

HOVNANIAN ENTERPRISES INC  
Form 10-Q  
September 11, 2006  
UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

(Mark One)

Quarterly report pursuant to Section 13 or 15(d) of the  
Securities Exchange Act of 1934

For quarterly period ended JULY 31, 2006 or

Transition report pursuant to Section 13 or 15(d) of the  
Securities Exchange Act of 1934

Commission file number 1-8551

Hovnanian Enterprises, Inc.

(Exact Name of Registrant as Specified in Its Charter)

|   |   |
|---|---|
| Delaware  | 22-1851059                              |
| (State or Other Jurisdiction of<br>Incorporation or Organization) | (I.R.S. Employer<br>Identification No.) |

110 West Front Street, P.O. Box 500, Red Bank, NJ 07701

(Address of Principal Executive Offices) (Zip Code)

732-747-7800

(Registrant's Telephone Number, Including Area Code)

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Same (Former Name, Former Address and Former Fiscal Year, if Changed

Since Last Report)

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes

No

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

Large Accelerated Filer  Accelerated Filer

Non-Accelerated Filer

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

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date. 47,125,974 shares of Class A Common Stock and 14,652,552 shares of Class B Common Stock were outstanding as of September 1, 2006.

HOVNIANIAN ENTERPRISES, INC.

FORM 10-Q

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## HOVNANIAN ENTERPRISES, INC. AND SUBSIDIARIES

## CONDENSED CONSOLIDATED BALANCE SHEETS

(In Thousands Except Share Amounts)

|  | July 31,<br>2006<br>(unaudited) | October 31,<br>2005 |
|--|---------------------------------|---------------------|
| <b>ASSETS</b>  |                                 |                     |
| Homebuilding:  |                                 |                     |
| Cash and cash equivalents                                    | \$ 36,787                       | \$ 201,641          |
| Restricted cash  | 9,500                           | 17,189              |
| Inventories - At the lower of cost or fair value:            |                                 |                     |
| Sold and unsold homes and lots under development             | 3,589,248                       | 2,459,431           |
| Land and land options held for future development or sale    | 501,059                         | 595,806             |
| Consolidated inventory not owned:                            |                                 |                     |
| Specific performance options                                 | 12,872                          | 9,289               |
| Variable interest entities                                   | 369,705                         | 242,825             |
| Other options  | 175,021                         | 129,269             |
| Total consolidated inventory not owned                       | 557,598                         | 381,383             |
| Total Inventories  | 4,647,905                       | 3,436,620           |
| Investments in and advances to unconsolidated joint ventures | 217,153                         | 187,205             |
| Receivables, deposits, and notes                             | 103,102                         | 125,388             |
| Property, plant, and equipment net                           | 111,542                         | 96,891              |
| Prepaid expenses and other assets                            | 182,964                         | 131,845             |
| Goodwill   | 32,658                          | 32,658              |
| Definite life intangibles                                    | 200,525                         | 249,506             |
| Total homebuilding   | 5,542,136                       | 4,478,943           |
| Financial services:  |                                 |                     |
| Cash and cash equivalents                                    | 11,015                          | 9,632               |
| Restricted cash  | 1,285                           | 1,037               |
| Mortgage loans held for sale                                 | 174,747                         | 211,248             |
| Other assets   | 8,722                           | 15,375              |
| Total financial services                                     | 195,769                         | 237,292             |
| Income taxes receivable including deferred tax benefits      | 150,795                         | 9,903               |
| Total assets   | \$ 5,888,700                    | \$ 4,726,138        |

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See notes to condensed consolidated financial statements (unaudited).

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HOVNIANIAN ENTERPRISES, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED BALANCE SHEETS

(In Thousands Except Share Amounts)

|   | July 31,<br>2006<br>(unaudited) | October 31,<br>2005 |
|---|---------------------------------|---------------------|
| <b>LIABILITIES AND STOCKHOLDERS EQUITY</b>  |                                 |                     |
| Homebuilding:   |                                 |                     |
| Nonrecourse land mortgages  | \$ 33,046                       | \$ 48,673           |
| Accounts payable and other liabilities  | 546,668                         | 510,529             |
| Customers deposits  | 205,721                         | 259,930             |
| Nonrecourse mortgages secured by operating properties   | 23,852                          | 24,339              |
| Liabilities from inventory not owned  | 283,905                         | 177,014             |
| Total homebuilding  | 1,093,192                       | 1,020,485           |
| Financial services:   |                                 |                     |
| Accounts payable and other liabilities  | 8,666                           | 8,461               |
| Mortgage warehouse line of credit   | 166,923                         | 198,856             |
| Total financial services  | 175,589                         | 207,317             |
| Notes payable:  |                                 |                     |
| Revolving credit agreement  | 273,225                         |                     |
| Senior notes  | 1,649,510                       | 1,098,739           |
| Senior subordinated notes   | 400,000                         | 400,000             |
| Accrued interest  | 30,762                          | 26,991              |
| Total notes payable   | 2,353,497                       | 1,525,730           |
| Total liabilities   | 3,622,278                       | 2,753,532           |
| Minority interest from inventory not owned  | 208,542                         | 180,170             |
| Minority interest from consolidated joint ventures  | 3,563                           | 1,079               |
| Stockholders equity:  |                                 |                     |
| Preferred stock, \$.01 par value-authorized 100,000 shares; issued 5,600 shares at July 31, 2006 and at October 31, 2005 with a liquidation preference of \$140,000   | 135,299                         | 135,389             |
| Common stock, Class A, \$.01 par value-authorized 200,000,000 shares; issued 58,593,879 shares at July 31, 2006 and 57,976,455 shares at October 31, 2005 (including 11,494,720 shares at July 31, 2006 and 10,995,656 shares at October 31, 2005 held in Treasury)                 | 586                             | 580                 |
| Common stock, Class B, \$.01 par value (convertible to Class A at time of sale) authorized 30,000,000 shares; issued 15,360,360 shares at July 31, 2006 and 15,370,250 shares at October 31, 2005 (including 691,748 shares at July 31, 2006 and October 31, 2005 held in Treasury) | 154                             | 154                 |
| Paid in capital common stock  | 247,488                         | 236,001             |
| Retained earnings   | 1,779,738                       | 1,522,952           |

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|  |              |              |
|--|--------------|--------------|
| Deferred compensation                      |              | (19,648)     |
| Treasury stock - at cost                   | (108,948)    | (84,071)     |
| Total stockholders' equity                 | 2,054,317    | 1,791,357    |
| Total liabilities and stockholders' equity | \$ 5,888,700 | \$ 4,726,138 |

See notes to condensed consolidated financial statements (unaudited).

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HOVNIANIAN ENTERPRISES, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF INCOME

(In Thousands Except Per Share Data)

(Unaudited)

|   | Three Months Ended |             | Nine Months Ended |             |
|---|--------------------|-------------|-------------------|-------------|
|   | July 31,<br>2006   | 2005        | July 31,<br>2006  | 2005        |
| Revenues:   |                    |             |                   |             |
| Homebuilding:                                       |                    |             |                   |             |
| Sale of homes                                       | \$1,499,826        | \$1,289,373 | \$4,225,571       | \$3,495,014 |
| Land sales and other revenues                       | 28,032             | 4,820       | 113,947           | 32,747      |
| Total homebuilding                                  | 1,527,858          | 1,294,193   | 4,339,518         | 3,527,761   |
| Financial services                                  | 22,661             | 18,533      | 63,114            | 48,995      |
| Total revenues                                      | 1,550,519          | 1,312,726   | 4,402,632         | 3,576,756   |
| Expenses:   |                    |             |                   |             |
| Homebuilding:                                       |                    |             |                   |             |
| Cost of sales, excluding interest                   | 1,170,272          | 940,202     | 3,285,258         | 2,588,285   |
| Cost of sales interest                              | 25,601             | 22,332      | 62,453            | 58,563      |
| Total cost of sales                                 | 1,195,873          | 962,534     | 3,347,711         | 2,646,848   |
| Selling, general and administrative                 | 154,050            | 116,388     | 441,137           | 319,680     |
| Inventory impairment and land option<br>write-offs  | 12,274             | 1,354       | 20,978            | 3,352       |
| Total homebuilding                                  | 1,362,197          | 1,080,276   | 3,809,826         | 2,969,880   |
| Financial services                                  | 15,127             | 12,296      | 43,174            | 33,683      |
| Corporate general and administrative                | 26,744             | 18,884      | 80,377            | 49,678      |
| Other interest                                      | 649                | 1,149       | 2,169             | 1,843       |
| Other operations                                    | 8,355              | 7,356       | 23,877            | 10,575      |
| Intangible amortization                             | 13,331             | 11,781      | 38,391            | 32,255      |
| Total expenses                                      | 1,426,403          | 1,131,742   | 3,997,814         | 3,097,914   |
| Income (loss) from unconsolidated joint<br>ventures | (3,239)            | 13,907      | 13,833            | 22,482      |
| Income before income taxes                          | 120,877            | 194,891     | 418,651           | 501,324     |
| State and federal income taxes:                     |                    |             |                   |             |
| State   | (3,897)            | 10,535      | 7,212             | 26,299      |
| Federal   | 47,727             | 68,262      | 146,647           | 171,313     |



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|  |           |            |            |            |
|--|-----------|------------|------------|------------|
| Total taxes  | 43,830    | 78,797     | 153,859    | 197,612    |
| Net income   | 77,047    | 116,094    | 264,792    | 303,712    |
| Less: preferred stock dividends                      | 2,668     |            | 8,006      |            |
| Net income available to common stockholders          | \$ 74,379 | \$ 116,094 | \$ 256,786 | \$ 303,712 |
| Per share data:                                      |           |            |            |            |
| Basic:   |           |            |            |            |
| Income per common share                              | \$ 1.18   | \$ 1.85    | \$ 4.09    | \$ 4.87    |
| Weighted average number of common shares outstanding | 62,804    | 62,754     | 62,843     | 62,412     |
| Assuming dilution:                                   |           |            |            |            |
| Income per common share                              | \$ 1.15   | \$ 1.76    | \$ 3.95    | \$ 4.63    |
| Weighted average number of common shares outstanding | 64,460    | 65,796     | 64,989     | 65,574     |

See notes to condensed consolidated financial statements (unaudited).

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HOVNIANIAN ENTERPRISES, INC. AND  
SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENT OF  
STOCKHOLDERS' EQUITY

(In Thousands Except Share Amounts)

(Unaudited)

|  | A Common Stock                      |        | B Common Stock                      |        | Preferred Stock                     |            | Paid-In<br>Capital - |                      |                  |                   |             |
|--|-------------------------------------|--------|-------------------------------------|--------|-------------------------------------|------------|----------------------|----------------------|------------------|-------------------|-------------|
|  | Shares Issued<br>and<br>Outstanding | Amount | Shares<br>Issued and<br>Outstanding | Amount | Shares<br>Issued and<br>Outstanding | Amount     | Common<br>Stock      | Retained<br>Earnings | Deferred<br>Comp | Treasury<br>Stock | Total       |
| Balance, October 31, 2005  | 46,980,799                          | \$ 580 | 14,678,502                          | \$ 154 | 5,600                               | \$ 135,389 | \$236,001            | \$1,522,952          | \$(19,648)       | \$(84,071)        | \$1,791,357 |
| Stock issuances for company<br>acquisitions                                | 175,936                             | 1      |                                     |        |                                     |            | 4,188                |                      |                  | 1,750             | 5,939       |
| Issuance costs   |                                     |        |                                     |        |                                     | (90)       |                      |                      |                  |                   | (90)        |
| Preferred dividend declared<br>(\$476.56 per share)                        |                                     |        |                                     |        |                                     |            |                      | (8,006)              |                  |                   | (8,006)     |
| Stock options amortization<br>and issuances, net of tax                    | 215,596                             | 2      |                                     |        |                                     |            | 14,536               |                      |                  |                   | 14,538      |
| Restricted stock<br>amortization, issuances and<br>forfeitures, net of tax | 391,938                             | 3      |                                     |        |                                     |            | 12,411               |                      |                  |                   | 12,414      |
| Reclass due to SFAS 123R<br>implementation (See Note 2)                    |                                     |        |                                     |        |                                     |            | (19,648)             | 19,648               |                  |                   | -           |
| Conversion of Class B to<br>Class A common stock                           | 9,890                               |        | (9,890)                             |        |                                     |            |                      |                      |                  |                   | -           |
| Treasury stock purchases   | (675,000)                           |        |                                     |        |                                     |            |                      |                      |                  | (26,627)          | (26,627)    |
| Net income   |                                     |        |                                     |        |                                     |            |                      | 264,792              |                  |                   | 264,792     |
| Balance, July 31, 2006   | 47,099,159                          | \$586  | 14,668,612                          | \$154  | 5,600                               | \$135,299  | \$247,488            | \$1,779,738          | \$ --            | \$(108,948)       | \$2,054,317 |

See notes to condensed consolidated financial statements (unaudited).



## HOVNIANIAN ENTERPRISES, INC. AND SUBSIDIARIES

## CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(In Thousands - Unaudited)

|   | Nine Months Ended |            |
|---|-------------------|------------|
|   | July 31,          |            |
|   | 2006              | 2005       |
| Cash flows from operating activities:   |                   |            |
| Net Income  | \$ 264,792        | \$ 303,712 |
| Adjustments to reconcile net income to net cash used in operating activities: |                   |            |
| Depreciation  | 10,587            | 5,912      |
| Intangible amortization   | 38,391            | 32,255     |
| Compensation from stock options and awards                                    | 21,079            | 4,293      |
| Amortization of bond discounts  | 771               | 470        |
| Excess tax benefits from share-based payment                                  | (4,661)           |            |
| Loss (gain) on sale and retirement of property and assets                     | 297               | (3,479)    |
| Equity earnings in unconsolidated entities                                    | (13,833)          | (22,482)   |
| Distributions from unconsolidated entities                                    | 15,060            | 15,241     |
| Deferred income taxes   | (33,911)          | (14,287)   |
| Impairment and land option deposit write-offs                                 | 20,978            | 3,352      |
| Decrease (increase) in assets:  |                   |            |
| Mortgage notes receivable   | 36,503            | 27,357     |
| Restricted cash, receivables, prepaids and other assets                       | 7,578             | (30,286)   |
| Inventories   | (1,055,065)       | (434,634)  |
| (Decrease) increase in liabilities:   |                   |            |
| State and Federal income taxes  | (106,981)         | (82,413)   |
| Customers deposits  | (53,962)          | 25,252     |
| Interest and other accrued liabilities  | (2,677)           | 12,554     |
| Accounts payable  | 16,692            | 12,312     |
| Net cash used in operating activities   | (838,362)         | (144,871)  |
| Cash flows from investing activities:   |                   |            |
| Net proceeds from sale of property and assets                                 | 258               | 8,040      |
| Purchase of property, equipment and other fixed assets and acquisitions       | (48,026)          | (131,872)  |
| Investments in and advances to unconsolidated Entities                        | (36,726)          | (105,975)  |
| Distributions from unconsolidated entities                                    | 5,600             | 239        |
| Net cash used in investing activities   | (78,894)          | (229,568)  |
| Cash flows from financing activities:   |                   |            |
| Proceeds from mortgages and notes   | 63,838            | 77,417     |
| Net proceeds (payments) related to revolving credit agreement                 | 273,225           | (71,950)   |
| Net payments related to mortgage warehouse line of credit                     | (31,933)          | (21,242)   |
| Proceeds from senior debt   | 550,000           | 200,000    |
| Proceeds from senior subordinated debt  |                   | 100,000    |
| Payments of issuance costs  | (90)              |            |
| Proceeds from preferred stock   |                   | 135,720    |
| Principal payments on mortgages and notes                                     | (77,156)          | (62,358)   |
| Excess tax benefits from share-based payment                                  | 4,661             |            |
| Preferred dividends paid  | (8,006)           |            |

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|   |           |           |
|---|-----------|-----------|
| Purchase of treasury stock                                | (26,627)  | (22,095)  |
| Proceeds from sale of stock and employee stock plan       | 5,873     | 14,750    |
| Net cash provided by financing activities                 | 753,785   | 350,242   |
| Net (decrease) in cash                                    | (163,471) | (24,197)  |
| Cash and cash equivalents balance, beginning<br>Of period | 211,273   | 60,959    |
| Cash and cash equivalents balance, end of period          | \$ 47,802 | \$ 36,762 |

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HOVNANIAN ENTERPRISES, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(In Thousands - Unaudited)

(Continued)

|   | Nine Months Ended |            |
|---|-------------------|------------|
|   | July 31,          |            |
|   | 2006              | 2005       |
| Supplemental disclosures of cash flow:                    |                   |            |
| Cash paid during the period for:                          |                   |            |
| Interest  | \$ 74,216         | \$ 66,724  |
| Income taxes  | \$ 262,563        | \$ 279,686 |
| Supplemental disclosures of noncash operating activities: |                   |            |
| Consolidated inventory not owned:                         |                   |            |
| Specific performance options                              | \$ 11,699         | \$ 5,415   |
| Variable interest entities                                | 336,570           | 121,989    |
| Other options   | 173,456           | 118,405    |
| Total inventory not owned                                 | \$ 521,725        | \$ 245,809 |

Supplemental disclosure of noncash investing and financing activities:

In 2006, the Company acquired substantially all of the assets of two mechanical contracting businesses by issuing 175,936 Class A common shares with a fair value of \$5.9 million on the date of the transaction.

