows from operating activities:** | | |
| Net earnings | $ 156,791 | $ 83,435 |
| Adjustments to reconcile net earnings to net cash used in operating activities: | | |
| Depreciation and amortization | 10,177 | 8,024 |
| Write-off of senior note issuance cost | | 4,977 |
| Write-off of deposits and land acquisition costs | 7,295 | |
| Decrease in deferred tax liability | (2,013) | |
| Stock-based compensation | 7,329 | |
| Excess tax benefit from stock-based compensation | (10,121) | |
| Tax benefit from stock option exercises | | 8,168 |
| Equity in earnings from unconsolidated entities | (10,839) | (6,514) |
| Distributions of earnings from unconsolidated entities | 7,836 | 6,934 |
| Changes in assets and liabilities, net of effect of acquisitions: | | |
| Increase in real estate | (163,203) | (250,249) |
| Increase in deposits on real estate under option or contract | (7,864) | (16,451) |
| Increase in receivables and prepaid expenses and other assets | (6,933) | (2,562) |
| (Decrease) increase in accounts payable and accrued liabilities | (34,193) | 70,822 |
| (Decrease) increase in home sale deposits | (8,224) | 15,238 |
| Net cash used in operating activities | (53,962) | (78,178) |
| | | |
| **Cash flows from investing activities:** | | |
| Investments in unconsolidated entities | (17,270) | (29,890) |
| Distributions of capital from unconsolidated entities | 15,357 | 10,789 |
| Cash paid for acquisitions | | (66,220) |
| Purchases of property and equipment | (16,356) | (11,009) |
| Proceeds from sales of property and equipment | 212 | 446 |
| Net cash used in investing activities | (18,057) | (95,884) |
| | | |
| **Cash flows from financing activities:** | | |
| Net borrowings under line of credit agreement | 135,000 | 37,600 |
| Proceeds from loans payable and other borrowings, net | 855 | |
| Repayments of loans payable and other borrowings, net | | (10,162) |
| Proceeds from issuance of senior notes, net | | 343,836 |
| Purchases of treasury stock | (101,488) | |
| Payments of senior notes | (1,254) | (285,472) |
| Proceeds from sale of common stock, net | | 69,699 |
| Excess tax benefit from stock-based compensation | 10,121 | |
| Proceeds from stock option exercises | 10,438 | 4,789 |
| Net cash provided by financing activities | 53,672 | 160,290 |
| | | |
| Net decrease in cash and cash equivalents | (18,347) | (13,772) |
| Cash and cash equivalents at beginning of period | 65,812 | 47,876 |
| Cash and cash equivalents at end of period | $ 47,465 | $ 34,104 |

See supplemental disclosures of cash flow information at Note 11.

See accompanying notes to condensed consolidated financial statements

**MERITAGE HOMES CORPORATION AND SUBSIDIARIES**

**NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**SIX MONTHS ENDED JUNE 30, 2006 AND 2005**

**NOTE 1 - ORGANIZATION AND BASIS OF PRESENTATION**

***Organization.*** We are a leading designer and builder of single-family homes in the growth regions of the southern and western United States, based on the number of home closings. We offer a variety of homes that are designed to appeal to a wide range of homebuyers, including first-time, move-up, luxury and active adult buyers. We have operations in three regions: West, Central and East, which are comprised of 14 metropolitan areas in Arizona, Texas, California, Nevada, Colorado and Florida. Meritage Homes Corporation was incorporated in 1988 as a real estate investment trust in the State of Maryland. In 1996 and 1997, through a merger and acquisition, we acquired the homebuilding operations of our predecessor companies having operations in Arizona and Texas. We currently focus exclusively on homebuilding and related activities and no longer operate as a real estate investment trust. At June 30, 2006, we were actively selling homes in 204 communities, with base prices ranging from $109,000 to $1,220,000.

***Basis of Presentation.*** The accompanying consolidated financial statements have been prepared in accordance with United States generally accepted accounting principles and include the accounts of Meritage Homes Corporation and those of our consolidated subsidiaries, partnerships and other entities in which we have a controlling financial interest, and of variable interest entities (see Note 3) in which we are deemed the primary beneficiary (collectively, the Company ). In management s opinion, the data reflects all adjustments, consisting of only normal recurring adjustments, necessary to fairly present our financial position and results of operations for the periods presented. Intercompany balances and transactions have been eliminated in consolidation and certain prior year amounts have been reclassified to conform to our current year financial statement presentation. These financial statements should be read in conjunction with our audited consolidated financial statements included in our Annual Report on Form 10-K/A for the year ended December 31, 2005.

The Company designs, constructs and sells a wide range of homes designed to meet the specific needs of each of its markets. Because each of our homebuilding regions has similar economic characteristics, housing products and classes of prospective buyers, each homebuilding region has been aggregated into a single homebuilding segment.

***Common Stock Repurchase.*** In August 2004, the Board of Directors approved a stock repurchase program authorizing the expenditure of up to $50 million to repurchase shares of our common stock. This program was completed in February 2006, with the repurchase of 601,000 shares at an average price of $59.21.

In February 2006, the Board of Directors approved a new stock repurchase program authorizing the expenditure of up to $100 million to repurchase shares of our common stock. There is no stated expiration date for this program but we will purchase shares subject to applicable securities law and at times and in amounts as management deems appropriate. In March 2006, we repurchased 255,000 shares at an average price of $53.77 under this program. In June 2006, we repurchased 1,000,000 shares from John R. Landon, our former Co-CEO and Co-Chairman, for $52.19 a share (see Note 12 - Other Events). At June 30, 2006, we had approximately $34.1 million available to repurchase additional shares under this program.

***Off-Balance Sheet Arrangements***. We often acquire finished building lots from various development entities pursuant to option and purchase agreements. The purchase price typically approximates the market price at the date the contract is executed. We believe this lot acquisition strategy reduces the financial requirements and risks associated with direct land ownership and land development. Under these option and purchase agreements, we are usually required to make deposits in the form of cash or letters of credit, which may be forfeited if we fail to perform under the applicable agreements. As of June 30, 2006, we had entered into option and purchase agreements with an aggregate purchase price of approximately $2.8 billion and had made deposits of approximately $172.6 million in the form of cash and approximately $75.0 million in letters of credit.

We participate in homebuilding and land development joint ventures from time to time as a means of accessing larger parcels of land and lot positions, expanding our market opportunities, managing our risk profile and leveraging our capital base. Our participation in joint ventures is an increasingly important part of our business model and we expect it to continue to increase in the future. We and/or our joint venture partners occasionally provide limited repayment guarantees on a pro rata basis on debt of certain unconsolidated land acquisition and development joint ventures. At June 30, 2006, our share of these limited pro rata repayment guarantees was $32.2 million.