See notes to condensed consolidated financial statements (unaudited).

HOVNANIAN ENTERPRISES, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS - UNAUDITED

1. The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. In the opinion of management, all adjustments for interim periods presented have been made, which include only normal recurring accruals and deferrals necessary for a fair presentation of our consolidated financial position, results of operations, and changes in cash flows. The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates and these differences could have a significant impact on the financial statements. Results for interim periods are not necessarily indicative of the results which might be expected for a full year. The balance sheet at October 31, 2005 has been derived from the audited financial statements at that date but does not include all of the information and footnotes required by accounting principles generally accepted in the United States for complete financial statements.

Certain prior year amounts have been reclassified to conform to the current year presentation.

The Company is in the process of responding to the SEC with respect to its segment reporting. Based on this correspondence, the Company believes it will have to file an amended Form 10-K for the fiscal year ended October 31, 2005, as well as an amended Form 10-Q for each of its fiscal quarters of 2006. These amendments will be filed as soon as the correspondence with the SEC is resolved. These amendments will expand the reporting segment footnote disclosures related to our homebuilding operations. The amendment will have no impact on our Consolidated Balance Sheets, Consolidated Income Statements, Consolidated Cash Flows, or Consolidated Statements of Stockholders Equity for any period presented.

2. Effective November 1, 2005, the Company adopted Statement of Financial Accounting Standards ( SFAS ) 123R, Share-Based Payments , which revises SFAS 123, Accounting for Stock-Based Compensation . Prior to fiscal year 2006, the Company 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, the recognition of stock-based compensation expense was generally limited to the expense attributed to nonvested stock awards, as well as the amortization of certain acquisition-related deferred compensation.

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. The Company uses the Black-Scholes model to value its new stock option grants under SFAS 123R, applying the modified prospective method for existing grants which requires the Company to value stock options prior to its adoption of SFAS 123R under the fair value method and expense the unvested portion over the remaining vesting period. The fair value for options is established at the date of grant using a Black-Scholes option pricing model with the following weighted average assumptions for July 31, 2006: risk-free interest rate of 4.30%; dividend yield of zero; volatility factor of the expected market price of our common stock of 0.44; and a weighted average expected life of the option of 5.7 years. SFAS 123R also requires the Company to estimate forfeitures in calculating the expense related to stock-based compensation (estimated at 2% for fiscal 2006 and fiscal 2005, respectively,) and requires the Company to reflect the benefits of tax deductions in excess of recognized compensation cost to be reported as both a financing cash inflow and an operating cash outflow upon adoption.

Compensation cost arising from nonvested stock granted to employees and from non-employee stock awards is recognized as expense using the straight-line method over the vesting period. Unearned compensation was included in deferred compensation in stockholders' equity beginning in

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the first quarter of fiscal 2004. Upon adoption of SFAS 123R, deferred compensation is no longer recorded for non vested stock awards, therefore deferred compensation was reclassified to paid in capital.

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For the three months and nine months ended July 31, 2006, the Company's total stock-based compensation expense was \$6.0 million (\$3.8 million net of tax) and \$21.1 million (\$13.3 million net of tax), respectively. Included in this total stock-based compensation expense was incremental expense for stock options of \$3.0 million (\$1.9 million net of tax) and \$10.4 million (\$6.6 million net of tax) for the three and nine months ended July 31, 2006, respectively.

The following table illustrates the effect (in thousands, except per share amounts) on net income and earnings per share for the three and nine months ended July 31, 2005 as if the Company's stock-based compensation had been determined based on the fair value at the grant dates for awards made prior to fiscal 2006, under those plans and consistent with SFAS 123R:

|   | Three Months Ended<br>July 31, 2005 | Nine Months Ended<br>July 31, 2005 |
|---|-------------------------------------|------------------------------------|
| Net income as reported  | \$116,094                           | \$303,712                          |
| Deduct: total stock-based employee compensation expense determined using Black-Scholes fair value based method for all awards | 1,689                               | 4,531                              |
| Pro forma net income  | \$114,405                           | \$299,181                          |
| Pro forma basic earnings per share  | \$ 1.82                             | \$ 4.79                            |
| Basic earnings per share as reported  | \$ 1.85                             | \$ 4.87                            |
| Pro forma diluted earnings per share  | \$ 1.74                             | \$ 4.56                            |
| Diluted earnings per share as reported  | \$ 1.76                             | \$ 4.63                            |

Pro forma information regarding net income and earnings per share is calculated as if we had accounted for our stock-based compensation under the fair value method of SFAS 123R. The fair value for options is established at the date of grant using a Black-Scholes option pricing model with the following weighted average assumptions for July 31, 2005: risk-free interest rate of 4.18%, dividend yield of zero; volatility factor of the expected market price of our common stock of 0.44; and a weighted average expected life of the option of 4.9 years.

The Black-Scholes option valuation model was developed for use in estimating the fair value of traded options, which have no vesting restrictions and are fully transferable. In addition, option valuation models require the input of highly subjective assumptions including the expected stock price volatility. Because our employee stock options have characteristics significantly different from traded options, and changes in the subjective input assumptions can materially affect the fair value estimate, management believes the existing models do not necessarily provide a reliable measure of the fair value of its employee stock options.

On November 10, 2005, the FASB issued FASB Staff Position No. SFAS 123(R)-3, Transition Election Related to Accounting for Tax Effects of Share-Based Payment Awards (FSP 123R-3). The alternative transition method includes simplified methods to establish the beginning balance of the additional paid in capital pool (APIC pool) related to the tax effects of employee stock-based compensation, and to determine the subsequent impact on the APIC pool and Consolidated Statements of Cash Flows of the tax effects of employee stock-based compensation awards that are outstanding upon adoption of SFAS 123R. The Company has until November 2006 to make a one-time election to adopt the transition method described in FSP 123R-3. The Company is currently evaluating FSP 123R-3; however, if the Company were to make the one-time election, it is not expected to affect operating income or net income.



3. Interest costs incurred, expensed and capitalized were:

|  | Three Months Ended<br>July 31, |           | Nine Months Ended<br>July 31, |           |
|--|--------------------------------|-----------|-------------------------------|-----------|
|  | 2006                           | 2005      | 2006                          | 2005      |
|  | (Dollars in Thousands)         |           |                               |           |
| Interest capitalized at beginning of period(1) | \$ 77,048                      | \$ 44,488 | \$ 48,366                     | \$ 37,465 |
| Plus interest incurred(2)                      | 41,515                         | 27,991    | 108,569                       | 71,939    |
| Less cost of sales interest expensed(3)        | 25,601                         | 22,332    | 62,453                        | 58,563    |
| Less other interest expensed                   | 649                            | 1,149     | 2,169                         | 1,843     |
| Interest capitalized at end of period          | \$ 92,313                      | \$ 48,998 | \$ 92,313                     | \$ 48,998 |

(1) Beginning balance for 2006 does not include interest incurred of \$2.3 million which is capitalized in property,

plant, and equipment.

(2) Data does not include interest incurred by our mortgage and finance subsidiaries.

(3) Represents interest on borrowings for construction, land and development costs, which are charged to interest

expense when homes are delivered.

4. Accumulated depreciation at July 31, 2006 and October 31, 2005 amounted to \$39.7 million and \$30.5 million, respectively, for our homebuilding assets.

5. In accordance with Financial Accounting Standards No. 144 ( SFAS 144 ), Accounting for the Impairment of or Disposal of Long Lived Assets , we record impairment losses on inventories related to communities under development when events and circumstances indicate that they may be impaired and the undiscounted cash flows estimated to be generated by those assets are less than their carrying amounts. For the three and nine months ended July 31, 2006 and 2005, these amounts were \$0.8 million and zero respectively, and \$2.4 million and zero, respectively. In addition, from time to time, we will write off certain residential land options including approval and engineering costs for land we decided not to purchase at the earlier of the option expiration or the decision to terminate. We wrote off such costs in the amount of \$11.4 million and \$1.4 million during the three months ended July 31, 2006 and 2005, respectively, and \$18.6 million and \$3.3 million during the nine months ended July 31, 2006 and 2005, respectively. Residential inventory impairment losses and option write-offs are reported in the Condensed Consolidated Statements of Income as Homebuilding-Inventory impairment and land option deposit write-offs .

6. We provide a warranty accrual for repair costs over \$1,000 to homes, community amenities, and land development infrastructure. We accrue for warranty costs as part of cost of sales at the time each home is closed and title and possession have been transferred to the homebuyer. In addition, we accrue warranty costs under our general liability insurance deductible as part of selling, general and administrative costs. For fiscal 2006, our deductible is \$20 million per occurrence with an aggregate \$20 million for premise liability claims and an aggregate \$20 million for construction defect claims under our general liability insurance. Once our \$20 million aggregate deductible is reached for construction defect claims, a \$250,000 per occurrence deductible is required on any additional claims. Additions and charges incurred in the warranty accrual and general liability accrual for the three and nine months ended July 31, 2006 and 2005 are as follows:

|                                    | Three Months Ended     |           | Nine Months Ended |           |
|------------------------------------|------------------------|-----------|-------------------|-----------|
|                                    | July 31,<br>2006       | 2005      | July 31,<br>2006  | 2005      |
|                                    | (Dollars in Thousands) |           |                   |           |
| Balance, beginning of period       | \$ 91,159              | \$ 81,122 | \$ 86,706         | \$ 64,922 |
| Company acquisitions during period |                        |           | 186               |           |
| Additions                          | 8,105                  | 15,329    | 27,699            | 41,246    |
| Charges incurred                   | (9,421)                | (8,841)   | (24,748)          | (18,558)  |
| Balance, end of period             | \$ 89,843              | \$ 87,610 | \$ 89,843         | \$ 87,610 |

Warranty accruals are based upon historical experience. We engage a third party actuary that uses our historical warranty data to estimate our unpaid claims, claim adjustment expenses and incurred but not reported claims reserves for the risks that we are assuming under the general liability and workers compensation programs. The estimates include provisions for inflation, claims handling and legal fees.

Insurance claims paid by our insurance carriers were \$4.7 million and \$7.9 million for the nine months ended July 31, 2006 and 2005, respectively, for prior year deliveries.

7. We are involved in litigation arising in the ordinary course of business, none of which is expected to have a material adverse effect on our financial position or results of operations and we are subject to extensive and complex regulations that affect the development and home building, sales and customer financing processes, including zoning, density, building standards and mortgage financing. These regulations often provide broad discretion to the administering governmental authorities. This can delay or increase the cost of development or homebuilding.

We also are subject to a variety of local, state, federal and foreign laws and regulations concerning protection of health and the environment. The particular environmental laws which apply to any given community vary greatly according to the community site, the site's environmental conditions and the present and former uses of the site. These environmental laws may result in delays, may cause us to incur substantial compliance, remediation, and/or other costs, and can prohibit or severely restrict development and homebuilding activity in certain environmentally sensitive regions or areas.

In March 2005, we received two requests for information pursuant to Section 308 of the Clean Water Act from Region 3 of the Environmental Protection Agency (the EPA). These requests sought information concerning storm water discharge practices in connection with completed, ongoing and planned homebuilding projects by subsidiaries in the states and district that comprise EPA Region 3. We also received a notice of violations for one project in Pennsylvania and requests for sampling plan implementation in two projects in Pennsylvania. The amount requested by the EPA to settle the asserted violations at the one project was not material. We provided the EPA with information in response to its requests. We have since been advised by the Department of Justice (DOJ) that it will be involved in the review of our storm water discharge

practices. We cannot predict the outcome of the review of these practices or estimate the costs that may be involved in resolving the matter. To the extent that the EPA or the DOJ asserts violations of regulatory requirements and requests injunctive relief or penalties, we will defend and attempt to resolve such asserted violations.

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In addition, in November 2005, we received two notices from the California Regional Water Quality Control Board alleging violations of certain storm water discharge rules and assessing an administrative civil liability of \$0.2 million and \$0.3 million. We do not consider these assessments to be material and are considering our response to the notices.

It can be anticipated that increasingly stringent requirements will be imposed on developers and homebuilders in the future. Although we cannot predict the effect of these requirements, they could result in time-consuming and expensive compliance programs and in substantial expenditures, which could cause delays and increase our cost of operations. In addition, the continued effectiveness of permits already granted or approvals already obtained is dependent upon many factors, some of which are beyond our control, such as changes in policies, rules and regulations and their interpretations and application.

Our sales and customer financing processes are subject to the jurisdiction of the U. S. Department of Housing and Urban Development ( HUD ). In connection with the Real Estate Settlement Procedures Act, HUD has inquired about our process of referring business to our affiliated mortgage company and has separately requested documents related to customer financing. We have responded to HUD 's inquiries. In connection with these inquiries, the Inspector General of HUD has recommended to the Secretary of HUD that we indemnify HUD for any losses that it may sustain in connection with nine loans that it alleges were improperly underwritten. We cannot predict the outcome of HUD 's inquiry or estimate the costs that may be involved in resolving the matter. We do not expect the ultimate cost to be material.

In August 2006, the Company canceled a purchase contract for a property located in Southern California based on the seller 's failure to perform certain obligations, and requested return of its \$16.5 million contract deposit. Refund of the deposit is currently in dispute with the seller and the Company anticipates that arbitration proceedings will commence during the fourth quarter of 2006 to resolve the dispute. At this time, the Company can not predict the outcome of this dispute.

8. As of July 31, 2006 and October 31, 2005, respectively, we are obligated under various performance letters of credit amounting to \$457.6 million and \$330.8 million.

9. Our amended and restated unsecured Revolving Credit Agreement ( Agreement ) with a group of lenders provides a revolving credit line of \$1.5 billion through May 2011. The facility contains an accordion feature under which the aggregate commitment can be increased to \$2.0 billion subject to the availability of additional commitments. Loans under the Agreement bear interest at various rates based on (1) a base rate determined by reference to the higher of (a) PNC Bank, National Association 's prime rate and (b) the federal funds rate plus 1/2% or (2) a margin ranging from 0.65% to 1.50% per annum, depending on our Leverage Ratio, as defined in the Agreement, and our debt ratings plus a LIBOR-based rate for a one, two, three, or six month interest period as selected by us. In addition, we pay a fee ranging from 0.15% to 0.25% per annum on the unused portion of the revolving credit line depending on our Leverage Ratio and our debt ratings and the average percentage unused portion of the revolving credit line. As of July 31, 2006 and October 31, 2005, the outstanding balance under the Agreement was \$273.2 million and zero, respectively.

We and each of our significant subsidiaries, except for K. Hovnanian Enterprises, Inc., the borrower, and various subsidiaries formerly engaged in the issuance of collateralized mortgage obligations, a subsidiary formerly engaged in homebuilding activity in Poland, our financial services subsidiaries, joint ventures, and certain other subsidiaries, is a guarantor under the Agreement.

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Our amended secured mortgage loan warehouse agreement with a group of banks, which is a short-term borrowing facility, provides up to \$250 million through May 18, 2007. Interest is payable monthly at the LIBOR Rate plus 1.0%. The loan is repaid when we sell the underlying mortgage loans to permanent investors. We also have a \$100 million commercial paper facility. The facility expires on April 20, 2007 and interest is payable monthly at the LIBOR Rate plus 0.65%. As of July 31, 2006 and October 31, 2005, borrowings under both agreements were \$166.9 million and \$198.9 million, respectively.

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10. On November 30, 2004, we issued \$200 million of 6 1/4% Senior Notes due 2015 and \$100 million of 6% Senior Subordinated Notes due 2010. The net proceeds of the issuance were used to repay the outstanding balance on our revolving credit facility as of November 30, 2004 and for general corporate purposes.

On August 8, 2005, we issued \$300 million of 6 1/4% Senior Notes due 2016. The notes were issued at a discount to yield 6.46% and have been reflected net of the unamortized discount in the Condensed Consolidated Balance Sheets. The notes are redeemable in whole or in part at our option at 100% of their principal amount plus the payment of a make-whole amount. The net proceeds of the issuance were used to repay the outstanding balance under our revolving credit facility as of August 8, 2005, and for general corporate purposes, including acquisitions.

On February 27, 2006, we issued \$300 million of 7 1/2% Senior Notes due 2016. The notes are redeemable in whole or in part at our option at 100% of their principal amount plus the payment of a make-whole amount. The net proceeds of the issuance were used to repay a portion of the outstanding balance under our revolving credit facility as of February 27, 2006.

On June 12, 2006, we issued \$250 million of 8 5/8% Senior Notes due 2017. The notes are redeemable in whole or in part at our option at 100% of their principal amount plus the payment of a make-whole amount. The net proceeds of the issuance were used to repay a portion of the outstanding balance under our revolving credit facility as of June 12, 2006.

At July 31, 2006, we had \$1,655.3 million of outstanding senior notes (\$1,649.5 million, net of discount), comprised of \$140.3 million 10 1/2% Senior Notes due 2007, \$100 million 8% Senior Notes due 2012, \$215 million 6 1/2% Senior Notes due 2014, \$150 million 6 3/8% Senior Notes due 2014, \$200 million 6 1/4% Senior Notes due 2015, \$300 million 6 1/4% Senior Notes due 2016, \$300 million 7 1/2% Senior Notes due 2016, and \$250 million 8 5/8% Senior Notes due 2017. At July 31, 2006, we had \$400.0 million of outstanding senior subordinated notes, comprised of \$150 million 8 7/8% Senior Subordinated Notes due 2012, \$150 million 7 3/4% Senior Subordinated Notes due 2013, and \$100 million 6% Senior Subordinated Notes due 2010.

Under the terms of the indentures governing our debt securities, we have the right to make certain redemptions and depending on market conditions, may do so from time to time.

11. Per Share Calculations - Basic earnings per common share is computed using the weighted average number of shares outstanding. Diluted earnings per common share is computed using the weighted average number of shares outstanding adjusted for the incremental shares attributed to non-vested stock and outstanding options to purchase common stock, of 1.7 million and 3.0 million for the three months ended July 31, 2006 and 2005, respectively, and approximately 2.1 million and 3.2 million for the nine months ended July 31, 2006 and 2005, respectively.

12. On July 12, 2005, we issued 5,600 shares of 7.625% Series A Preferred Stock, with a liquidation preference of \$25,000 per share for net proceeds of \$135 million. Dividends on the Series A Preferred Stock are not cumulative and are paid at an annual rate of 7.625%. The Series A Preferred Stock is not convertible into the Company's common stock and is redeemable in whole or in part at our option at the liquidation preference of the shares beginning on the fifth anniversary of their issuance. The Series A Preferred Stock is traded as depositary shares, with each depositary share representing 1/1000<sup>th</sup> of a share of Series A Preferred Stock. The depositary shares are listed on the Nasdaq Global Market under the symbol HOVNP. The net proceeds from the offering, reflected in Preferred Stock in the Condensed Consolidated Balance Sheets, were used for the partial repayment of the outstanding balance under our revolving credit facility as of July 12, 2005. In October 2005, we paid \$2.8 million of dividends on the Series A Preferred Stock. In each completed quarter of fiscal 2006, we paid \$2.7 million of dividends.



13. Variable Interest Entities - In January 2003, the Financial Accounting Standards Board ( FASB ) issued Interpretation No. 46, Consolidation of Variable Interest Entities ( FIN 46 ). A Variable Interest Entity ( 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 or (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 if they occur. If an entity is deemed to be a

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VIE pursuant to FIN 46, an enterprise that absorbs a majority of the expected losses of the VIE is considered the primary beneficiary and must consolidate the VIE.

Based on the provisions of FIN 46, we have concluded that whenever we option land or lots from an entity and pay a non-refundable deposit, a VIE is created under condition (ii) (b) and (c) of the previous paragraph. 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 theoretical losses if they occur. For each VIE created with a significant nonrefundable option fee (we currently define significant as greater than \$100,000 because we have determined that in the aggregate the VIEs related to deposits of this size or less are not material), we compute expected losses and residual returns based on the probability of future cash flows as outlined in FIN 46. If we are deemed to be the primary beneficiary of the VIE, we consolidate it on our balance sheet. The fair value of the VIE's inventory is reported as Consolidated inventory not owned - variable interest entities.

Typically, the determining factor in whether or not we are the primary beneficiary is the deposit amount as a percentage of the total purchase price, because it determines the amount of the first risk of loss we take on the contract. The higher this percentage deposit, the more likely we are to be the primary beneficiary. Other important criteria that impact the outcome of the analysis, are the probability of getting the property through the approval process for residential homes, because this impacts the ultimate value of the property, as well as who is the responsible party (seller or buyer) for funding the approval process and development work that will take place prior to the decision to exercise the option.

Management believes FIN 46 was not clearly thought out for application in the homebuilding industry for land and lot options. Under FIN 46, we can have an option and put down a small deposit as a percentage of the purchase price and still have to consolidate the entity. Our exposure to loss as a result of our involvement with the VIE is only the deposit, not its total assets consolidated on the balance sheet. In certain cases, we will have to place inventory the VIE has optioned to other developers on our balance sheet. In addition, if the VIE has creditors, its debt will be placed on our balance sheet even though the creditors have no recourse against us. Based on these observations, we believe consolidating VIEs based on land and lot option deposits does not reflect the economic realities or risks of owning and developing land.

At July 31, 2006, all 37 VIEs we were required to consolidate were the result of our options to purchase land or lots from the selling entities. We paid cash or issued letters of credit deposits to these VIEs totaling \$44.8 million. Our option deposits represent our maximum exposure to loss. The fair value of the property owned by these VIEs was \$369.7 million. Since we do not own an equity interest in any of the unaffiliated variable interest entities that we must consolidate pursuant to FIN 46, we generally have little or no control or influence over the operations of these entities or their owners. When our requests for financial information are denied by the land sellers, certain assumptions about the assets and liabilities of such entities are required. In most cases, we determine the fair value of the assets of the consolidated entities based on the remaining contractual purchase price of the land or lots we are purchasing. In these cases, it is assumed that the entities have no debt obligations and the only asset recorded is the land or lots we have the option to buy with a related offset to minority interest for the assumed third party investment in the variable interest equity. At July 31, 2006, the balance reported in minority interest from inventory not owned was \$208.5 million. Creditors of these VIEs have no recourse against us.

We will continue to control land and lots using options. Not all of our deposits are with VIEs. Including the deposits with the 37 VIEs described above, at July 31, 2006, we have total cash and letters of credit deposits amounting to approximately \$189.0 million and \$264.5 million to purchase land and lots with a total purchase price of \$5.1 billion. The maximum exposure to loss is limited to the deposits, although some deposits are refundable at our request or refundable if certain conditions are not met.

14. Investments in Unconsolidated Homebuilding and Land Development Joint Ventures - We enter into homebuilding and land development joint ventures from time to time as a means of accessing lot positions, expanding our market opportunities, establishing strategic alliances, managing our risk profile, leveraging our capital base, and enhancing returns on capital. Our homebuilding joint ventures are generally entered into with third party investors to develop land and construct homes that are sold directly to third party homebuyers. Our land development joint ventures include those entered into with developers, other homebuilders, and financial investors to develop finished lots for sale to the joint

venture s members or other third parties. As of July 31, 2006, we have

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investments in ten homebuilding joint ventures and nine land development joint ventures. The tables set forth below summarize the combined financial information related to our unconsolidated homebuilding and land development joint ventures that are accounted for under the equity method.

|                                | Homebuilding | July 31, 2006<br>Land Development | Total        |
|--------------------------------|--------------|-----------------------------------|--------------|
| <b>Assets:</b>                 |              |                                   |              |
| Cash and cash equivalents      | \$ 40,233    | \$ 5,958                          | \$ 46,191    |
| Inventories                    | 741,354      | 205,194                           | 946,548      |
| Other assets                   | 88,982       | 4,968                             | 93,950       |
| Total assets                   | \$ 870,569   | \$ 216,120                        | \$ 1,086,689 |
| <b>Liabilities and equity:</b> |              |                                   |              |
| Accounts payable and accrued   |              |                                   |              |
| liabilities                    | \$ 148,515   | \$ 27,804                         | \$ 176,319   |
| Notes payable                  | 355,528      | 51,839                            | 407,367      |
| Equity of:                     |              |                                   |              |
| Hovnanian Enterprises, Inc.    | 88,976       | 92,624                            | 181,600      |
| Others                         | 277,550      | 43,853                            | 321,403      |
| Total equity                   | 366,526      | 136,477                           | 503,003      |
| Total liabilities and equity   | \$ 870,569   | \$ 216,120                        | \$ 1,086,689 |
| Debt to capitalization ratio   | 49%          | 28%                               | 45%          |

|                                | Homebuilding | October 31, 2005<br>Land Development | Total        |
|--------------------------------|--------------|--------------------------------------|--------------|
| <b>Assets:</b>                 |              |                                      |              |
| Cash and cash equivalents      | \$ 46,200    | \$ 5,012                             | \$ 51,212    |
| Inventories                    | 694,408      | 198,267                              | 892,675      |
| Other assets                   | 166,974      | 295                                  | 167,269      |
| Total assets                   | \$ 907,582   | \$ 203,574                           | \$ 1,111,156 |
| <b>Liabilities and equity:</b> |              |                                      |              |
| Accounts payable and accrued   |              |                                      |              |
| liabilities                    | \$ 228,264   | \$ 21,523                            | \$ 249,787   |
| Notes payable                  | 316,532      | 59,131                               | 375,663      |
| Equity of:                     |              |                                      |              |
| Hovnanian Enterprises, Inc.    | 75,349       | 86,593                               | 161,942      |
| Others                         | 287,437      | 36,327                               | 323,764      |
| Total equity                   | 362,786      | 122,920                              | 485,706      |
| Total liabilities and equity   | \$ 907,582   | \$ 203,574                           | \$ 1,111,156 |
| Debt to capitalization ratio   | 47%          | 32%                                  | 44%          |

As of July 31, 2006 and October 31, 2005, we had advances outstanding of approximately \$35.6 million and \$23.7 million, respectively, to these unconsolidated joint ventures, which were included in the accounts payable and accrued liabilities balances in the table above. On our Hovnanian Enterprises, Inc. Condensed Consolidated Balance Sheets our Investments in and advances to unconsolidated joint ventures amounted to \$217.2 million and \$187.2 million at July 31, 2006 and October 31, 2005, respectively. The minor difference between the Hovnanian equity balance plus advances to unconsolidated joint ventures balance disclosed here compared to the Hovnanian



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Enterprises, Inc. Condensed Consolidated Balance Sheets is due to a different inside basis versus outside basis in certain joint ventures.

|                                | For the Three Months Ended July 31,2006 |                  | Total       |
|--------------------------------|---|------------------|-------------|
|                                | Homebuilding                            | Land Development |             |
| Revenues                       | \$ 192,918                              | \$ 7,447         | \$ 200,365  |
| Cost of sales and expenses (1) | (209,541)                               | (7,259)          | (216,800)   |
| Net income (loss)              | \$ (16,623)                             | \$ 188           | \$ (16,435) |
| Our share of net losses        | \$ (3,397)                              | \$ (145)         | \$ (3,542)  |

|                            | For the Three Months Ended July 31,2005 |                  | Total      |
|----------------------------|---|------------------|------------|
|                            | Homebuilding                            | Land Development |            |
| Revenues                   | \$ 196,340                              | \$ 13,124        | \$ 209,464 |
| Cost of sales and expenses | (171,374)                               | (12,746)         | (184,120)  |
| Net income                 | \$ 24,966                               | \$ 378           | \$ 25,344  |
| Our share of net earnings  | \$ 13,781                               | \$ 125           | \$ 13,906  |

|                                    | For the Nine Months Ended July 31,2006 |                  | Total      |
|------------------------------------|--|------------------|------------|
|                                    | Homebuilding                           | Land Development |            |
| Revenues                           | \$ 657,086                             | \$ 19,878        | \$ 676,964 |
| Cost of sales and expenses (1)     | (614,741)                              | (19,501)         | (634,242)  |
| Net income                         | \$ 42,345                              | \$ 377           | \$ 42,722  |
| Our share of net earnings (losses) | \$ 13,644                              | \$ (19)          | \$ 13,625  |

|                                    | For the Nine Months Ended July 31,2005 |                  | Total      |
|------------------------------------|--|------------------|------------|
|                                    | Homebuilding                           | Land Development |            |
| Revenues                           | \$ 332,005                             | \$ 21,334        | \$ 353,339 |
| Cost of sales and expenses         | (288,149)                              | (22,219)         | (310,368)  |
| Net income (loss)                  | \$ 43,856                              | \$ (885)         | \$ 42,971  |
| Our share of net earnings (losses) | \$ 22,733                              | \$ (89)          | \$ 22,644  |

(1) Expenses in the third quarter of 2006 include the \$27 million write-off of the Town & Country

Homes trade name intangible in Florida by our joint venture with affiliates of Blackstone Real Estate Advisors.

Income (loss) from unconsolidated joint ventures is reflected as a separate line in the accompanying Condensed Consolidated Financial Statements and reflects our proportionate share of the income or loss of these unconsolidated homebuilding and land development joint ventures. The minor difference between our share of the income or loss from these unconsolidated joint ventures disclosed here compared to the Hovnianian Enterprises, Inc. Condensed Consolidated Income Statements is due to the reclass of the intercompany portion of management fee income from certain joint ventures. Our ownership interests in the joint ventures vary but are generally less than or equal to 50 percent. In determining whether or not we must consolidate joint ventures where we are the manager of the joint venture, we consider the guidance in EITF 04-5 in assessing whether the other partners have specific rights to overcome the presumption of control by us as the manager of the joint venture. In most cases, the presumption is overcome because the joint venture agreements require that both partners agree on establishing the operating and capital decisions of the partnership, including budgets, in the ordinary course of business.

Typically, our unconsolidated joint ventures obtain separate project specific mortgage financing for each venture. Generally, the amount of such financing is limited to no more than 50% of the joint venture's total assets, and such financing is obtained on a non-recourse basis, with guarantees from us limited only to performance and completion guarantees and limited environmental indemnifications.

15. Recent Accounting Pronouncements In May 2005, the FASB issued SFAS 154, Accounting Changes and Error Corrections. This statement, which replaces APB Opinion No. 20, Accounting Changes, and SFAS No. 3, Reporting Accounting Changes in Interim Financial Statements, changes the requirements for the accounting for and reporting of a change in accounting principle. The statement requires retrospective application of changes in accounting principle to prior periods' financial statements unless it is impracticable to determine the period-specific effects or the cumulative effect of the change. SFAS No. 154 is effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005. The adoption of SFAS No. 154 is not expected to have a material impact on our consolidated financial position, results of operations or cash flows.