In addition, we and/or our joint venture partners occasionally provide guarantees that are only applicable if and when the joint venture directly, or indirectly through agreement with its joint venture partners or other third parties, causes the joint venture to voluntarily file a bankruptcy or similar liquidation or reorganization action or take other actions that are fraudulent or improper (commonly referred to as bad boy guarantees ). These types of guarantees typically are on a pro rata basis and are designed to protect the respective secured lender s remedies with respect to its mortgage or other secured lien on the joint venture s underlying property. To date, no such guarantees have been invoked and we believe it is unlikely that such a guarantee would be invoked in the future as it would require us to voluntarily take actions that would generally be disadvantageous to the joint venture and to us. At June 30, 2006, we had outstanding guarantees of this type totaling approximately $63.9 million. By definition, these guarantees, unless invoked as described above, are not considered guarantees or indebtedness under our revolving credit facility or senior note indentures.

We and our joint venture partners are also typically obligated to the project lenders to complete land development improvements if the joint venture does not perform the required development. Provided we and the other joint venture partners are in compliance with these completion obligations, the project lenders are generally obligated to fund these improvements through any financing commitments available under the applicable joint venture development and construction loans. In addition, we and our joint venture partners have from time to time provided unsecured environmental indemnities to joint venture project lenders. In some instances, our exposure under these indemnities is limited. These indemnities generally obligate us to reimburse the project lenders only for claims related to environmental matters for which such lenders are held responsible. As part of our project acquisition due diligence process to determine potential environmental risks, we generally obtain, or the joint venture entity generally obtains, an independent environmental review from outside consultants.

Additionally, we and our joint venture partners sometimes agree to indemnify third party surety providers with respect to performance bonds issued on behalf of certain of our joint ventures. If a joint venture does not perform its obligations, the surety bond could be called. If these surety bonds are called and the joint venture fails to reimburse the surety, we and our joint venture partners would be obligated to indemnify the surety. These surety indemnity arrangements are generally joint and several obligations with our other joint venture partners. As of June 30, 2006, we had approximately $40.1 million of surety bonds outstanding subject to these indemnity arrangements. None of these bonds have been called to date and we believe it is unlikely that any of these bonds will be called.

We also obtain letters of credit and performance, maintenance and other bonds in support of our related obligations with respect to the development of our projects. The amount of these obligations outstanding at any time varies depending on the stage and level of our development activities. In the event the letters of credit or bonds are drawn upon, we would be obligated to reimburse the issuer of the letter of credit or bond. At June 30, 2006, we had approximately $31.7 million in outstanding letters of credit and $255.1 million in performance bonds for such purposes. We believe it is unlikely that any of these letters of credit or bonds will be drawn upon.

***Intangibles, net.*** Intangible assets consist primarily of non-compete agreements, tradenames and home plan designs acquired in connection with our February 2005 acquisition of Colonial Homes and our September 2005 acquisition of Greater Homes. These intangible assets were valued at the acquisition dates utilizing accepted valuation procedures. The non-compete agreements, tradenames and home plan designs are being amortized over their estimated useful lives. The cost and accumulated amortization of our intangible assets was $11.5 million and $3.3 million, respectively, at June 30, 2006. In the first six months of 2006, amortization expense was $1.5 million. Amortization expense is expected to be approximately $1.4 million in the remaining six months of 2006 and $2.8, $2.3, $1.2 and $0.5 million per year in 2007, 2008, 2009 and 2010, respectively.

Additionally, in accordance with SOP 98-1 Accounting for Costs of Computer Software Developed or Obtained for Internal Use , we have capitalized software costs at June 30, 2006 of $5.9 million, net of accumulated amortization of $3.8 million. In the first six months of 2006, amortization expense was approximately $1.3 million related to the capitalized software costs and is expected to be approximately $1.7 million for the remaining six months of 2006 and $1.8, $0.7, $0.7, $0.7 and $0.3 million in 2007, 2008, 2009, 2010 and 2011, respectively.

***Accrued Liabilities.*** Accrued liabilities consists of the following (in thousands):

| | June 30, 2006 | December 31, 2005 |
|---|---|---|
| Accruals related to real estate development and construction activities | $ 141,697 | $ 135,953 |
| Payroll and other benefits | 54,932 | 51,382 |
| Accrued taxes | | 48,941 |
| Warranty reserves | 26,494 | 25,168 |
| Other accruals | 30,342 | 28,831 |
| Total | $ 253,465 | $ 290,275 |

***Warranty Reserves.*** As is customary in the homebuilding industry, we have obligations related to post-construction warranties and defect claims for homes closed. We have established reserves for these obligations based on historical data and trends with respect to similar product types and geographic areas. Warranty reserves are included in accrued liabilities on the accompanying condensed consolidated balance sheets. Additions to warranty reserves are included in cost of sales within the accompanying condensed consolidated statements of earnings. We periodically review the adequacy of our warranty reserves, and believe they are sufficient to cover potential costs for materials and labor related to post-construction warranties and defects. A summary of changes in our warranty reserves follows (in thousands):

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| | 2006 | 2005 | 2006 | 2005 |
| Balance, beginning of period | $ 26,229 | $ 16,300 | $ 25,168 | $ 14,967 |
| Additions to reserve | 5,165 | 3,656 | 10,393 | 7,202 |
| Warranty claims and expenses | (4,900 ) | (2,738 ) | (9,067 ) | (4,951 ) |
| Balance, end of period | $ 26,494 | $ 17,218 | $ 26,494 | $ 17,218 |

***Recently Issued Accounting Pronouncements.*** In June 2006, the Financial Accounting Standards Board ( FASB ) issued FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes*, an interpretation of FASB No. 109 ( FIN 48 ). FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise s financial statements in accordance with FASB No. 109, *Accounting for Income Taxes*. FIN 48 prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN 48 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. FIN 48 is effective for fiscal years beginning after December 15, 2006. Earlier application of the provisions of FIN 48 is encouraged if the enterprise has not yet issued financial statements, including interim financial statements, in the period this interpretation is adopted. We are currently evaluating the impact of the adoption of FIN 48 on our results of operations and statement of financial position.