In June 2005, the Emerging Issues Task Force (EITF) released Issue No. 04-5, Determining Whether a General Partner, or the General Partners as a Group, Controls a Limited Partnership or Similar Entity When the Limited Partners Have Certain Rights (EITF 04-5). EITF 04-5 creates a framework for evaluating whether a general partner or a group of general partners controls a limited partnership and therefore should consolidate the partnership. EITF 04-5 states that the presumption of general partner control would be overcome only when the limited partners have certain specific rights as outlined in EITF 04-5. EITF 04-5 is effective immediately for all newly formed limited partnerships and for existing limited partnership agreements that are modified. For general partners in all other limited partnerships, EITF 04-5 is effective no later than the beginning of the first reporting period in fiscal years beginning after December 15, 2005. Implementation of EITF 04-5 is not expected to have a material impact on our consolidated financial position, results of operations or cash flows.

In July 2006, the FASB issued Interpretation No. 48 (FIN 48), Accounting to Uncertainty in Income Taxes - An Interpretation of FASB Statement No. 109. FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with SFAS 109. FIN 48 also 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. The new FASB standard also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition. The provisions of FIN 48 are effective for the Company's first quarter ending January 31, 2007. We are in the process of assessing the impact, if any, this will have on our financial statements.

16. Intangible Assets The intangible assets recorded on our balance sheet are goodwill, which has an indefinite life, and definite life intangibles, including tradenames, architectural designs, distribution processes, and contractual agreements resulting from our acquisitions. We no longer amortize goodwill, but instead assess it periodically for impairment. We are amortizing the definite life intangibles over their expected useful lives, ranging from three to eight years.

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17. Acquisitions - On August 3, 2005, we acquired substantially all of the homebuilding assets of Oster Homes, a privately held Ohio homebuilder, headquartered in Lorain, Ohio.

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On August 8, 2005, we acquired substantially all of the assets of First Home Builders of Florida, a privately held homebuilder and provider of related financial services headquartered in Cape Coral, Florida.

In connection with the First Home Builders of Florida and Oster Homes acquisitions, based on an appraisal of acquisition intangibles, we have definite life intangible assets equal to the excess purchase price over the fair value of net tangible assets of \$121 million in the aggregate. We are amortizing the definite life intangibles over their estimated lives.

On April 17, 2006, we acquired for cash the assets of CraftBuilt Homes, a privately held homebuilder headquartered in Bluffton, South Carolina. In connection with the acquisition, we have definite life intangible assets equal to the excess purchase price over the fair value of net tangible assets of \$4.5 million in the aggregate. We are awaiting the appraisal from this acquisition. Until the appraisal is received, we are estimating the intangible value for amortization calculations. We expect to have the final appraisal by the end of the second quarter of fiscal 2007. We expect to amortize the definite life intangibles over their estimated lives.

On May 1, 2006, we acquired through the issuance of 175,936 shares of Class A common stock substantially all of the assets of two mechanical contracting businesses.

All fiscal 2006 and 2005 acquisitions provide for other payments to be made, generally dependent upon achievement of certain future operating and return objectives.

18. Hovnanian Enterprises, Inc., the parent company (the "Parent"), is the issuer of publicly traded common stock and preferred stock. One of its wholly owned subsidiaries, K. Hovnanian Enterprises, Inc. (the "Subsidiary Issuer"), acts as a finance entity that as of July 31, 2006 had issued and outstanding \$400 million of Senior Subordinated Notes, \$1,655.3 million face value of Senior Notes, and \$273.2 million drawn on a Revolving Credit Agreement. The Senior Subordinated Notes, Senior Notes and the Revolving Credit Agreement are fully and unconditionally guaranteed by the Parent.

In addition to the Parent, each of the wholly owned subsidiaries of the Parent other than the Subsidiary Issuer (collectively, the "Guarantor Subsidiaries"), with the exception of various subsidiaries formerly engaged in the issuance of collateralized mortgage obligations, our mortgage lending subsidiaries, a subsidiary formerly engaged in homebuilding activity in Poland, our title insurance subsidiaries, joint ventures, and certain other subsidiaries (collectively, the "Non-guarantor Subsidiaries"), have guaranteed fully and unconditionally, on a joint and several basis, the obligations of the Subsidiary Issuer to pay principal and interest under the Senior Notes, Senior Subordinated Notes, and the Revolving Credit Agreement.

In lieu of providing separate audited financial statements for the Guarantor Subsidiaries we have included the accompanying condensed consolidating financial statements. Management does not believe that separate financial statements of the Guarantor Subsidiaries are material to investors. Therefore, separate financial statements and other disclosures concerning the Guarantor Subsidiaries are not presented.

The following condensed consolidating financial information presents the results of operations, financial position, and cash flows of (i) the Parent, (ii) the Subsidiary Issuer, (iii) the Guarantor Subsidiaries, (iv) the Non-guarantor Subsidiaries, and (v) the eliminations to arrive at the

information for Hovnanian Enterprises, Inc. on a consolidated basis.

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HOVNANIAN ENTERPRISES, INC. AND SUBSIDIARIES  
 NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS UNAUDITED  
 CONDENSED CONSOLIDATING BALANCE SHEET  
 JULY 31, 2006  
 (Dollars in Thousands)

|  | Parent      | Subsidiary<br>Issuer | Guarantor<br>Subsidiaries | Non-<br>Guarantor<br>Subsidiaries | Eliminations  | Consolidated |
|--|-------------|----------------------|---------------------------|-----------------------------------|---------------|--------------|
| <b>ASSETS:</b>   |             |                      |                           |                                   |               |              |
| Homebuilding   | \$ 242      | \$ 130,042           | \$5,125,510               | \$ 286,342                        | \$            | \$5,542,136  |
| Financial services   |             |                      | 106                       | 195,663                           |               | 195,769      |
| Income taxes (payable) receivable                                    | 53,149      |                      | 96,671                    | 975                               |               | 150,795      |
| Investments in and amounts due to and from consolidated subsidiaries | 2,000,926   | 2,588,249            | (2,665,652)               | (241,476)                         | (1,682,047)   | -            |
| Total assets   | \$2,054,317 | \$2,718,291          | \$2,556,635               | \$ 241,504                        | \$(1,682,047) | \$5,888,700  |
| <b>LIABILITIES AND STOCKHOLDERS EQUITY:</b>                          |             |                      |                           |                                   |               |              |
| Homebuilding   | \$          | \$                   | \$1,064,700               | \$ 28,492                         | \$            | \$1,093,192  |
| Financial services   |             |                      | 72                        | 175,517                           |               | 175,589      |
| Notes payable  |             | 2,352,379            | 1,118                     |                                   |               | 2,353,497    |
| Minority interest  |             |                      | 208,542                   | 3,563                             |               | 212,105      |
| Stockholders equity  | 2,054,317   | 365,912              | 1,282,203                 | 33,932                            | (1,682,047)   | 2,054,317    |
| Total liabilities and stockholders equity                            | \$2,054,317 | \$2,718,291          | \$2,556,635               | \$ 241,504                        | \$(1,682,047) | \$5,888,700  |

HOVNANIAN ENTERPRISES, INC. AND SUBSIDIARIES  
 NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS  
 CONDENSED CONSOLIDATING BALANCE SHEET  
 OCTOBER 31, 2005  
 (Dollars in Thousands)

|  | Parent      | Subsidiary<br>Issuer | Guarantor<br>Subsidiaries | Non-<br>Guarantor<br>Subsidiaries | Eliminations  | Consolidated |
|--|-------------|----------------------|---------------------------|-----------------------------------|---------------|--------------|
| <b>ASSETS:</b>   |             |                      |                           |                                   |               |              |
| Homebuilding   | \$ 1,192    | \$ 332,180           | \$3,931,333               | \$ 214,238                        |               | \$4,478,943  |
| Financial services   |             |                      | 200                       | 237,092                           |               | 237,292      |
| Income taxes (payable) receivable                                    | (22,704)    |                      | 32,970                    | (363)                             |               | 9,903        |
| Investments in and amounts due to and from consolidated subsidiaries | 1,812,869   | 1,413,666            | (1,617,271)               | (189,626)                         | (1,419,638)   | -            |
| Total assets   | \$1,791,357 | \$1,745,846          | \$2,347,232               | \$ 261,341                        | \$(1,419,638) | \$4,726,138  |
| <b>LIABILITIES AND STOCKHOLDERS EQUITY:</b>                          |             |                      |                           |                                   |               |              |
| Homebuilding   | \$          | \$ 20,431            | \$ 996,428                | \$ 3,626                          | \$            | \$1,020,485  |
| Financial services   |             |                      | 81                        | 207,236                           |               | 207,317      |
| Notes payable  |             | 1,504,922            | (3,531)                   | 24,339                            |               | 1,525,730    |
| Minority interest  |             |                      | 180,170                   | 1,079                             |               | 181,249      |
| Stockholders equity  | 1,791,357   | 220,493              | 1,174,084                 | 25,061                            | (1,419,638)   | 1,791,357    |
| Total liabilities and stockholders equity                            | \$1,791,357 | \$1,745,846          | \$2,347,232               | \$ 261,341                        | \$(1,419,638) | \$4,726,138  |

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HOVNIANIAN ENTERPRISES, INC. AND SUBSIDIARIES  
 NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS UNAUDITED  
 CONDENSED CONSOLIDATING STATEMENT OF OPERATIONS  
 THREE MONTHS ENDED JULY 31, 2006  
 (Dollars in Thousands)

|  | Parent    | Subsidiary<br>Issuer | Guarantor<br>Subsidiaries | Non-Guarantor<br>Subsidiaries | Eliminations | Consolidated |
|--|-----------|----------------------|---------------------------|-------------------------------|--------------|--------------|
| Revenues:  |           |                      |                           |                               |              |              |
| Homebuilding   | \$        | \$ 119               | \$1,512,360               | \$ 15,379                     | \$           | \$1,527,858  |
| Financial services                                   |           |                      | 2,240                     | 20,421                        |              | 22,661       |
| Intercompany charges                                 |           | 81,758               | 81,317                    |                               | (163,075)    | -            |
| Equity in pretax income of consolidated subsidiaries | 120,877   |                      |                           |                               | (120,877)    | -            |
| Total revenues                                       | 120,877   | 81,877               | 1,595,917                 | 35,800                        | (283,952)    | 1,550,519    |
| Expenses:  |           |                      |                           |                               |              |              |
| Homebuilding   |           | 560                  | 1,444,103                 | 8,039                         | (41,426)     | 1,411,276    |
| Financial services                                   |           |                      | 1,263                     | 13,864                        |              | 15,127       |
| Total expenses                                       |           | 560                  | 1,445,366                 | 21,903                        | (41,426)     | 1,426,403    |
| Income from unconsolidated joint ventures            |           |                      | (3,239)                   |                               |              | (3,239)      |
| Income (loss) before income taxes                    | 120,877   | 81,317               | 147,312                   | 13,897                        | (242,526)    | 120,877      |
| State and federal income taxes                       | 43,830    | 31,191               | 50,247                    | 4,971                         | (86,409)     | 43,830       |
| Net income (loss)                                    | \$ 77,047 | \$ 50,126            | \$ 97,065                 | \$ 8,926                      | \$ (156,117) | \$ 77,047    |

HOVNIANIAN ENTERPRISES, INC. AND SUBSIDIARIES  
 NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS UNAUDITED  
 CONDENSED CONSOLIDATING STATEMENT OF OPERATIONS  
 THREE MONTHS ENDED JULY 31, 2005  
 (Dollars in Thousands)

|  | Parent     | Subsidiary<br>Issuer | Guarantor<br>Subsidiaries | Non-Guarantor<br>Subsidiaries | Eliminations | Consolidated |
|--|------------|----------------------|---------------------------|-------------------------------|--------------|--------------|
| Revenues:  |            |                      |                           |                               |              |              |
| Homebuilding   | \$         | \$ 60                | \$1,293,968               | \$ 165                        | \$           | \$1,294,193  |
| Financial services                                   |            |                      | 1,009                     | 17,524                        |              | 18,533       |
| Intercompany charges                                 |            | 53,685               | 54,559                    |                               | (108,244)    | -            |
| Equity in pretax income of consolidated subsidiaries | 194,891    |                      |                           |                               | (194,891)    | -            |
| Total revenues                                       | 194,891    | 53,745               | 1,349,536                 | 17,689                        | (303,135)    | 1,312,726    |
| Expenses:  |            |                      |                           |                               |              |              |
| Homebuilding   |            | (814)                | 1,136,550                 | 881                           | (17,171)     | 1,119,446    |
| Financial services                                   |            |                      | 315                       | 12,895                        | (914)        | 12,296       |
| Total expenses                                       |            | (814)                | 1,136,865                 | 13,776                        | (18,085)     | 1,131,742    |
| Income from unconsolidated joint ventures            |            |                      | 13,907                    |                               |              | 13,907       |
| Income (loss) before income taxes                    | 194,891    | 54,559               | 226,578                   | 3,913                         | (285,050)    | 194,891      |
| State and federal income taxes                       | 78,797     | 31,571               | 129,114                   | 3,078                         | (163,763)    | 78,797       |
| Net income (loss)                                    | \$ 116,094 | \$ 22,988            | \$ 97,464                 | \$ 835                        | \$ (121,287) | \$ 116,094   |

HOVNIANIAN ENTERPRISES, INC. AND SUBSIDIARIES  
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS UNAUDITED  
CONDENSED CONSOLIDATING STATEMENT OF OPERATIONS  
NINE MONTHS ENDED JULY 31, 2006  
(Dollars in Thousands)

|  | Parent     | Subsidiary<br>Issuer | Guarantor<br>Subsidiaries | Non-Guarantor<br>Subsidiaries | Eliminations | Consolidated |
|--|------------|----------------------|---------------------------|-------------------------------|--------------|--------------|
| Revenues:  |            |                      |                           |                               |              |              |
| Homebuilding   | \$         | \$ 370               | \$ 4,310,378              | \$ 28,770                     | \$           | \$4,339,518  |
| Financial services                                   |            |                      | 6,516                     | 56,598                        |              | 63,114       |
| Intercompany charges                                 |            | 224,600              | 223,705                   |                               | (448,305)    | -            |
| Equity in pretax income of consolidated subsidiaries | 418,651    |                      |                           |                               | (418,651)    | -            |
| Total revenues                                       | 418,651    | 224,970              | 4,540,599                 | 85,368                        | (866,956)    | 4,402,632    |
| Expenses:  |            |                      |                           |                               |              |              |
| Homebuilding   |            | 1,265                | 4,045,861                 | 15,180                        | (107,666)    | 3,954,640    |
| Financial services                                   |            |                      | 3,442                     | 39,977                        | (245)        | 43,174       |
| Total expenses                                       |            | 1,265                | 4,049,303                 | 55,157                        | (107,911)    | 3,997,814    |
| Income from unconsolidated joint ventures            |            |                      | 13,833                    |                               |              | 13,833       |
| Income (loss) before income taxes                    | 418,651    | 223,705              | 505,129                   | 30,211                        | (759,045)    | 418,651      |
| State and federal income taxes                       | 153,859    | 79,239               | 181,997                   | 11,762                        | (272,998)    | 153,859      |
| Net income (loss)                                    | \$ 264,792 | \$ 144,466           | \$ 323,132                | \$ 18,449                     | \$ (486,047) | \$ 264,792   |

HOVNIANIAN ENTERPRISES, INC. AND SUBSIDIARIES  
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS UNAUDITED  
CONDENSED CONSOLIDATING STATEMENT OF OPERATIONS  
NINE MONTHS ENDED JULY 31, 2005  
(Dollars in Thousands)

|  | Parent    | Subsidiary<br>Issuer | Guarantor<br>Subsidiaries | Non-Guarantor<br>Subsidiaries | Eliminations | Consolidated |
|--|-----------|----------------------|---------------------------|-------------------------------|--------------|--------------|
| Revenues:  |           |                      |                           |                               |              |              |
| Homebuilding   | \$        | \$ 161               | \$3,526,539               | \$ 1,061                      | \$           | \$3,527,761  |
| Financial services                                   |           |                      | 3,983                     | 45,012                        |              | 48,995       |
| Intercompany charges                                 |           | 154,345              | 156,408                   |                               | (310,753)    | -            |
| Equity in pretax income of consolidated subsidiaries | 501,324   |                      |                           |                               | (501,324)    | -            |
| Total revenues                                       | 501,324   | 154,506              | 3,686,930                 | 46,073                        | (812,077)    | 3,576,756    |
| Expenses:  |           |                      |                           |                               |              |              |
| Homebuilding   |           | (1,902)              | 3,133,308                 | 2,909                         | (70,084)     | 3,064,231    |
| Financial services                                   |           |                      | 2,087                     | 34,388                        | (2,792)      | 33,683       |
| Total expenses                                       |           | (1,902)              | 3,135,395                 | 37,297                        | (72,876)     | 3,097,914    |
| Income from unconsolidated joint ventures            |           |                      | 22,482                    |                               |              | 22,482       |
| Income (loss) before income taxes                    | 501,324   | 156,408              | 574,017                   | 8,776                         | (739,201)    | 501,324      |
| State and federal income taxes                       | 197,612   | 54,743               | 221,741                   | 4,384                         | (280,868)    | 197,612      |
| Net income (loss)                                    | \$303,712 | \$ 101,665           | \$ 352,276                | \$ 4,392                      | \$ (458,333) | \$ 303,712   |

HOVNIANIAN ENTERPRISES, INC. AND SUBSIDIARIES  
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS UNAUDITED  
CONDENSED CONSOLIDATING STATEMENT OF CASH FLOWS  
NINE MONTHS ENDED JULY 31, 2006  
(Dollars in Thousands)

|  | Parent     | Subsidiary<br>Issuer | Guarantor<br>Subsidiaries | Non-Guarantor<br>Subsidiaries | Elim  |
|--|------------|----------------------|---------------------------|-------------------------------|-------|
| Cash flows from operating activities:  |            |                      |                           |                               |       |
| Net income   | \$ 264,792 | \$ 144,466           | \$ 323,132                | \$ 18,449                     | \$ (4 |
| Adjustments to reconcile net income to net cash provided by (used in) operating activities | (76,641)   | (7,698)              | (1,401,483)               | (103,379)                     | 486   |
| Net cash provided by (used in) investing activities  | 188,151    | 136,768              | (1,078,351)               | (84,930)                      |       |
| Net cash (used in) investing activities  |            |                      | (67,692)                  | (11,202)                      |       |
| Net cash provided by (used in) financing activities  | (94)       | 823,225              | (105,042)                 | 35,696                        |       |
| Intercompany investing and financing activities net  | (188,057)  | (1,174,583)          | 1,310,790                 | 51,850                        |       |
| Net increase (decrease) in cash  | -          | (214,590)            | 59,705                    | (8,586)                       |       |
| Cash and cash equivalents balance, beginning of period                                     | 16         | 298,596              | (97,024)                  | 9,685                         |       |
| Cash and cash equivalents balance, end of period   | \$ 16      | \$ 84,006            | \$ (37,319)               | \$ 1,099                      | \$    |

HOVNIANIAN ENTERPRISES, INC. AND SUBSIDIARIES  
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS UNAUDITED  
CONDENSED CONSOLIDATING STATEMENT OF CASH FLOWS  
NINE MONTHS ENDED JULY 31, 2005  
(Dollars in Thousands)

|  | Parent     | Subsidiary<br>Issuer | Guarantor<br>Subsidiaries | Non-Guarantor<br>Subsidiaries | Elim  |
|--|------------|----------------------|---------------------------|-------------------------------|-------|
| Cash flows from operating activities:  |            |                      |                           |                               |       |
| Net income   | \$ 303,712 | \$ 101,665           | \$ 352,276                | \$ 4,392                      | \$ (4 |
| Adjustments to reconcile net income to net cash provided by (used in) operating activities | (70,247)   | 361,828              | (1,090,783)               | (107,714)                     | 458   |
| Net cash provided by (used in) operating activities  | 233,465    | 463,493              | (738,507)                 | (103,322)                     |       |
| Net cash (used in) investing activities  |            |                      | (229,486)                 | (82)                          |       |
| Net cash provided by (used in) financing activities  | 128,374    | 228,049              | 18,304                    | (24,485)                      |       |
| Intercompany investing and financing activities net  | (361,838)  | (667,602)            | 902,645                   | 126,795                       |       |
| Net increase (decrease) in cash  | 1          | 23,940               | (47,044)                  | (1,094)                       |       |
| Cash and cash equivalents balance, beginning of period                                     | 15         | 29,369               | 20,017                    | 11,558                        |       |
| Cash and cash equivalents balance, end of period   | \$ 16      | \$ 53,309            | \$ (27,027)               | \$ 10,464                     | \$    |

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION  
AND RESULTS OF OPERATIONS

CRITICAL ACCOUNTING POLICIES

Management believes that the following critical accounting policies affect its more significant judgments and estimates used in the preparation of its consolidated financial statements:

**Business Combinations** When we make an acquisition of another company, we use the purchase method of accounting in accordance with the Statement of Financial Accounting Standards (SFAS) No. 141 Business Combinations. Under SFAS No. 141, we record as our cost the estimated fair value of the acquired assets less liabilities assumed. Any difference between the cost of an acquired company and the sum of the fair values of tangible and intangible assets less liabilities is recorded as goodwill. The reported income of an acquired company includes the operations of the acquired company from the date of acquisition.

**Income Recognition from Home and Land Sales** We are primarily engaged in the development, construction, marketing and sale of residential single-family and multi-family homes where the planned construction cycle is less than 12 months. For these homes, in accordance with SFAS No. 66, Accounting for Sales of Real Estate ( SFAS 66 ), revenue is recognized when title is conveyed to the buyer, adequate cash payment has been received and there is no continued involvement.

Additionally, in certain markets, we sell lots to customers, transferring title, collecting proceeds, and entering into contracts to build homes on these lots. In these cases, we do not recognize the revenue from the lot sale until we deliver the completed home and have no continued involvement related to that home. The cash received on the lot is recorded as a component of inventory until the revenue is recognized.

**Income Recognition from High-Rise/Mid-Rise Projects** We are developing several high-rise/mid-rise projects that will take more than 12 months to complete. If these projects qualify, revenues and costs are recognized using the percentage of completion method of accounting in accordance with SFAS 66. Under the percentage of completion method, revenues and costs are to be recognized when construction is beyond the preliminary stage, the buyer is committed to the extent of having a sufficient deposit that the buyer cannot require be refunded except for non-delivery of the home, sufficient units in the project have been sold to ensure that the property will not be converted to rental property, the sales prices are collectible and the aggregate sales proceeds and the total cost of the project can be reasonably estimated. We currently do not have any projects that meet these criteria, therefore the revenues from delivering homes in high-rise/mid-rise projects are recognized when title is conveyed to the buyer, adequate cash payment has been received and there is no continued involvement with respect to that home.

**Income Recognition from Mortgage Loans** Profits and losses relating to the sale of mortgage loans are recognized when legal control passes to the buyer of the mortgage and the sales price is collected.

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Interest Income Recognition for Mortgage Loans Receivable and Recognition of Related Deferred Fees and Costs - Interest income is recognized as earned for each mortgage loan during the period from the loan closing date to the sale date when legal control passes to the buyer and the sale price is collected. All fees related to the origination of mortgage loans and direct loan origination costs are deferred and recorded as either (a) an adjustment to the related mortgage loans upon the closing of a loan or (b) recognized as a deferred asset or deferred revenue while the loan is in process. These fees and costs include loan origination fees, loan discount, and salaries and wages. Such deferred fees and costs relating to the closed loans are recognized over the life of the loans as an adjustment of yield or taken into operations upon sale of the loan to a permanent investor.

Inventories - Inventories and long-lived assets held for sale are recorded at the lower of cost or fair value less selling costs. Fair value is defined as the amount at which an asset could be bought or sold in a current transaction between willing parties, that is, other than in a forced or liquidation sale. Construction costs are accumulated during the period of construction and charged to cost of sales under specific identification methods. Land, land development, and common facility costs are allocated based on buildable acres to product types within

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each community then charged to cost of sales equally based upon the number of homes to be constructed in each product type. For inventories of communities under development, a loss is recorded when events and circumstances indicate impairment and the undiscounted future cash flows generated are less than the related carrying amounts. The impairment loss is based on discounted future cash flows generated from expected revenue, less cost to complete including interest, and selling costs.

**Insurance Deductible Reserves** For fiscal 2006, our deductible is \$20 million per occurrence with an aggregate \$20 million for premise liability claims and an aggregate \$20 million for construction defect claims under our general liability insurance. Once our \$20 million aggregate deductible is reached for construction defect claims, a \$250,000 per occurrence deductible is required on any additional claims. Our workers compensation insurance deductible is \$1 million per occurrence in fiscal 2006. Reserves have been established based upon actuarial analysis of estimated losses for fiscal 2006 and fiscal 2005. We engage a third party actuary that uses our historical warranty data to estimate our unpaid claims, claim adjustment expenses and incurred but not reported claims reserves for the risks that we are assuming under the general liability and workers compensation programs. The estimates include provisions for inflation, claims handling and legal fees.

**Interest** In accordance with SFAS 34 Capitalization of Interest Cost, interest incurred is first capitalized to properties under development during the land development and home construction period and expensed along with the associated cost of sales as the related inventories are sold. Interest in excess of interest capitalized or interest incurred on borrowings directly related to properties not under development is expensed immediately in Other Interest.

**Land Options** - Costs are capitalized when incurred and either included as part of the purchase price when the land is acquired or charged to operations when we determine we will not exercise the option. In accordance with Financial Accounting Standards Board (FASB) Interpretation No. 46R (FIN 46R) Consolidation of Variable Interest Entities, an interpretation of Accounting Research Bulletin No. 51, SFAS No. 49 Accounting for Product Financing Arrangements (SFAS 49), SFAS No. 98 Accounting for Leases (SFAS 98), and Emerging Issues Task Force (EITF) No. 97-10 The Effects of Lessee Involvement in Asset Construction (EITF 97-10), we record on the Condensed Consolidated Balance Sheets specific performance options, options with variable interest entities, and other options under Consolidated inventory not owned with the offset to Liabilities from inventory not owned and Minority interest from inventory not owned.

**Unconsolidated Homebuilding and Land Development Joint Ventures** - Investments in unconsolidated homebuilding and land development joint ventures are accounted for under the equity method of accounting. Under the equity method, we recognize our proportionate share of earnings and losses earned by the joint venture upon the delivery of lots or homes to third parties. Our ownership interest in joint ventures varies but is generally less than or equal to 50%. In determining whether or not we must consolidate joint ventures where we are the managing member of the joint venture, we consider the guidance in EITF 04-5 in assessing whether the other partners have specific rights to overcome the presumption of control by us as the manager of the joint venture. In most cases, the presumption is overcome because the joint venture agreements require that both partners agree on establishing the operating and capital decisions of the partnership, including budgets, in the ordinary course of business.

**Intangible Assets** The intangible assets recorded on our balance sheet are goodwill, which has indefinite life, and definite life intangibles, including tradenames, architectural designs, distribution processes, and contractual agreements resulting from our acquisitions. We no longer amortize goodwill, but instead assess it periodically for impairment. We are amortizing the definite life intangibles over their expected useful lives, ranging from three to eight years.

**Post Development Completion and Warranty Costs** - In those instances where a development is substantially completed and sold and we have additional construction work to be incurred, an estimated liability is provided to cover the cost of such work. In addition, our warranty accrual includes estimated costs for construction work that is unforeseen, but estimable based on past history, at the time of closing. Both of these liabilities are recorded in Accounts payable and other liabilities in the Condensed Consolidated Balance Sheets.

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The Company is in the process of responding to the SEC with respect to its segment reporting. Based on this correspondence, the Company believes it will have to file an amended Form 10-K for the fiscal year ended

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October 31, 2005, as well as an amended Form 10-Q for each of its fiscal quarters of 2006. These amendments will be filed as soon as the correspondence with the SEC is resolved. These amendments will be done to expand the reporting segment footnote disclosures related to our homebuilding operations. The amendment will have no impact on our Consolidated Balance Sheets, Consolidated Income Statements, Consolidated Cash Flows, or Consolidated Statements of Stockholders Equity for any period presented.

### CAPITAL RESOURCES AND LIQUIDITY

Our operations consist primarily of residential housing development and sales in our Northeast Region (New Jersey, New York State, Pennsylvania, Ohio, Michigan, Illinois and Minnesota), our Southeast Region (Washington D. C., Delaware, Maryland, Virginia, West Virginia, North Carolina, South Carolina, Georgia, and Florida), our Southwest Region (Texas and Arizona), and our West Region (California). In addition, we provide financial services to our homebuilding customers.

Our cash uses during the nine months ended July 31, 2006 were for operating expenses, increases in housing inventories, construction, income taxes, interest, preferred stock dividends, the acquisition of CraftBuilt Homes and repayments of our revolving credit facility. We provided for our cash requirements from housing and land sales, the revolving credit facility, Senior Notes issued in February and June 2006, financial service revenues, and other revenues. We believe that these sources of cash are sufficient to finance our working capital requirements and other needs.

On July 3, 2001, our Board of Directors authorized a stock repurchase program to purchase up to 4 million shares of Class A Common Stock. As of July 31, 2006, 3.2 million shares of Class A Common Stock have been purchased under this program.

On July 12, 2005, we issued 5,600 shares of 7.625% Series A Preferred Stock, with a liquidation preference of \$25,000 per share for net proceeds of \$135 million. Dividends on the Series A Preferred Stock are not cumulative and are paid at an annual rate of 7.625%. The Series A Preferred Stock is not convertible into the Company's common stock and is redeemable in whole or in part at our option at the liquidation preference of the shares beginning on the fifth anniversary of their issuance. The Series A Preferred Stock is traded as depositary shares, with each depositary share representing 1/1000<sup>th</sup> of a share of Series A Preferred Stock. The depositary shares are listed on the Nasdaq Global Market under the symbol HOVNP. The net proceeds from the offering, reflected in Preferred stock in the Condensed Consolidated Balance Sheets, were used for the partial repayment of the outstanding balance under our revolving credit facility as of July 12, 2005. In October 2005, we paid \$2.8 million of dividends on the Series A Preferred Stock. In each completed quarter of fiscal 2006, we paid \$2.7 million of dividends.

Our homebuilding bank borrowings are made pursuant to an amended and restated unsecured revolving credit agreement ("Agreement") effective May 31, 2006, that provides a revolving credit line and letter of credit line of \$1.5 billion through May 2011. The facility contains an accordion feature under which the aggregate commitment could be increased to \$2.0 billion subject to the availability of additional commitments. Loans under the Agreement bear interest at various rates based on (1) a base rate determined by reference to the higher of (a) PNC Bank, National Association's prime rate and (b) the federal funds rate plus 1/2% or (2) a margin ranging from 0.65% to 1.50% per annum, depending on our Leverage Ratio, as defined in the Agreement, and our debt ratings plus a LIBOR-based rate for a one, two, three, or six month interest period as selected by us. In addition, we pay a fee ranging from 0.15% to 0.25% per annum on the unused portion of the revolving credit line depending on our Leverage Ratio and our debt ratings and the average percentage unused portion of the revolving credit line. At July 31, 2006, there was \$273.2 million drawn under this Agreement and we had approximately \$36.8 million of homebuilding cash. At July 31, 2006, we had issued \$457.6 million of letters of credit which reduced cash available under the Agreement.