Reference is made to Note 9 regarding our adoption of SFAS No. 123R, *Share-based Payment.*

**NOTE 2 - REAL ESTATE AND CAPITALIZED INTEREST**

Real estate consists of the following (in thousands):

| | June 30, 2006 | December 31, 2005 |
|---|---|---|
| Homes under contract under construction | $ 809,951 | $ 815,925 |
| Finished home sites and home sites under development | 440,614 | 370,921 |
| Unsold homes, completed and under construction | 192,223 | 116,088 |
| Model homes | 67,883 | 45,060 |
| Model home lease program | 34,096 | 39,336 |
| Land held for development | 4,055 | 3,473 |

| | | | | |
|---|---|---|---|---|
| Real estate not owned | | | 1,464 | |
| | $ | 1,548,822 | $ | 1,392,267 |

Subject to sufficient qualifying assets, we capitalize all development period interest costs incurred in connection with the development and construction of real estate. Capitalized interest is allocated to real estate when incurred and charged

10

to cost of home closings when the related property is delivered. Certain information regarding capitalized interest follows (in thousands):

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| | **2006** | **2005** | **2006** | **2005** |
| Capitalized interest, beginning of period | $ 24,753 | $ 21,902 | $ 23,939 | $ 19,701 |
| Interest incurred and capitalized | 12,600 | 9,710 | 24,175 | 19,839 |
| Amortization to cost of home closings | (9,518) | (9,583) | (20,279) | (17,511) |
| Capitalized interest, end of period | $ 27,835 | $ 22,029 | $ 27,835 | $ 22,029 |

**NOTE 3 - VARIABLE INTEREST ENTITIES AND CONSOLIDATED REAL ESTATE NOT OWNED**

FASB Interpretation No. 46 (revised December 2003), *Consolidation of Variable Interest Entities* ( FIN 46R ) requires the consolidation of entities in which an enterprise absorbs a majority of the entity s expected losses, receives a majority of the entity s expected residual returns, or both, as a result of ownership, contractual or other financial interests in the entity. Prior to the issuance of FIN 46R, entities were generally consolidated by an enterprise when it had a controlling financial interest through ownership of a majority voting interest in the entity.

Under FIN 46R, a variable interest entity, or VIE, is created when (i) the equity investment at risk is not sufficient to permit the entity to finance its activities without additional subordinated financial support from other parties, (ii) equity holders either (a) lack direct or indirect ability to make decisions about the entity, (b) are not obligated to absorb expected losses of the entity, or (c) do not have the right to receive expected residual returns of the entity or (iii) the equity of investors as a group are considered to lack the direct or indirect ability to make decisions about the entity if (x) the voting rights of some investors are not proportional to their obligations to absorb the expected losses of the entity, their rights to receive the expected residual returns of the entity, or both, and (y) substantially all of the entity s activities either involve or are conducted on behalf of an investor that has disproportionately fewer voting rights.

Based on the provisions of FIN 46R, we have concluded that when we enter into an option or purchase agreement to acquire land or lots from an entity and pay a non-refundable deposit, a VIE is created because we are deemed to have provided subordinated financial support, which refers to variable interests that will absorb some or all of an entity s expected losses if they occur. For each VIE created, we compute expected losses and residual returns based on the probability of future cash flows as outlined in FIN 46R. If we are deemed to be the primary beneficiary of the VIE, because we are obligated to absorb the majority of the expected losses, receive the majority of the residual returns, or both, we will consolidate the VIE in our consolidated financial statements. Not all of our purchase and option agreements are determined to be VIEs.

We have applied FIN 46R by developing a methodology to determine whether or not we are the primary beneficiary of the VIE. Part of this methodology requires the use of estimates in assigning probabilities to various future cash flow possibilities relative to changes in the fair value and changes in the development costs associated with the property. Although we believe that our accounting policy properly identifies our primary beneficiary status with these VIEs, changes in the probability estimates could produce different conclusions regarding our primary beneficiary status.

We generally do not have any ownership interest in the VIEs that hold the lots and land under option or contract, and accordingly, we generally do not have legal or other access to the VIE s books or records. Therefore, it is not possible for us to compel the VIEs to provide financial or other data to us in performing our primary beneficiary evaluation. Accordingly, this lack of information from the VIEs may result in our evaluation being conducted primarily based on management s judgments and estimates.

In most cases, creditors of the entities with which we have option agreements have no recourse against us and the maximum exposure to loss in our option agreements is limited to our option deposit. Often, we are at risk for items over budget related to land development on property we have under option. In these cases, we have contracted to complete development at a fixed cost on behalf of the land owner. Some of our option deposits may be refundable if certain contractual conditions are not performed by the party selling the lots to us. At June 30, 2006, we had no specific performance options, as none of our option agreements require us to purchase lots.

The table below presents a summary of our lots under option or contract at June 30, 2006 (dollars in thousands):

| | Number of Lots | Purchase Price | Option/Earnest Money Deposits Cash | Letters of Credit |
|---|---|---|---|---|
| Option contracts not recorded on balance sheet non-refundable deposits (1) | 32,516 | $ 2,047,780 | $ 141,844 | $ 74,467 |
| Purchase contracts not recorded on balance sheet non-refundable deposits (1) | 13,508 | 493,244 | 29,178 | 484 |
| Purchase contracts not recorded on balance sheet refundable deposits (2) | 6,102 | 242,630 | 1,614 | |
| Total lots under option or contract not recorded on balance sheet | 52,126 | $ 2,783,654 | $ 172,636 | $ 74,951 |

Notes: Our options to purchase lots remain effective so long as we purchase a pre-established minimum number of lots each month or quarter, as determined by the applicable agreement. The pre-established number of lots typically is structured to approximate our expected rate of home orders, although as demand slows, in some instances starts may fall below the pre-established minimum number. This could force us to purchase lots in advance of corresponding sales, re-negotiate the takedown schedule, or discontinue lot purchases and forfeit the related non-refundable option deposit.

(1) Deposits are non-refundable except if certain contractual conditions are not performed by the selling party.

(2) Deposits are refundable at our sole discretion. Includes 5,135 lots under contract for which we have not completed our due diligence process.

**NOTE 4 - INVESTMENTS IN UNCONSOLIDATED ENTITIES**

We participate in homebuilding and land development joint ventures from time to time as a means of accessing larger parcels of land and lot positions, expanding our market opportunities, managing our risk profile and leveraging our capital base. For the periods presented, we do not have controlling financial interests in these unconsolidated entities. Our joint venture partners generally are other homebuilders, land sellers or other real estate investors. We also enter into mortgage and title business joint ventures from time to time. These unconsolidated entities follow accounting principles generally accepted in the United States of America and we generally share in their profits and losses in accordance with our ownership interests.

For land development joint ventures, we and, in some cases our joint venture partners, usually receive an option or other similar arrangement to purchase portions of the land held by the joint venture. Option prices are generally negotiated prices that approximate market value when we enter into the option contract. For homebuilding and land development joint ventures, our share of the joint venture earnings relating to lots we purchase from the joint ventures is deferred until homes are delivered by us and title passes to a homebuyer. At such time, we allocate our joint venture earnings to the land acquired by us as a reduction in the basis of the property.

We and/or our joint venture partners occasionally provide limited repayment guarantees on a pro rata basis on the debt of certain unconsolidated land acquisition and development joint ventures. At June 30, 2006, our share of these limited pro rata repayment guarantees was approximately $32.2 million.