We believe that we will be able either to extend the Agreement beyond May 2011 or negotiate a replacement facility, but there can be no assurance of such extension or replacement facility. We currently are in compliance and intend to maintain compliance with the covenants under

the Agreement. We and each of our significant subsidiaries, except for K. Hovnanian Enterprises, Inc., the borrower, and various subsidiaries formerly

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engaged in the issuance of collateralized mortgage obligations, a subsidiary formerly engaged in homebuilding activity in Poland, our financial services subsidiaries, joint ventures, and certain other subsidiaries, is a guarantor under the Agreement.

At July 31, 2006, we had \$1,655.3 million of outstanding senior notes (\$1,649.5 million, net of discount), comprised of \$140.3 million 10 1/2% Senior Notes due 2007, \$100 million 8% Senior Notes due 2012, \$215 million 6 1/2% Senior Notes due 2014, \$150 million 6 3/8% Senior Notes due 2014, \$200 million 6 1/4% Senior Notes due 2015, \$300 million 6 1/4% Senior Notes due 2016, \$300 million 7 1/2% Senior Notes due 2016, and \$250 million 8 5/8% Senior Notes due 2017. At July 31, 2006, we had \$400.0 million of outstanding senior subordinated notes, comprised of \$150 million 8 7/8% Senior Subordinated Notes due 2012, \$150 million 7 3/4% Senior Subordinated Notes due 2013, and \$100 million 6% Senior Subordinated Notes due 2010. We and each of our wholly owned subsidiaries, except for K. Hovnanian Enterprises, Inc., the issuer of the senior and senior subordinated notes, and various subsidiaries formerly engaged in the issuance of collateralized mortgage obligations, our mortgage lending subsidiaries, a subsidiary formerly engaged in homebuilding activity in Poland, our title insurance subsidiaries, joint ventures, and certain other subsidiaries, is a guarantor of the senior notes and senior subordinated notes.

Our mortgage banking subsidiary's warehouse agreement was amended on May 19, 2006. Pursuant to the agreement, we may borrow up to \$250 million through May 18, 2007. Interest is payable monthly at the LIBOR Rate plus 1.0%. We also have a \$100 million commercial paper facility. The facility expires on April 20, 2007, and interest of LIBOR Rate plus 0.65% is payable monthly. As of July 31, 2006, the aggregate principal amount of all borrowings under these agreements were \$166.9 million.

Total inventory increased \$1.0 billion during the nine months ended July 31, 2006. This increase excluded the increase in consolidated inventory not owned of \$176.2 million consisting of specific performance options, options with variable interest entities, and other options that were added to our balance sheet in accordance with SFAS 49, SFAS 98, and EITF 97-10, and variable interest entities in accordance with FIN 46R. See Notes to Condensed Consolidated Financial Statements Note 13 for additional information on FIN 46R. Excluding the impact from an acquisition of \$31.3 million, the total inventory in the Southeast Region increased \$229.6 million, the Northeast Region increased \$286.0 million, the Southwest Region increased \$117.6 million, and our West Region increased \$370.2 million. The increase in inventory was primarily the result of planned organic growth in our existing markets as we have increased the number of communities open for sale from 367 at October 31, 2005 to 436 at July 31, 2006. Substantially all homes under construction or completed and included in inventory at July 31, 2006 are expected to be closed during the next twelve months. Most inventory completed or under development is partially financed through our revolving credit agreement and senior and senior subordinated indebtedness.

We usually option property for development prior to acquisition. By optioning property, we are only subject to the loss of the cost of the option and predevelopment costs if we choose not to exercise the option. As a result, our commitment for major land acquisitions is reduced. Inventory impairment losses increased \$10.9 million and \$17.6 million for the three and nine months ended July 31, 2006, compared to the same period in the prior year. These increases are primarily attributable to walking away from option deposits where the current market conditions yield a lower than acceptable return on investment.

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The following table summarizes the number of buildable homes included in our total residential real estate.

|  | Active<br>Communities | Active<br>Communities<br>Homes | Proposed<br>Developable<br>Homes | Grand Total Homes |
|--|-----------------------|--------------------------------|----------------------------------|-------------------|
| July 31, 2006:   |                       |                                |                                  |                   |
| Northeast Region                                       | 82                    | 11,340                         | 21,198                           | 32,538            |
| Southeast Region                                       | 179                   | 22,764                         | 24,788                           | 47,552            |
| Southwest Region                                       | 114                   | 13,633                         | 5,506                            | 19,139            |
| West Region  | 61                    | 13,144                         | 6,391                            | 19,535            |
| Consolidated total                                     | 436                   | 60,881                         | 57,883                           | 118,764           |
| Unconsolidated joint<br>ventures                       |                       | 6,343                          | 1,517                            | 7,860             |
| Total including<br>unconsolidated joint<br>ventures    |                       | 67,224                         | 59,400                           | 126,624           |
| Owned  |                       | 30,548                         | 5,952                            | 36,500            |
| Optioned   |                       | 26,766                         | 51,931                           | 78,697            |
| Controlled lots  |                       | 57,314                         | 57,883                           | 115,197           |
| Construction to<br>permanent financing<br>lots         |                       | 3,567                          |                                  | 3,567             |
| Lots controlled by<br>unconsolidated joint<br>ventures |                       | 6,343                          | 1,517                            | 7,860             |
| Total including<br>unconsolidated joint<br>ventures    |                       | 67,224                         | 59,400                           | 126,624           |



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|  | Active<br>Communities | Active<br>Communities<br>Homes | Proposed<br>Developable<br>Homes | Grand Total<br>Homes |
|--|-----------------------|--------------------------------|----------------------------------|----------------------|
| October 31, 2005:                                |                       |                                |                                  |                      |
| Northeast Region                                 | 65                    | 10,797                         | 22,928                           | 33,725               |
| Southeast Region                                 | 148                   | 21,713                         | 26,113                           | 47,826               |
| Southwest Region                                 | 102                   | 12,905                         | 7,547                            | 20,452               |
| West Region                                      | 52                    | 9,285                          | 9,718                            | 19,003               |
| Consolidated total                               | 367                   | 54,700                         | 66,306                           | 121,006              |
| Unconsolidated joint ventures                    |                       | 6,655                          | 3,396                            | 10,051               |
| Total Including unconsolidated joint ventures    |                       | 61,355                         | 69,702                           | 131,057              |
| Owned  |                       | 24,731                         | 5,657                            | 30,388               |
| Optioned   |                       | 25,046                         | 60,649                           | 85,695               |
| Controlled lots                                  |                       | 49,777                         | 66,306                           | 116,083              |
| Construction to permanent financing lots         |                       | 4,923                          |                                  | 4,923                |
| Lots controlled by unconsolidated joint ventures |                       | 6,655                          | 3,396                            | 10,051               |
| Total including unconsolidated joint ventures    |                       | 61,355                         | 69,702                           | 131,057              |

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The following table summarizes our started or completed unsold homes and models. The increase in total started or completed unsold homes compared to the prior year is primarily due to the increase in our community count from 367 at October 31, 2005 to 436 at July 31, 2006, as well as an increase in our contract cancellation rates and our purchase of a completed high rise building with 130 unsold homes available for sale.

|                  | July 31, 2006 |        |       | October 31, 2005 |        |       |
|------------------|---------------|--------|-------|------------------|--------|-------|
|                  | Unsold Homes  | Models | Total | Unsold Homes     | Models | Total |
| Northeast Region | 724           | 53     | 777   | 469              | 35     | 504   |
| Southeast Region | 811           | 58     | 869   | 417              | 56     | 473   |
| Southwest Region | 961           | 85     | 1,046 | 901              | 70     | 971   |
| West Region      | 796           | 154    | 950   | 275              | 157    | 432   |
| Total            | 3,292         | 350    | 3,642 | 2,062            | 318    | 2,380 |

Investments in and advances to unconsolidated joint ventures increased \$29.9 million during the nine months ended July 31, 2006. This increase is due to income from joint ventures not distributed and additional investment in joint ventures. As of July 31, 2006, we have investments in ten homebuilding joint ventures and nine land development joint ventures. Other than performance and completion guarantees and limited environmental indemnifications, no other guarantees associated with unconsolidated joint ventures have been given.

Receivables, deposits, and notes decreased \$22.3 million to \$103.1 million at July 31, 2006. The decrease was primarily due to a decrease in miscellaneous receivables for a payment received in the first quarter of 2006 from an unconsolidated joint venture, offset by an increase in deposits during the quarter.

Prepaid expenses and other assets are as follows:

|                                      | July 31,<br>2006 | October 31,<br>2005 | Dollar<br>Change |
|--------------------------------------|------------------|---------------------|------------------|
| Prepaid insurance                    | \$ 12,199        |                     | \$ 12,199        |
| Prepaid project costs                | 85,501           | \$ 61,773           | 23,728           |
| Senior residential rental properties | 8,453            | 8,754               | (301)            |
| Other prepaids                       | 44,641           | 30,730              | 13,911           |
| Other assets                         | 32,170           | 30,588              | 1,582            |
|                                      | \$182,964        | \$131,845           | \$ 51,119        |

Prepaid insurance increased due to a payment of a full year of liability insurance premium costs during the first quarter of every year. These costs are amortized on a straight line basis. Prepaid project costs and other prepaids increased due to the growth in the number of communities. Prepaid project costs consist of community specific expenditures that are used over the life of the community. Such prepaids are expensed as homes are delivered. The increase in other prepaids is primarily due to prepaid bond fees, recorded in connection with the Company's two new bond issuances in fiscal 2006.

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At July 31, 2006, we had \$32.7 million of goodwill. This amount resulted from Company acquisitions prior to fiscal 2000.

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Definite life intangibles decreased \$49.0 million to \$200.5 million at July 31, 2006. The decrease was the result of amortization during the nine months of \$38.4 million, and an adjustment to the First Home Builders of Florida acquisition accounting, offset by current year acquisitions and contingent payments related to past acquisitions. As we finalized our valuation of the assets acquired from First Home Builders of Florida, we established a deferred tax asset as part of the purchase price allocation, which reduced the recorded intangibles. For any acquisition, professionals are hired to appraise all acquired intangibles. See - Critical Accounting Policies Intangible Assets above for additional information on intangibles. For tax purposes all our intangibles, except those resulting from an acquisition classified as a tax free exchange, are being amortized over 15 years.

Income Taxes Receivable Including Deferred Tax Benefits increased \$140.9 million due to estimated tax payments made during 2006, based on 2005 actual taxes, while pre-tax income is lower in 2006 than in 2005. Also, as noted above, we finalized our valuation of the assets acquired from First Home Builders of Florida and we established a deferred tax asset as part of the purchase price allocation, which reduced the recorded intangibles.

Accounts payable and other liabilities are as follows:

|                      | July 31,<br>2006 | October 31,<br>2005 | Dollar<br>Change |
|----------------------|------------------|---------------------|------------------|
| Accounts payable     | \$208,859        | \$191,469           | \$ 17,390        |
| Reserves             | 100,525          | 95,310              | 5,215            |
| Accrued expenses     | 56,128           | 48,647              | 7,481            |
| Accrued compensation | 67,427           | 75,655              | (8,228)          |
| Other liabilities    | 113,729          | 99,448              | 14,281           |
|                      | \$546,668        | \$510,529           | \$ 36,139        |

The increase in accounts payable was primarily due to timing of payments and an increase in new communities under construction, which resulted in more activity and higher payables. Reserves increased for our general liability insurance deductible and bonding. As each home closes, we accrue for warranty costs under our general liability insurance. Any claims for warranty costs may not occur until the later years of the ten year warranty period, therefore, as our number of closed homes continues to increase each year, our reserves will increase until charges are incurred or the warranty period expires. The increase in accrued expenses is due to timing of acquisition earnout obligations and a significant increase in the number of homes closed in one of our Southeast markets in the third quarter of 2006, resulting in a higher volume of invoices not yet received for work completed in the last few weeks of the quarter. The decrease in accrued compensation was primarily due to the payout of our fiscal year 2005 fourth quarter bonuses during the first quarter of 2006. Traditionally higher bonuses are earned in the fourth quarter of the fiscal year, as the Company earns its highest profits in the fourth quarter. The increase in other liabilities is mainly due to an increase in deferred income from advances related to lot options in the Northeast and Southwest Regions.

Financial Services - Mortgage loans held for sale consist of residential mortgages receivable of which \$174.7 million and \$211.2 million at July 31, 2006 and October 31, 2005, respectively, are being temporarily warehoused and awaiting sale in the secondary mortgage market. We may incur risk with respect to mortgages that are delinquent, but only to the extent the losses are not covered by mortgage insurance or resale value of the house. Historically, we have incurred minimal credit losses. The decrease in the receivable from October 31, 2005 is directly related to a decrease in the amount of loans financed at July 31, 2006.



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RESULTS OF OPERATIONS FOR THE THREE AND NINE MONTHS ENDED JULY 31, 2006 COMPARED TO THE THREE AND NINE MONTHS ENDED JULY 31, 2005

Total revenues:

Compared to the same prior period, revenues increased as follows:

|                               | Three Months Ended                      |               | Dollar Change | Percentage Change |
|-------------------------------|---|---------------|---------------|-------------------|
|                               | July 31, 2006<br>(Dollars In Thousands) | July 31, 2005 |               |                   |
| Homebuilding:                 |   |               |               |                   |
| Sale of homes                 | \$1,499,826                             | \$1,289,373   | \$ 210,453    | 16.3%             |
| Land sales and other revenues | 28,032                                  | 4,820         | 23,212        | 481.6%            |
| Financial services            | 22,661                                  | 18,533        | 4,128         | 22.3%             |
| Total revenues                | \$1,550,519                             | \$1,312,726   | \$ 237,793    | 18.1%             |
|                               |   |               |               |                   |
|                               | Nine Months Ended                       |               | Dollar Change | Percentage Change |
|                               | July 31, 2006<br>(Dollars In Thousands) | July 31, 2005 |               |                   |
| Homebuilding:                 |   |               |               |                   |
| Sale of homes                 | \$4,225,571                             | \$3,495,014   | \$ 730,557    | 20.9%             |
| Land sales and other revenues | 113,947                                 | 32,747        | 81,200        | 248.0%            |
| Financial services            | 63,114                                  | 48,995        | 14,119        | 28.8%             |
| Total revenues                | \$4,402,632                             | \$3,576,756   | \$ 825,876    | 23.1%             |

Homebuilding:

Compared to the same prior period, homebuilding revenues increased \$233.7 million or 18% during the three months ended July 31, 2006 and increased \$811.8 million or 23% during the nine months ended July 31, 2006. Land sales are ancillary to our homebuilding operations and are expected to continue in the future but may significantly fluctuate up or down. For further details on land sales and other revenues, see paragraph titled "Land Sales and Other Revenues" later in this document.



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Information on homes delivered by market area is set forth below:

|                                    | Three Months Ended |             | Nine Months Ended |             |
|------------------------------------|--------------------|-------------|-------------------|-------------|
|                                    | July 31,           |             | July 31,          |             |
|                                    | 2006               | 2005        | 2006              | 2005        |
| (Dollars in Thousands)             |                    |             |                   |             |
| Northeast Region (1):              |                    |             |                   |             |
| Dollars                            | \$ 286,250         | \$ 244,973  | \$ 744,704        | \$ 750,679  |
| Homes                              | 721                | 644         | 1,979             | 2,056       |
| Southeast Region (2):              |                    |             |                   |             |
| Dollars                            | \$ 617,412         | \$ 405,467  | \$1,647,282       | \$1,004,201 |
| Homes                              | 2,030              | 1,212       | 5,364             | 3,232       |
| Southwest Region:                  |                    |             |                   |             |
| Dollars                            | \$ 220,211         | \$ 189,766  | \$ 635,759        | \$ 489,810  |
| Homes                              | 1,022              | 1,021       | 2,948             | 2,636       |
| West Region:                       |                    |             |                   |             |
| Dollars                            | \$ 375,953         | \$ 449,167  | \$1,197,826       | \$1,250,324 |
| Homes                              | 850                | 1,090       | 2,732             | 3,057       |
| Consolidated total:                |                    |             |                   |             |
| Dollars                            | \$1,499,826        | \$1,289,373 | \$4,225,571       | \$3,495,014 |
| Homes                              | 4,623              | 3,967       | 13,023            | 10,981      |
| Unconsolidated joint ventures (3): |                    |             |                   |             |
| Dollars                            | \$ 189,287         | \$ 195,716  | \$ 648,301        | \$ 331,033  |
| Homes                              | 498                | 571         | 1,695             | 944         |
| Totals:                            |                    |             |                   |             |
| Housing revenues                   | \$1,689,113        | \$1,485,089 | \$4,873,872       | \$3,826,047 |
| Homes delivered                    | 5,121              | 4,538       | 14,718            | 11,925      |

(1) Northeast Region includes deliveries from our Ohio acquisition of Oster Homes on August 3, 2005.