In addition, we and/or our joint venture partners occasionally provide guarantees that are only applicable if and when the joint venture directly, or indirectly through agreement with its joint venture partners or other third parties, causes the joint venture to voluntarily file a bankruptcy or similar liquidation or reorganization action or take other actions that are fraudulent or improper (commonly referred to as bad boy guarantees ). These types of guarantees typically are on a pro rata basis and are designed to protect the respective secured lender s remedies with respect to its mortgage or other secured lien on the joint venture s underlying property. To date, no such guarantees have been invoked and we believe it is unlikely that such a guarantee would be invoked in the future as it would require us to voluntarily take actions that would generally be disadvantageous to the joint venture and to us. At June 30, 2006, we had outstanding guarantees of this type totaling approximately $63.9 million. By definition, these guarantees, unless invoked as described above, are not considered guarantees or indebtedness under our revolving credit facility or senior note indentures.

Summarized condensed financial information related to unconsolidated joint ventures that are accounted for using the equity method was as follows (in thousands):

| | June 30, 2006 | December 31, 2005 |
|---|---|---|
| **Assets:** | | |
| Cash | $ 16,567 | $ 10,337 |
| Real estate | 625,733 | 524,775 |
| Other assets | 21,440 | 22,373 |
| Total assets | $ 663,740 | $ 557,485 |
| | | |
| **Liabilities and equity:** | | |
| Accounts payable and other liabilities | $ 50,612 | $ 32,244 |
| Notes and mortgages payable | 416,072 | 299,498 |
| Equity of: | | |
| Meritage | 69,898 | 72,362 |
| Others | 127,158 | 153,381 |
| Total liabilities and equity | $ 663,740 | $ 557,485 |

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| | 2006 | 2005 | 2006 | 2005 |
| Revenues | $ 18,804 | $ 52,868 | $ 45,932 | $ 83,535 |
| Costs and expenses | (8,437 ) | (38,546 ) | (17,664 ) | (59,376 ) |
| Net earnings of unconsolidated entities | $ 10,367 | $ 14,322 | 28,268 | 24,159 |
| Meritage s share of pre-tax earnings (1) | $ 5,251 | $ 3,137 | $ 11,530 | $ 7,598 |

(1) Our share of pre-tax earnings is recorded in Earnings from unconsolidated entities, net on our consolidated statements of earnings. Our share of pre-tax earnings excludes joint venture earnings related to lots we purchased from the joint ventures. Those earnings are deferred until homes are delivered by us and title passes to a homebuyer.

At June 30, 2006 and December 31, 2005, our investments in unconsolidated entities includes $1.5 million related to the difference between the amounts at which our investments are carried and the amount of underlying equity in net assets. These amounts are amortized to equity of earnings of unconsolidated entities over the life of the respective joint ventures, which offsets their related earnings. We amortized approximately $1.1 million to our equity of the joint venture earnings in the second quarter of 2005 and approximately $0.7 million and $1.1 million in the first six months of 2006 and 2005, respectively. We had no such amortization in the second quarter of 2006.

In addition to joint ventures accounted for under the equity method summarized in the above table, at June 30, 2006, and December 31, 2005, our investments in unconsolidated entities included joint ventures recorded under the cost method. These joint ventures were formed to acquire large parcels of land, to perform off-site development work and to sell lots to the

joint venture members and other third parties. As of June 30, 2006, and December 31, 2005, our investments in unconsolidated entities recorded under the cost method were $15.9 and $14.9 million, respectively. As of June 30, 2006, we have not recorded any income or distributions from these joint ventures.

As of June 30, 2006, our total investment in unconsolidated joint ventures of $87.3 million was primarily comprised of $27.3 million in our West Region, $59.4 million in our Central Region and $0.2 million in our East Region. As of December 31, 2005, our total investment in unconsolidated joint ventures of $88.7 million was primarily comprised of $28.5 million in our West Region and $59.4 million in our Central Region.

**NOTE 5 - LOANS PAYABLE AND OTHER BORROWINGS**

Loans payable consists of the following (in thousands):

| | June 30, 2006 | December 31, 2005 |
|---|---|---|
| $850 million unsecured revolving credit facility maturing May 2010 with extension provisions, and interest payable monthly approximating LIBOR (approximately 5.50% at June 30, 2006) plus 1.7% or Prime (approximately 8.25% at June 30, 2006) | $ 207,600 | $ 72,600 |
| Model home lease program, with interest in the form of lease payments payable monthly approximating 7.71% at June 30, 2006 | 34,096 | 39,336 |
| Other borrowings, acquisition and development financing | 1,317 | 462 |
| Total loans payable and other borrowings | $ 243,013 | $ 112,398 |

We have determined that the construction costs and related debt associated with certain model homes that are owned and leased to us by others and that we use to market our communities are required to be included on our balance sheet. We do not legally own these model homes, but we are reimbursed by the owner for our construction costs and we have the right, but not the obligation, to purchase these homes. Although we have no legal obligation to repay any amounts received from the third-party owner, such amounts are recorded as debt and are typically deemed repaid when we simultaneously exercise our option to purchase the model home and sell it to a third-party home buyer. Should we elect not to exercise our rights to purchase these model homes, the model home costs and related debt under the model lease program will be eliminated upon the termination of the lease, which is generally between one and three years from the origination of the lease.

On May 16, 2006, we amended and restated our senior unsecured revolving credit facility. Under the First Amended and Restated Credit Agreement with Guaranty Bank, as administrative agent, and a number of other financial institutions (the New Credit Agreement ), our credit facility was increased from $600 million to $800 million, and the term was extended from May 2009 to May 2010. The maximum borrowings under the New Credit Agreement are based on the amount of qualifying borrowing base assets (generally real estate assets), limited to the facility size. In addition, the New Credit Agreement includes an accordion feature that will allow Meritage to request from time to time an increase of up to $250 million in the maximum borrowing commitment. Each member of the lending group may elect to participate or not participate in any request we make to increase the maximum borrowing commitment. In addition, any increase in the borrowing capacity pursuant to this accordion feature is subject to certain terms and conditions, including the absence of an event of default. On June 30, 2006, we exercised a portion of the accordion feature under the New Credit Agreement to increase our borrowing capacity by $50 million to $850 million and amended the New Credit Agreement to make certain other minor changes.

**NOTE 6 - SENIOR NOTES**

Senior notes consist of the following (in thousands):

| | June 30, 2006 | December 31, 2005 |
|---|---|---|
| 6.25% senior notes due 2015. At June 30, 2006, and December 31, 2005, there was approximately $1.5 and $1.6 million, respectively, in unamortized discount | $ 348,484 | $ 348,396 |
| 7.0% senior notes due 2014. At both June 30, 2006, and December 31, 2005, there was approximately $0.1 million in unamortized premium | 130,069 | 130,074 |
| 9.75% senior notes due 2011 | | 1,256 |
| | $ 478,553 | $ 479,726 |

In March 2005, we used a portion of the proceeds from the $350 million sale of our 6.25% senior notes to repurchase pursuant to a tender offer and consent solicitation approximately $276.8 million of our outstanding 9.75% senior notes due 2011. In connection with this tender offer and repurchase, we reported a one-time pre-tax charge of approximately $31.5 million for premiums, commissions and expenses associated with the tender offer and the write-off of existing offering costs associated with the 9.75% senior notes, net of the accretion of existing note premiums on the 9.75% senior notes. Later during 2005, we repurchased an additional $2 million of our 9.75% senior notes. During the second quarter of 2006, we repurchased the remaining $1.2 million of our outstanding 9.75% senior notes.