(2) Southeast Region includes deliveries from our Florida acquisitions of Cambridge Homes and First

Home Builders of Florida on March 1, 2005 and August 8, 2005, respectively, and our acquisition of CraftBuilt Homes on April 1, 2006 with deliveries in South Carolina and Georgia.

(3) Unconsolidated Joint Ventures includes deliveries from our joint venture with affiliates of Blackstone

Real Estate Advisors that acquired Town & Country Homes existing residential communities on March 2, 2005.

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An important indicator of our future results are recently signed contracts and home contract backlog for future deliveries. Our sales contracts and homes in contract backlog primarily using base sales prices by market area are set forth below:

|                                    | Net Contracts(1) for the   |             |                                 |             |
|------------------------------------|----------------------------|-------------|---------------------------------|-------------|
|                                    | Nine Months Ended July 31, |             | Contract Backlog as of July 31, |             |
|                                    | 2006                       | 2005        | 2006                            | 2005        |
|                                    | (Dollars in Thousands)     |             |                                 |             |
| Northeast Region (2):              |                            |             |                                 |             |
| Dollars                            | \$ 754,855                 | \$ 729,637  | \$ 862,227                      | \$ 798,113  |
| Homes                              | 2,064                      | 1,981       | 2,249                           | 2,181       |
| Southeast Region (3):              |                            |             |                                 |             |
| Dollars                            | \$1,371,689                | \$1,308,952 | \$1,950,945                     | \$1,232,152 |
| Homes                              | 3,673                      | 3,630       | 5,771                           | 3,305       |
| Southwest Region:                  |                            |             |                                 |             |
| Dollars                            | \$ 635,986                 | \$ 647,975  | \$ 300,375                      | \$ 333,875  |
| Homes                              | 2,981                      | 3,320       | 1,329                           | 1,608       |
| West Region:                       |                            |             |                                 |             |
| Dollars                            | \$ 872,358                 | \$1,272,462 | \$ 490,893                      | \$ 840,758  |
| Homes                              | 1,943                      | 3,076       | 964                             | 1,936       |
| Consolidated total:                |                            |             |                                 |             |
| Dollars                            | \$3,634,888                | \$3,959,026 | \$3,604,440                     | \$3,204,898 |
| Homes                              | 10,661                     | 12,007      | 10,313                          | 9,030       |
| Unconsolidated joint ventures (4): |                            |             |                                 |             |
| Dollars                            | \$ 323,557                 | \$ 671,277  | \$ 706,057                      | \$ 993,259  |
| Homes                              | 903                        | 1,426       | 1,548                           | 2,301       |
| Totals:                            |                            |             |                                 |             |
| Dollars                            | \$3,958,445                | \$4,630,303 | \$4,310,497                     | \$4,198,157 |
| Homes                              | 11,564                     | 13,433      | 11,861                          | 11,331      |

(1) Net contracts are defined as new contracts during the period for the purchase of homes, less cancellations of prior contracts.

(2) The number and the dollar amount of net contracts and contract backlog in the Northeast in 2006 include the effect of the Oster Homes acquisition, which closed in August 2005.

(3) The number and the dollar amount of net contracts and contract backlog in the Southeast in 2006 include the effects of the Cambridge Homes, First Home Builders of Florida and CraftBuilt Homes acquisitions, which closed in March 2005, August 2005 and April 2006, respectively.

(4) The number and the dollar amount of net contracts and contract backlog in Unconsolidated Joint Ventures in

2006 include our joint venture with affiliates of Blackstone Real Estate Advisors that acquired Town & Country Homes existing residential communities on March 2, 2005.





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Our reported level of net contracts has been impacted by an increase in our cancellation rates over the past few quarters, due to weakening market conditions. The cancellation rate represents the number of cancelled contracts in the quarter divided by the number of gross sales contracts executed in the quarter. For comparison, the following are historical cancellation rates, excluding unconsolidated joint ventures:

| <u>Quarter</u> | <u>2003</u> | <u>2004</u> | <u>2005</u> | <u>2006</u> |
|----------------|-------------|-------------|-------------|-------------|
| First          | 23%         | 23%         | 27%         | 30%         |
| Second         | 18%         | 19%         | 21%         | 32%         |
| Third          | 21%         | 20%         | 24%         | 33%         |
| Fourth         | 25%         | 24%         | 25%         |             |

Most cancellations occur within the legal rescission period, which varies by state but is generally less than two weeks. However, in recent quarters we have experienced a higher than normal number of cancellations later in the construction process. Cancellations also occur as a result of buyer failure to qualify for a mortgage, which generally occurs during the first few weeks after signing. Cancellation rates can be higher in markets where buyers sign contracts so as to tie up a house they like and then cancel within the rescission period once they reach a final decision on the house they want. This situation is more common in certain markets, particularly California.

Cost of sales includes expenses for homebuilding and land sales. A breakout of such expenses for homebuilding sales and homebuilding gross margin is set forth below:

|  | Three Months Ended     |             | Nine Months Ended |             |
|--|------------------------|-------------|-------------------|-------------|
|  | July 31,<br>2006       | 2005        | July 31,<br>2006  | 2005        |
|  | (Dollars in Thousands) |             |                   |             |
| Sale of homes                                      | \$1,499,826            | \$1,289,373 | \$4,225,571       | \$3,495,014 |
| Cost of sales, excluding interest                  | 1,148,530              | 939,815     | 3,203,882         | 2,571,916   |
| Homebuilding gross margin, before interest expense | 351,296                | 349,558     | 1,021,689         | 923,098     |
| Homebuilding cost of sales interest                | 25,551                 | 22,304      | 61,523            | 58,324      |
| Homebuilding gross margin, after interest expense  | \$ 325,745             | \$ 327,254  | \$ 960,166        | \$ 864,774  |
| Gross margin percentage, before interest expense   | 23.4%                  | 27.1%       | 24.2%             | 26.4%       |
| Gross margin percentage, after interest expense    | 21.7%                  | 25.4%       | 22.7%             | 24.7%       |

Cost of Sales expenses as a percentage of home sales revenues are presented below:

|   | Three Months Ended |        | Nine Months Ended |        |
|---|--------------------|--------|-------------------|--------|
|   | July 31,           |        | July 31,          |        |
|   | 2006               | 2005   | 2006              | 2005   |
| Sale of homes   | 100.0%             | 100.0% | 100.0%            | 100.0% |
| Cost of sales, excluding interest:<br>homebuilding, land & development<br>costs | 68.6%              | 64.8%  | 67.7%             | 65.5%  |
| Commissions   | 2.3%               | 2.6%   | 2.3%              | 2.3%   |
| Financing concessions   | 1.0%               | 1.0%   | 0.9%              | 1.0%   |
| Overheads   | 4.7%               | 4.6%   | 4.9%              | 4.9%   |
| Total cost of sales, before interest<br>expense                                 | 76.6%              | 72.9%  | 75.8%             | 73.6%  |
| Gross margin percentage, before<br>interest expense                             | 23.4%              | 27.1%  | 24.2%             | 26.4%  |
| Cost of sales interest  | 1.7%               | 1.7%   | 1.5%              | 1.7%   |
| Gross margin percentage, after interest<br>expense                              | 21.7%              | 25.4%  | 22.7%             | 24.7%  |

We sell a variety of home types in various local communities, each yielding a different gross margin, depending on local factors such as competition, economic trends and community location. As a result, depending on the geographic mix of deliveries and the mix of specific communities, consolidated quarterly gross margin will fluctuate up or down and may not be representative of the consolidated gross margin for the year. The consolidated gross margin before interest expense for the three and nine months ended July 31, 2006 was 370 and 220 basis points lower than the same period in 2005, respectively. Our gross margin after interest expense for the three and nine months ended July 31, 2006 was 370 and 200 basis points less than the same period last year, respectively. These decreases are attributed to home price reductions, more prevalent use of incentives and increases in land and material costs such as asphalt and copper.

Homebuilding selling, general and administrative expenses as a percentage of homebuilding revenues increased to 10.1% for the three months ended July 31, 2006, compared to 9.0% for the three months ended July 31, 2005 and increased to 10.2% for the nine months ended July 31, 2006, compared to 9.1% for the nine months ended July 31, 2005. Such expenses increased \$37.7 million for the three months ended July 31, 2006 and increased \$121.5 million for the nine months ended July 31, 2006 compared to the same period last year. Included in these expenses are increased advertising costs associated with new community openings and more active selling communities in total, as well as additional advertising expenditures to generate traffic and sales during current slower market conditions, and higher costs due to the acquisitions of Cambridge Homes, First Home Builders of Florida, Oster Homes and to a lesser extent CraftBuilt Homes in the last 13 months.

Land Sales and Other Revenues:

Land sales and other revenues consist primarily of land and lot sales. A breakout of land and lot sales is set forth below:

|   | Three Months Ended |        | Nine Months Ended July 31, |           |
|---|--------------------|--------|----------------------------|-----------|
|   | July 31,<br>2006   | 2005   | 2006                       | 2005      |
| Land sales                                  | \$ 23,045          | \$ 441 | \$103,838                  | \$ 24,618 |
| Cost of sales, excluding interest           | 21,742             | 387    | 81,376                     | 16,369    |
| Land sales gross margin, excluding interest | 1,303              | 54     | 22,462                     | 8,249     |
| Interest expense                            | 50                 | 28     | 930                        | 239       |
| Land sales gross margin, including interest | \$ 1,253           | \$ 26  | \$ 21,532                  | \$ 8,010  |

Land sales are ancillary to our residential homebuilding operations and are expected to continue in the future but may significantly fluctuate up or down. Profits from land sales in the first nine months of the year were significantly more than the first nine months of 2005, and for the full fiscal year 2006, we expect pre-tax profit from land sales to be higher than they were in fiscal 2005. The increase in land sale profits has to do with a few larger developments that we have undertaken, where we have strategically decided at the outset to sell some portion of the community to one or more other builders. Although we budget land sales, they are often dependent upon receiving approvals and entitlements, the timing of which can be uncertain. As a result, projecting the amount and timing of land sales is difficult.

Financial Services

Financial services consist primarily of originating mortgages from our homebuyers and selling such mortgages in the secondary market, and title insurance activities. For the three and nine months ended July 31, 2006, financial services provided a \$7.5 million and \$19.9 million profit before income taxes, compared to a profit of \$6.2 million and \$15.3 million for the same period in 2005, respectively. The increase in pretax profit for the three and nine months ended July 31, 2006 is primarily due to increased mortgage settlements and the addition of mortgage operations as a result of our 2005 acquisitions.

Corporate General and Administrative

Corporate general and administrative expenses represent the operations at our headquarters in Red Bank, New Jersey. Such expenses include our executive offices, information services, human resources, corporate accounting, training, treasury, process redesign, internal audit, construction services, and administration of insurance, quality, and safety. As a percentage of total revenues, such expenses increased to 1.7% for the three months ended July 31, 2006 from 1.4% for the prior year's three months and increased to 1.8% from the nine months ended July 31, 2006 from 1.4% for the prior year's nine months. Corporate general and administrative expenses increased \$7.9 and \$30.7 million during the three and nine

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months ended July 31, 2006, respectively, compared to the same period last year. The increase in corporate general and administrative expenses is primarily attributed to increased depreciation expense for new software systems, increased consulting services related to the new software implementation, Sarbanes-Oxley compliance costs, increased compensation with more headcount, as well as the adoption of SFAS 123R resulting in the expensing of stock options.

The sum of homebuilding, selling, general and administrative expenses and corporate general and administrative expenses as a percentage of total revenues for the third quarter is higher than the prior year's third

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quarter percentage. We expect the increase in these expenses as a percentage of revenues for the full fiscal year compared to the prior full fiscal year to be similar.

#### Other Interest

Other interest decreased \$0.5 million and increased \$0.3 million for the three and nine months ended July 31, 2006, compared to three and nine months ended July 31, 2005. This slight decrease for the three months and increase for the nine months is primarily due to a fluctuation in interest incurred and expensed on nonrecourse land mortgages directly related to property not yet under development.

#### Other Operations

Other operations consist primarily of miscellaneous residential housing operations expenses, senior rental residential property operations, earnout payments from homebuilding company acquisitions, minority interest relating to consolidated joint ventures, and corporate owned life insurance. Other operations increased to \$8.4 and \$23.9 million for the three and nine months ended July 31, 2006, respectively, compared to \$7.4 and \$10.6 million for the three and nine months ended July 31, 2005, respectively. The increases are primarily due to an increase in minority interest resulting from increased profits in a consolidated joint venture for the three and nine months ended July 31, 2006 and increased earnout expenses related to several recent acquisitions for the nine months ended July 31, 2006.

#### Intangible Amortization

We are amortizing our definite life intangibles over their expected useful life, ranging from three to eight years. Intangible amortization increased \$1.6 million and \$6.1 million for the three and nine months ended July 31, 2006, when compared to the same period last year. This increase was the result of the amortization expense related to the acquisition of Cambridge Homes in March 2005, Oster Homes in August 2005, First Home Builders of Florida in August 2005 and CraftBuilt Homes in April 2006, offset by reduced amortization on older acquisitions.

#### Recent Accounting Pronouncements

In May 2005, the FASB issued SFAS 154, *Accounting Changes and Error Corrections*. This statement, which replaces APB Opinion No. 20, *Accounting Changes* and SFAS No. 3, *Reporting Accounting Changes in Interim Financial Statements*, changes the requirements for the accounting for and reporting of a change in accounting principle. The statement requires retrospective application of changes in accounting principle to prior periods' financial statements unless it is impracticable to determine the period-specific effects or the cumulative effect of the change. SFAS No. 154 is effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005. The adoption of SFAS No. 154 is not expected to have a material impact on our consolidated financial position, results of operations or cash flows.

In June 2005, the Emerging Issues Task Force (EITF) released Issue No. 04-5 *Determining Whether a General Partner, or the General Partners as a Group, Controls a Limited Partnership or Similar Entity When the Limited Partners Have Certain Rights* (EITF 04-5). EITF 04-5 creates a framework for evaluating whether a general partner or a group of general partners controls a limited partnership and therefore should consolidate

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the partnership. EITF 04-5 states that the presumption of general partner control would be overcome only when the limited partners have certain specific rights as outlined in EITF 04-5. EITF 04-5 is effective immediately for all newly formed limited partnerships and for existing limited partnership agreements that are modified. For general partners in all other limited partnerships, EITF 04-5 is effective no later than the beginning of the first reporting period in fiscal years beginning after December 15, 2005. Implementation of EITF 04-5 is not expected to have a material impact on the Company's results of operations or financial position.

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In July 2006, the FASB issued Interpretation No. 48 (FIN 48), Accounting to Uncertainty in Income Taxes – An Interpretation of FASB Statement No. 109. FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with SFAS 109. FIN 48 also 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. The new FASB standard also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition. The provisions of FIN 48 are effective for the Company's first quarter ending January 31, 2007. We are in the process of assessing the impact, if any, this will have on our financial statements.