The New Credit Agreement and indentures for the 7% senior notes due 2014 and the 6.25% senior notes due 2015 contain covenants that require maintenance of certain levels of tangible net worth and compliance with certain minimum financial ratios, place limitations on the payment of dividends and redemptions of equity, and limit the incurrence of additional indebtedness, asset dispositions, mergers, certain investments and creations of liens, among other items. As of and for the quarter ended June 30, 2006, we were in compliance with these covenants. After considering our most restrictive bank covenants, our borrowing availability under the New Credit Agreement was approximately $496.0 million at June 30, 2006 as determined by borrowing base limitations defined by our agreement with the lending banks. The New Credit Agreement and indentures relating to our senior notes restrict our ability to pay dividends, and at June 30, 2006, our maximum permitted amount available to pay dividends was $337.0 million.

Obligations to pay principal and interest on the New Credit Agreement and senior notes are guaranteed by all of our subsidiaries (collectively, the Guarantor Subsidiaries), each of which is directly or indirectly 100% owned by Meritage Homes Corporation. Such guarantees are full and unconditional, and joint and several. We do not provide separate financial statements of the Guarantor Subsidiaries because Meritage (the parent company) has no independent assets or operations, the guarantees are full and unconditional and joint and several and there are no non-guarantor subsidiaries. There are no significant restrictions on the ability of Meritage or any Guarantor Subsidiary to obtain funds from their respective subsidiaries, as applicable, by dividend or loan.

**NOTE 7 - ACQUISITIONS AND GOODWILL**

***Greater Homes Acquisition***. In September 2005 we purchased all of the outstanding stock of Greater Homes, Inc. ( Greater Homes ), a builder of single-family homes in Orlando, Florida. The purchase price was approximately $86.2 million in cash, including the repayment of existing debt of approximately $27.7 million. The results of Greater Homes operations have been included in our financial statements since September 1, 2005, the effective date of the acquisition. Assets and liabilities were recorded at their estimated fair market value at the date of acquisition, and are subject to change when we finalize our analysis.

***Colonial Homes Acquisition***. In February 2005 we purchased the homebuilding and related assets of Colonial Homes of Florida ( Colonial Homes ), which operates primarily in the Ft. Myers/Naples area. The purchase price was approximately $66.2 million in cash. The results of Colonial Homes operations have been included in our consolidated financial statements as of the effective date of acquisition, February 1, 2005.

***Goodwill.*** Goodwill represents the excess of the purchase price of our acquisitions over the fair value of the assets acquired. The acquisitions of Colonial Homes and Greater Homes were recorded using the purchase method of accounting. The purchase price for each was allocated based on estimated fair values of the assets acquired and liabilities assumed at the date of the acquisition. The excess purchase price over the fair value of the net assets acquired of $27.9 and $10.1 million for Colonial Homes and Greater Homes, respectively, was recorded as goodwill.

The changes in the carrying amount of goodwill for the six months ended June 30, 2006, follow (in thousands):

| | Corporate | West | Central | East | Total |
|---|---|---|---|---|---|
| Balance at December 31, 2005 | $ 1,323 | $ 37,395 | $ 54,043 | $ 37,461 | $ 130,222 |
| Tax benefit of amortization of excess tax basis | | (37) | (59) | (186) | (282) |
| Balance at June 30, 2006 | $ 1,323 | $ 37,358 | $ 53,984 | $ 37,275 | $ 129,940 |

Under the guidelines contained in SFAS No. 142, *Goodwill and Other Intangible Assets*, in the first quarter of 2006 management performed its annual assessment of goodwill and determined that no impairment existed.

See Note 11 for a summary of the allocation of the purchase price to acquired assets and liabilities.

**NOTE 8 - EARNINGS PER SHARE**

Basic and diluted earnings per common share are presented in conformity with SFAS No. 128, *Earnings Per Share.* The following table presents the calculation of basic and diluted earnings per common share (in thousands, except per share amounts):

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| | 2006 | 2005 | 2006 | 2005 |
| Basic weighted average number of shares outstanding | 26,609 | 27,110 | 26,792 | 26,664 |
| Effect of dilutive securities: | | | | |
| Stock options and restricted stock | 753 | 1,796 | 827 | 1,881 |
| Diluted weighted average shares outstanding | 27,362 | 28,906 | 27,619 | 28,545 |
| Net earnings | $ 77,055 | $ 59,239 | $ 156,791 | $ 83,435 |
| Basic earnings per share | $ 2.90 | $ 2.19 | $ 5.85 | $ 3.13 |
| Diluted earnings per share | $ 2.82 | $ 2.05 | $ 5.68 | $ 2.92 |
| Antidilutive stock options not included in the calculation of diluted earnings per share | 760 | | 679 | |

**NOTE 9 - STOCK-BASED COMPENSATION**

In the first quarter of 2006, we adopted SFAS 123R, *Share-Based Payment* ( SFAS 123R ), which revises SFAS 123, *Accounting for Stock-Based Compensation*. Prior to 2006, we accounted for stock awards granted to employees under the recognition and measurement principles of Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees, and Related Interpretations*. As a result, in periods prior to fiscal year 2006, no compensation expense was recognized for stock options granted to employees because we did not grant stock options with exercise prices below the market price of the underlying stock on the date of the grant.

SFAS 123R applies to new awards and to awards modified, repurchased or cancelled after the required effective date, as well as to the unvested portion of awards outstanding as of the required effective date. We use the Black-Scholes model to value new stock option grants under SFAS 123R. We have applied the modified prospective method for existing grants, which requires us to value stock options prior to our adoption of SFAS 123R under the fair value method and expense the unvested portion over the remaining vesting period. SFAS 123R also requires us to estimate forfeitures in calculating the expense related to stock-based compensation and to reflect the benefits of tax deductions in excess of recognized compensation expense as both a financing inflow and an operating cash outflow upon adoption.

We have two stock compensation plans, the Meritage Stock Option Plan, which was adopted in 1997 and has been amended from time to time (the 1997 Plan ), and the 2006 Stock Incentive Plan (the 2006 Plan and together with the 1997 Plan, the Plans ). The Plans, which were approved by our stockholders, are administered by our Board of Directors. The provisions of the Plans are generally consistent with the exception that the 2006 Plan allows for the grant of stock appreciation rights, restricted stock awards, performance share awards and performance-based awards in addition to the non-qualified and incentive stock options allowed under the 1997 Plan. The Plans authorize awards to officers, key employees, non-employee directors and consultants for up to 6,600,000 shares of common stock, of which 729,207 shares remain available for grant at June 30, 2006. We believe that such awards provide a means of performance-based compensation to attract and retain qualified employees and better align the interests of our employees with those of our stockholders. Generally, option awards are granted with an exercise price equal to the market price of Meritage stock at the date of grant, a five-year ratable vesting period and a seven-year contractual term.

The following table illustrates the effect on net income and earnings per share for the three and six months ended June 30, 2005, as if our stock-based compensation had been determined based on the fair value at the grant dates for awards made prior to 2006, under the Plans and consistent with SFAS 123R (in thousands, except per share amounts):

| | | Three Months Ended June 30, 2005 | | | Six Months Ended | | |
|---|---|---|---|---|---|---|---|
| Net earnings | As reported | $ | 59,239 | | $ | 83,435 | |
| | Deduct (1) | (1,989 | | ) | (3,355 | | ) |
| | Pro forma | $ | 57,250 | | $ | 80,080 | |
| | | | | | | | |
| Basic earnings per share | As reported | $ | 2.19 | | $ | 3.13 | |
| | Pro forma | $ | 2.11 | | $ | 3.00 | |
| | | | | | | | |
| Diluted earnings per share | As reported | $ | 2.05 | | $ | 2.92 | |
| | Pro forma | $ | 1.98 | | $ | 2.81 | |

(1) Total stock-based compensation expense determined using the fair value method for awards, net of related tax effects.

The pro forma results above are not intended to be indicative of, or a projection of, future results.

The fair values of option awards are estimated using a Black-Scholes option pricing model that uses the assumptions noted in the following table. Beginning January 1, 2006, expected volatilities are based on a combination of implied volatilities from traded options on our stock and historical volatility of our stock. Expected term, which represents the period of time that options granted are expected to be outstanding, is estimated using historical data. Groups of employees that have similar historical exercise behavior are considered separately for valuation purposes. The risk-free interest rate for periods within the contractual life of the option is based on the U.S. Treasury yield curve.

| | Six Months Ended June 30, 2006 | | 2005 | |
|---|---|---|---|---|
| Expected volatility | 46 48 | % | 52 | % |
| Expected dividends | 0 | % | 0 | % |
| Expected term (in years) | 4.80 5.85 | | 7 | |
| Risk-free interest rate | 5.04 5.05 | % | 4.43 | % |
| Weighted average grant date fair value of options granted | $ 25.63 | | $ 34.44 | |

A summary of option activity under the Plans as of June 30, 2006, and changes during the six months then ended is presented below:

| Options | Shares | Weighted Average Exercise Price | Weighted Average Remaining Contractual Term | Aggregate Intrinsic Value (in thousands) |
|---|---|---|---|---|
| Outstanding at January 1, 2006 | 2,799,282 | $ 27.90 | | |
| Granted | 587,000 | $ 53.99 | | |
| Exercised | (753,326 ) | $ 13.86 | | |
| Forfeited or expired | (173,800 ) | $ 31.67 | | |
| Outstanding at June 30, 2006 | 2,459,156 | $ 38.16 | 4.81 | $ 33,432 |
| Exercisable at June 30, 2006 | 874,654 | $ 25.76 | 3.26 | $ 20,554 |

A summary of the status of the Company s restricted stock as of June 30, 2006 is presented below:

| Restricted Stock | Shares | Weighted-Average Grant-Date Fair Value |
|---|---|---|
| Nonvested at January 1, 2006 | | $ |
| Granted | 34,886 | 57.33 |
| Vested | | |
| Forfeited | | |
| Nonvested at June 30, 2006 | 34,886 | $ 57.33 |

The total intrinsic value of options exercised during the three and six months ended June 30, 2006 was $16.3 million and $31.3 million, respectively, and $15.8 million and $28.5 million during the three and six months ended June 30, 2005, respectively. The intrinsic value of a stock option is the amount by which the market value of the underlying stock exceeds the exercise price of the stock option.

As of June 30, 2006, we had $37.2 million of total unrecognized compensation cost related to non-vested stock-based compensation arrangements granted under the Plans that will be recognized on a straight-line basis over the remaining vesting periods. That cost is expected to be recognized over a weighted-average period of 3.42 years. For the three and six months ended June 30, 2006, our total stock-based compensation expense was $4.7 million ($3.3 million net of tax) and $7.3 million ($5.3 million net of tax), respectively. Stock compensation expense net of tax for the three months ended June 30, 2006 was $0.12 per basic and diluted share. Stock compensation expense for the six months ended June 30, 2006 was $0.19 per basic share and $0.20 per diluted share.

Cash received from option exercises under the Plans for the three and six months ended June 30, 2006, was $8.0 million and $10.4 million, respectively, and $3.3 million and $4.8 million for the three and six months ended June 30, 2005, respectively. The actual tax benefit realized for the tax deductions from option exercises totaled $5.1 million and $10.1 million for the three and six months ended June 30, 2006, respectively, and $5.5 million and $8.2 million for the three and six months ended June 30, 2005, respectively.

**NOTE 10 - INCOME TAXES**

Components of the provision for income taxes are (in thousands):

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| | **2006** | **2005** | **2006** | **2005** |
| Federal | $ 41,614 | $ 30,813 | $ 85,995 | $ 43,393 |
| State | 6,481 | 4,744 | 13,155 | 6,689 |
| Total | $ 48,095 | $ 35,557 | $ 99,150 | $ 50,082 |

**NOTE 11 - SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION**

The February 2005 acquisition of Colonial Homes (East Region) resulted in the following changes in assets and liabilities (in thousands):

| | **June 30, 2005** |
|---|---|
| Increase in real estate | $ (47,592 ) |
| Increase in deposits on real estate under option or contract | (1,343 ) |
| Increase in receivables and other assets | (1,065 ) |
| Increase in goodwill | (22,111 ) |
| Increase in intangibles | (2,763 ) |
| Increase in property and equipment | (327 ) |
| Increase in accounts payable and accrued liabilities | 3,758 |
| Increase in home sale deposits | 5,223 |
| | |
| Net cash paid for acquisition | $ (66,220 ) |

The following presents certain supplemental cash flow information (in thousands):

| | Six Months Ended June 30, | |
|---|---|---|
| | **2006** | **2005** |
| Cash paid during the period for: | | |
| Interest | $ 22,072 | $ 14,510 |
| Income taxes | $ 150,515 | $ 52,463 |
| Non-cash distributions from unconsolidated entities | $ 4,011 | $ 19,863 |

**NOTE 12 OTHER EVENTS**

On May 17, 2006, John R. Landon, the Company s Co-CEO, resigned. In connection with Mr. Landon s departure, both his employment and change of control agreement terminated (other than certain provisions in the Employment Agreement that survive termination). Under the terms of the Employment Agreement, subject to his compliance with certain restrictive covenants and other requirements therein, Mr. Landon is entitled to a payment of $10,000,000, payable in equal monthly installments over the course of 24 months, and acceleration of the vesting of all outstanding stock options that were granted to him after the effective date of the employment agreement, which was July 1, 2003. During the quarter ended June 30, 2006, the Company expensed approximately $10.0 million related to the obligations owed to Mr. Landon pursuant to the terms of his employment agreement and also recorded stock-based compensation expense of approximately $2.3 million related to the accelerated vesting of certain of his outstanding stock options. On June 12, 2006, the Company entered into a Stock Purchase Agreement with Mr. Landon, pursuant to which the Company acquired 1,000,000 shares of the Company s common stock from Mr. Landon at a price of $52.19 per share, or an aggregate purchase price of $52.2 million.

**NOTE 13 OPERATING AND REPORTING SEGMENTS (AS RESTATED)**

Subsequent to the issuance of our unaudited condensed consolidated financial statements for the three and six months ended June 30, 2006, management determined that the notes to the consolidated financial statements for the three and six months ended June 30, 2006 and 2005 should be restated to contain revised and expanded reportable segments disclosures in accordance with SFAS No. 131, *Disclosures About Segments of an Enterprise and Related Information*. Historically, we have reported our six operating segments (the six states in which we are currently actively selling homes) as a single homebuilding segment, but have revised and restated our segment disclosure by aggregating our operating segments into three reportable segments: the West, Central and East regions, as further described below. Revenues in these segments are derived primarily from the sale of homes that we construct. This restatement has no impact on our condensed consolidated financial statements, related earnings per share amounts or cash flows.

As required by SFAS No. 131, the operating segments aggregating into each reporting segment have been determined to have similar economic characteristics such as: historical and projected future operating results, employment trends, land acquisition and land constraints, municipality behavior as well as meeting the other qualitative aggregation criteria. The reportable homebuilding segments are aggregated as follows:

| | |
|---|---|
| *West:* | California and Nevada |
| *Central:* | Texas, Arizona and Colorado |
| *East:* | Florida |

Management s evaluation of segment performance is based on segment operating income, which we define as homebuilding and land revenues less cost of home construction, commissions and other sales costs, land development and other land sales costs and other costs incurred by or allocated to each segment. Each reportable segment follows the same accounting policies described in Note 1, Organization and Basis of Presentation, to the consolidated financial statements in our 2005 Annual Report on Form 10-K/A. Operating results for each segment may not be indicative of the results for such segment had it been an independent, stand-alone entity for the periods presented. The following segment information is in thousands:

| | **Three Months Ended June 30,** | | **Six Months Ended June 30,** | |
|---|---|---|---|---|
| | **2006** | **2005** | **2006** | **2005** |
| Revenue (a): | | | | |
| West | $ 288,691 | $ 253,905 | $ 609,730 | $ 479,581 |
| Central | 556,483 | 380,125 | 1,008,413 | 690,256 |
| East | 69,486 | 19,541 | 143,788 | 34,902 |
| Consolidated total | 914,660 | 653,571 | 1,761,931 | 1,204,739 |
| | | | | |
| Operating income: | | | | |
| West | 41,396 | 56,492 | 105,519 | 102,005 |
| Central | 90,562 | 41,791 | 159,637 | 68,389 |
| East | 9,118 | 2,400 | 18,884 | 4,540 |
| | | | | |
| Segment operating income | 141,076 | 100,683 | 284,040 | 174,934 |
| Corporate and unallocated (b) | (24,651 ) | (10,059 ) | (44,323 ) | (20,410 ) |
| Earnings from unconsolidated entities, net | 5,251 | 2,053 | 10,839 | 6,514 |
| Other income, net | 3,474 | 2,316 | 5,385 | 3,956 |
| Loss on extinguishment of debt | | (197 ) | | (31,477 ) |
| | | | | |
| Earnings before provision for income tax | $ 125,150 | $ 94,796 | $ 255,941 | $ 133,517 |

| | **At June 30,** | **At December 31,** |
|---|---|---|
| | **2006** | **2005** |
| Assets | | |
| West | $ 615,277 | $ 587,236 |
| Central | 1,136,838 | 1,003,839 |
| East | 171,316 | 207,692 |
| Corporate and unallocated (c) | 204,921 | 172,590 |
| Consolidated total | $ 2,128,352 | $ 1,971,357 |

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*(a) Revenue includes the following land closing revenue, by segment (in thousands): three months ended June 30, 2006 - $11,474 in West Region and $335 in Central Region; three months ended June 30, 2005 - $1,788 in Central Region; six months ended June 30, 2006 - $11,474 in West Region and $1,232 in Central Region; six months ended June 30, 2005 - $2,009 in Central Region.*

*(b) Balance consists primarily of corporate costs and numerous shared service functions such as finance, legal and treasury that are not allocated to the operating segments.*

*(c) Balance consists primarily of goodwill and intangibles and other corporate assets not allocated to the segments.*

See additional segment discussions in Notes 4, 7 and 11.

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

The following discussion gives effect to the restatement discussed in Note 13 to the condensed condoliated financial statement.

***Overview***

We are a leading designer and builder of single-family homes in the growth regions of the western and southern United States based on the number of home closings. We focus on providing a broad range of first-time, move-up, active adult and luxury homes to our targeted customer base. We believe that population, job and income growth, as well as the favorable migration characteristics in our markets, provide us opportunities for long-term growth. At June 30, 2006, we were actively selling homes in 204 communities, with base prices ranging from $109,000 to $1,220,000. We operate in the following geographic regions, which are presented as our reportable business segments:

West: California and Nevada

Central: Arizona, Texas and Colorado

East: Florida

Total home closing revenue was $902.9 million for the three months ended June 30, 2006, increasing 39% from $651.8 million for the same period last year. Net earnings for the second quarter of 2006 increased 30% to $77.1 million from $59.2 million in the same period last year. Net earnings for the six months ended June 30, 2005, included a bond refinancing charge related to a series of refinancing transactions that resulted in a charge of $31.5 million, which reduced after-tax net earnings by $19.7 million. Excluding this charge, net earnings for the six months ended June 30, 2006 increased 52% compared to the same period last year.

During the second quarter of 2006, our pre-tax earnings were reduced by approximately $19.0 million due to severance and other employee-related departure costs of approximately $11.7 million, as well as an additional $7.3 million in real estate write-offs to reduce the carrying amount of certain projects to fair value and for write-offs of option deposits for projects we no longer believe are economically viable.

Our strong second quarter 2006 revenue and net income are the result of closing orders taken mostly during the robust housing markets in 2005. As a result of these market conditions, we benefited from pricing power, which resulted in our home closing gross margin for the second quarter of 2006 increasing to 24.3% from 23.4% in the same period last year. We began experiencing slowdowns in our West Region in the fourth quarter of 2005, which continued through the second quarter of 2006. Beginning in the first quarter of 2006 and continuing through the second quarter, our Central and East Regions have also experienced moderating demand as these markets pull back from a record-setting environment in 2004 and 2005, resulting in a decline in orders in these higher-margin markets, while demand in Texas remained strong. This change has caused a significant shift in the mix of home orders during the first six months of 2006, with a higher percentage coming from Texas, where we historically achieve a lower margin than in many of our markets that are currently softening. Based on these conditions, we expect our home closing gross margins to trend lower in the remainder of 2006 and throughout 2007.

It is also our expectation that sales in our markets that experienced robust sales activity in 2005 will continue to moderate, and we expect the home order rate to decrease in 2006 and beyond from the levels achieved in 2005. At June 30, 2006, our backlog of approximately $2.0 billion decreased by 10% compared to March 31, 2006, and 8% at June 30, 2005, as a result of decreasing sales orders. In the second quarter of 2006, our cancellation rate on sales orders increased to approximately 32% from 22% in the same period a year ago, and from 28% at March 31, 2006, which has resulted in an increase in the percentage of unsold homes recorded on our balance sheet. Consequently, we are using various incentive and discount offerings to reduce the number of unsold homes in inventory. We believe our experiences are consistent with the overall trends in the homebuilding industry. Looking beyond 2006, based on current market conditions, we do not believe we will sustain the revenue growth rates that we achieved during the last several years and we expect our 2007 revenue and earnings to be somewhat lower compared to anticipated 2006 results.

***Critical Accounting Policies***

We have established various accounting policies that govern the application of accounting principles generally accepted in the United States of America in the preparation and presentation of our consolidated financial statements. Our significant policies are described in Note 1 of the consolidated financial statements in our Annual Report on Form 10-K for the year ended December 31, 2005. Certain of these policies involve significant judgments, assumptions and estimates by management that may have a material impact on the carrying value of certain assets and liabilities, and revenue and costs. We are subject to uncertainties such as the impact of future events, economic, environmental and political factors and changes in our business environment; therefore, actual results could differ from these estimates. Accordingly, the accounting estimates used in the preparation of our financial statements will change as new events occur, as more experience is acquired, as additional information is obtained or as our operating environment changes. Such changes in estimates and refinements in estimation methodologies are reflected in our reported results of operations and, if material, the effects of these changes are disclosed in the notes to the consolidated financial statements. The judgments, assumptions and estimates we use and believe to be critical to our business are based on historical experience, knowledge of the accounts and other factors, which we believe to be reasonable under the circumstances. Because of the nature of the judgments and assumptions we have made, actual results may differ from these judgments and estimates, which could have a material impact on the carrying values of assets and liabilities and the results of our operations.

The accounting policies that we deem most critical to us, and that involve the most difficult, subjective or complex judgments, include:

*Real Estate*

Real estate is stated at cost, which includes direct construction costs for homes, development period interest and certain common costs that benefit the entire community. We assess these assets for recoverability whenever events or circumstances change indicating that the carrying amount of an asset may not be recoverable. Recoverability of assets is measured by comparing the carrying amount of an asset to its fair value less cost to sell. If the fair value of an asset is less than its carrying amount (less costs to sell), an impairment loss is recognized.

*Goodwill*

We review the carrying value of goodwill annually or whenever events or circumstances change that indicate that the carrying amount is not recoverable. In evaluating impairment, we base our estimates of fair value on an analysis of selected business acquisitions in the homebuilding industry provided to us by an independent third party. Such evaluations for impairment are significantly impacted by the amount a buyer is willing to pay in the current market for a like business. Our reporting units are determined in accordance with SFAS 142, *Goodwill and Other Intangible Assets*, which defines a reporting unit as an operating segment or one level below an operating segment.

*Warranty Reserves*

Warranty reserves are included in other liabilities in the consolidated balance sheets. We record a reserve covering our anticipated warranty costs for each home closed. We review the adequacy of warranty reserves based on historical experience and our estimate of the costs to remediate the claims, and adjust these provisions accordingly. Factors that affect our warranty liability include the number of homes sold, historical and anticipated rates of warranty claims, and cost per claim.

*Off-Balance Sheet Arrangements*

We invest in entities that acquire and develop land for sale to us in connection with our homebuilding operations or for sale to third parties. Our partners generally are unrelated homebuilders, land sellers and financial or other strategic partners.

Most of the unconsolidated entities through which we acquire and develop land are accounted for by the equity method of accounting because such arrangements do not meet the criteria for consolidation set forth in FASB Interpretation No. 46 (revised December 2003), *Consolidation of Variable Interest Entities* ( FIN 46R ). We record our investments in these entities in our consolidated balance sheets as Investments in unconsolidated entities and our pro rata share of the entities earnings or losses in our consolidated statements of earnings as Earnings from unconsolidated entities, net. See Note 4 in the accompanying financial statements for additional information related to our investments in unconsolidated entities.

We also enter into option or purchase agreements to acquire land or lots from entities, for which we generally pay non-refundable deposits. We analyze these agreements under FIN 46R to determine whether we are the primary beneficiary of the VIE created as result of these agreements using a model developed by management. If we are deemed to be the primary beneficiary of the VIE because we are obligated to absorb the majority of the expected losses, receive the majority of the residual returns, or both, we will consolidate the VIE in our consolidated financial statements. See Note 3 in the accompanying financial statements for additional information related to our off-balance sheet arrangements.

*Results of Operation Segment Analysis*

The following discussion and analysis of financial condition and results of operations is based on our consolidated unaudited financial statements at and for the three and six months ended June 30, 2006 and 2005. All balances and transactions between us and our subsidiaries have been eliminated. In management s opinion, the data reflects all adjustments, consisting of only normal recurring adjustments, necessary to fairly present our financial position and results of operations for the periods presented. The results of operations for any interim period are not necessarily indicative of results expected for a full fiscal year.

The data provided below presents operating and financial data regarding our homebuilding activities (dollars in thousands):

***Home Closing Revenue***

| | Three Months Ended June 30, 2006 | Three Months Ended June 30, 2005 | Six Months Ended June 30, 2006 | Six Months Ended June 30, 2005 |
|---|---|---|---|---|
| **Total** | | | | |
| Dollars | $ 902,851 | $ 651,783 | $ 1,749,225 | $ 1,202,730 |
| Homes closed | 2,722 | 2,095 | 5,250 | 3,882 |
| Average sales price | $ 331.7 | $ 311.1 | $ 333.2 | $ 309.8 |
| **West Region** | | | | |
| California | | | | |
| Dollars | $ 208,111 | $ 228,412 | $ 454,994 | |