#### Total Taxes

Total taxes as a percentage of income before taxes decreased for the three months ended July 31, 2006 to 36.3% from 40.4% for the three months ended July 31, 2005, and for the nine months ended July 31, 2006 to 36.8% from 39.4% for the nine months ended July 31, 2005. This decrease is primarily due to the benefit of the tax deduction on qualified production activities provided by the American Jobs Creation Act of 2004 and tax return to provision adjustments for 2005 tax returns filed in the third quarter of 2006. In addition, in the quarter ended July 31, 2006, the percentage of earnings declined in California where state income rates are higher, and increased in Florida where due to prior year loss carryforwards, the Company does not currently pay state income taxes.

Deferred federal and state income tax assets primarily represent the deferred tax benefits arising from temporary differences between book and tax income which will be recognized in future years as an offset against future taxable income. If, for some reason, the combination of future years income (or loss) combined with the reversal of the timing differences results in a loss, such losses can be carried back to prior years to recover the deferred tax assets. As a result, management is confident such deferred tax assets are recoverable regardless of future income.

#### Inflation

Inflation has a long-term effect, because increasing costs of land, materials, and labor result in increasing sale prices of our homes. In general, these price increases have been commensurate with the general rate of inflation in our housing markets and have not had a significant adverse effect on the sale of our homes. A significant risk faced by the housing industry generally is that rising house construction costs, including land and interest costs, will substantially outpace increases in the income of potential purchasers. Recently in the more highly regulated markets that have seen significant home price appreciation, customer affordability has become a concern. Our broad product array insulates us to some extent, but customer affordability of our homes is something we monitor closely.

Inflation has a lesser short-term effect, because we generally negotiate fixed price contracts with many, but not all, of our subcontractors and material suppliers for the construction of our homes. These prices usually are applicable for a specified number of residential buildings or for a time period of between three to twelve months. Construction costs for residential buildings represent approximately 60% of our homebuilding cost of sales.

#### Mergers and Acquisitions



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On August 3, 2005, we acquired substantially all of the homebuilding assets of Oster Homes, a privately held Ohio homebuilder, headquartered in Lorain, Ohio. The acquisition provides Hovnanian with a complementary presence to its Ohio build-on-your-own-lot homebuilding operations. Oster Homes builds in Lorain County in Northeast Ohio, just west of Cleveland. Oster Homes designs, markets and sells single family homes, with a focus on first-time and move-up homebuyers. Additionally, Oster Homes utilizes a design center to market extensive pre-prices, options and upgrades.

On August 8, 2005, we acquired substantially all of the assets of First Home Builders of Florida, a privately held homebuilder and provider of related financial services headquartered in Cape Coral, Florida. First Home

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Builders of Florida designs, markets and sells single family homes, with a focus on the first-time home buying segment. The company also provides mortgage financing, title and settlement services to its homebuyers.

Both the First Home Builders of Florida and the Oster Homes acquisitions were accounted for as purchases with the results of their operations included in our consolidated financial statements as of the dates of the acquisitions.

On April 17, 2006, we acquired for cash the assets of CraftBuilt Homes, a privately held homebuilder headquartered in Bluffton, South Carolina. The acquisition expands our operations into the coastal markets of South Carolina and Georgia. CraftBuilt Homes designs, markets and sells single family detached homes. Due to its close proximity to Hilton Head, CraftBuilt Homes focuses on first-time, move-up, empty-nester and retiree homebuyers. This acquisition is being accounted for as a purchase with the results of its operations included in our consolidated financial statements as of the date of the acquisition.

On May 1, 2006, we acquired through the issuance of 175,936 shares of Class A common stock substantially all of the assets of two mechanical contracting businesses.

All fiscal 2006 and 2005 acquisitions provide for other payments to be made, generally dependant upon achievement of certain future operating and return objectives.

### Transactions with Related Parties

In December 2005, we entered into an agreement to purchase land in New Jersey from an entity that is owned by family relatives of our Chairman of the Board and our Chief Executive Officer at a base price of \$25 million. The land will be acquired in four phases over a period of 30 months from the date of acquisition of the first phase. The purchase prices for phases two through four are subject to an increase in the purchase price for the phase of not less than 6% per annum and not more than 8% per annum from the date of the closing of the first phase based on an identified prime rate. As of the end of the third quarter of 2006, no land has been acquired. A deposit in the amount of \$500,000, however, has been made by the Company. Neither the Company nor the Chairman of the Board or the Chief Executive Officer has a financial interest in the relatives' company from whom the land will be purchased.

During the second quarter of 2006, an existing lease on a building occupied by one of our companies in the Southeast Region was amended. The lessor is a company, whom at the time of the transaction, was owned partly by Geaton A. Decesaris, Jr., formerly a member of the Company's Board of Directors. The amendment provided for an increase in the square footage of the lease space, an increased security deposit related to the square footage increase and an increase in the lease term. In total the lease is for 39,637 square feet at \$18.86 per square foot per year, with a total security deposit of \$34,511.

Pursuant to the Board of Director requirements, prior to these agreements being finalized, an independent appraisal of each transaction was performed. Upon review of the appraisals by the independent members of the Board of Directors the transactions were approved.

Safe Harbor Statement

All statements in this Form 10-Q that are not historical facts should be considered as Forward-Looking Statements within the meaning of the Private Securities Litigation Reform Act of 1995. Such statements involve known and unknown risks, uncertainties and other factors that may cause actual results, performance or achievements of the Company to be materially different from any future results, performance or achievements expressed or implied by the forward-looking statements. Although we believe that our plans, intentions and expectations reflected in, or suggested by such forward-looking statements are reasonable, we can give no assurance that such plans, intentions, or expectations will be achieved. Such risks, uncertainties and other factors include, but are not limited to:

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- . Changes in general and local economic and business conditions;
- . Adverse weather conditions and natural disasters;
- . Changes in market conditions;
- . Changes in home prices and sales activity in the markets where the Company builds homes;
- . Government regulation, including regulations concerning development of land, the home building, sales and customer financing processes, and the environment;
- . Fluctuations in interest rates and the availability of mortgage financing;
- . Shortages in, and price fluctuations of, raw materials and labor;
- . The availability and cost of suitable land and improved lots;
- . Levels of competition;
- . Availability of financing to the Company;
- . Utility shortages and outages or rate fluctuations; and
- . Geopolitical risks, terrorist acts and other acts of war.

Certain risks, uncertainties, and other factors are described in detail in Item 1 and 2 Business and Properties in our Form 10-K for the year ended October 31, 2005.

### Item 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK.

The primary market risk facing us is interest rate risk on our long-term debt. In connection with our mortgage operations, mortgage loans held for sale and the associated mortgage warehouse line of credit are subject to interest rate risk; however, such obligations reprice frequently and are short-term in duration. In addition, we hedge the interest rate risk on mortgage loans by obtaining forward commitments from private investors. Accordingly, the risk from mortgage loans is not material. We do not hedge interest rate risk other than on mortgage loans using financial instruments. We are also subject to foreign currency risk but this risk is not material. The following table sets forth as of July 31, 2006, our long term debt obligations, principal cash flows by scheduled maturity, weighted average interest rates and estimated fair market value ( FMV ).

|                       | As of July 31, 2006    |           |       |       |           |             |             | FMV @<br>7/31/06 |
|-----------------------|------------------------|-----------|-------|-------|-----------|-------------|-------------|------------------|
|                       | Expected Maturity Date |           |       |       |           |             |             |                  |
|                       | 2006                   | 2007      | 2008  | 2009  | 2010      | Thereafter  | Total       |                  |
|                       | (Dollars in Thousands) |           |       |       |           |             |             |                  |
| Long term debt(1):    |                        |           |       |       |           |             |             |                  |
| Fixed rate            | \$33,046               | \$140,937 | \$736 | \$786 | \$100,841 | \$1,835,802 | \$2,112,148 | \$1,937,190      |
| Average interest rate | 5.98%                  | 10.48%    | 6.70% | 6.72% | 6.01%     | 7.26%       | 7.39%       |                  |

(1) Does not include bonds collateralized by mortgages receivable or the warehouse line of credit.

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In addition, we have reassessed the market risk for our variable rate debt, which is based on (1) a base rate determined by reference to the higher of (a) PNC Bank, National Association's prime rate and (b) the federal funds rate plus 1/2% or (2) a margin ranging from 0.65% to 1.50% per annum, depending on our Leverage Ratio, as defined in the Revolving Credit Agreement, and our debt ratings plus a LIBOR-based rate for a one, two, three, or six month interest period as selected by us. We believe that a one percent increase in this rate would have an approximate \$1.0 million increase in interest expense for the nine months ended July 31, 2006, assuming an average of \$136.6 million of variable rate debt outstanding from November 1, 2005 to July 31, 2006.

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Item 4. CONTROLS AND PROCEDURES

The Company maintains disclosure controls and procedures that are designed to ensure that information required to be disclosed in the Company's reports under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms, and that such information is accumulated and communicated to the Company's management, including its chief executive officer and chief financial officer, as appropriate, to allow timely decisions regarding required disclosures. Any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives. The Company's management, with the participation of the Company's chief executive officer and chief financial officer, has evaluated the effectiveness of the design and operation of the Company's disclosure controls and procedures as of July 31, 2006. Based upon that evaluation and subject to the foregoing, the Company's chief executive officer and chief financial officer concluded that the design and operation of the Company's disclosure controls and procedures are effective to accomplish their objectives.

In addition, there was no change in the Company's internal control over financial reporting that occurred during the quarter ended July 31, 2006 that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

PART II. Other Information

Item 1. Legal Proceedings

We are involved in litigation arising in the ordinary course of business, none of which is expected to have a material adverse effect on our financial position or results of operations and we are subject to extensive and complex regulations that affect the development and home building, sales and customer financing processes, including zoning, density, building standards and mortgage financing. These regulations often provide broad discretion to the administering governmental authorities. This can delay or increase the cost of development or homebuilding.

We also are subject to a variety of local, state, federal and foreign laws and regulations concerning protection of health and the environment. The particular environmental laws which apply to any given community vary greatly according to the community site, the site's environmental conditions and the present and former uses of the site. These environmental laws may result in delays, may cause us to incur substantial compliance, remediation, and/or other costs, and can prohibit or severely restrict development and homebuilding activity in certain environmentally sensitive regions or areas.

In March 2005, we received two requests for information pursuant to Section 308 of the Clean Water Act from Region 3 of the Environmental Protection Agency (the EPA). These requests sought information concerning storm water discharge practices in connection with completed, ongoing and planned homebuilding projects by subsidiaries in the states and district that comprise EPA Region 3. We also received a notice of violations for one project in Pennsylvania and requests for sampling plan implementation in two projects in Pennsylvania. The amount requested by the EPA to settle the asserted violations at the one project was not material. We provided the EPA with information in response to its requests. We have since been advised by the Department of Justice (DOJ) that it will be involved in the review of our storm water discharge practices. We cannot predict the outcome of the review of these practices or estimate the costs that may be involved in resolving the matter. To the extent that the EPA or the DOJ asserts violations of regulatory requirements and request injunctive relief or penalties, we will defend and attempt to resolve such asserted violations.

In addition, in November 2005, we received two notices from the California Regional Water Quality Control Board alleging violations of certain storm water discharge rules and assessing an administrative civil liability of \$0.2 million and \$0.3 million. We do not consider these assessments to be material and are considering our response to the notices.

It can be anticipated that increasingly stringent requirements will be imposed on developers and homebuilders in the future. Although we cannot predict the effect of these requirements, they could result in time-consuming and expensive compliance programs and in substantial expenditures, which could cause delays and increase our cost of operations. In addition, the continued effectiveness of permits already granted or approvals already obtained is dependent upon many factors, some of which are beyond our control, such as changes in policies, rules and regulations and their interpretations and application.

Our sales and customer financing processes are subject to the jurisdiction of the U. S. Department of Housing and Urban Development (HUD). In connection with the Real Estate Settlement Procedures Act, HUD has inquired about our process of referring business to our affiliated mortgage company and has separately requested documents related to customer financing. We have responded to HUD's inquiries. In connection with these inquiries, the Inspector General of HUD has recommended to the Secretary of HUD that we indemnify HUD for any losses that it may sustain in connection with nine loans that it alleges were improperly underwritten. We cannot predict the outcome of HUD's inquiry or estimate the costs that may be involved in resolving the matter. We do not expect the ultimate cost to be material.

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In August 2006, the Company canceled a purchase contract for a property located in Southern California based on the seller's failure to perform certain obligations, and requested return of its \$16.5 million contract deposit. Refund of the deposit is currently in dispute with the seller and the Company anticipates that arbitration proceedings will commence during the fourth quarter of 2006 to resolve the dispute. At this time, the Company can not predict the outcome of this dispute.

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

This table provides information with respect to purchases of shares of our Class A Common Stock made by or on behalf of Hovnanian Enterprises or any affiliated purchaser during the third fiscal quarter of 2006.

Issuer Purchases of Equity Securities (1)

| Period                             | Total Number of Shares Purchased | Average Price Paid Per Share | Total Number Of Shares Purchased as Part of Publicly Announced Plans or Programs | Maximum Number of Shares That May Yet Be Purchased Under The Plans or Programs |
|------------------------------------|----------------------------------|------------------------------|--|--|
| May 1, 2006 through May 31, 2006   | 200,000                          | \$36.19                      | 200,000  | 987,668  |
| June 1, 2006 through June 30, 2006 | 175,000                          | \$29.86                      | 175,000  | 812,668  |
| July 1, 2006 through               |                                  |                              |  |  |
| July 31, 2006                      |                                  |                              |  | 812,668  |
| Total                              | 375,000                          | \$33.23                      | 375,000  |  |

(1) In July 2001, our Board of Directors authorized a stock repurchase program to purchase up to 4 million shares

of Class A Common Stock.

No shares of our Class B Common Stock or of our 7.625% Series A Preferred Stock were purchased by or on behalf of Hovnanian Enterprises or any affiliated purchaser during the third fiscal quarter of 2006.

Item 6.

Exhibits

Exhibit 3(a) Certificate of Incorporation of the Registrant. (1)

Exhibit 3(b) Certificate of Amendment of Certificate of Incorporation of the Registrant. (2)

Exhibit 3(c) Certificate of Amendment of Certificate of Incorporation of the Registrant. (3)

Exhibit 3(d) Restated Bylaws of the Registrant. (4)

Exhibit 4(a) Indenture, dated as of November 3, 2003, among K. Hovnanian Enterprises, Inc., Hovnanian Enterprises, Inc. and Wachovia Bank, National Association, as Trustee. (5)

Exhibit 4(b) First Supplemental Indenture, dated as of November 3, 2003, among K. Hovnanian Enterprises, Inc., Hovnanian Enterprises, Inc., the other Guarantors named therein and Wachovia Bank, National Association, as Trustee. (6)

Exhibit 4(c) Second Supplemental Indenture, dated as of March 18, 2004, among K. Hovnanian Enterprises, Inc., Hovnanian Enterprises, Inc., the other Guarantors named therein and Wachovia Bank, National Association, as Trustee. (7)

Exhibit 4(d) Third Supplemental Indenture, dated as of July 15, 2004, among K. Hovnanian Enterprises, Inc., Hovnanian Enterprises, Inc., the other Guarantors named therein and Wachovia Bank, National Association, as Trustee. (7)

Exhibit 4(e) Fourth Supplemental Indenture, dated as of April 19, 2005, among K. Hovnanian Enterprises, Inc., Hovnanian Enterprises, Inc., the other Guarantors named therein and Wachovia Bank, National Association, as Trustee. (7)

Exhibit 4(f) Fifth Supplemental Indenture, dated as of September 6, 2005, among K. Hovnanian Enterprises, Inc., Hovnanian Enterprises, Inc., the other Guarantors named therein and Wachovia Bank, National Association, as Trustee. (7)

Exhibit 4(g) Sixth Supplemental Indenture, dated as of February 27, 2006, among K. Hovnanian Enterprises, Inc., Hovnanian Enterprises, Inc., the other Guarantors named therein and Wachovia Bank, National Association, as Trustee. (8)

Exhibit 4(h) Seventh Supplemental Indenture, dated as of June 12, 2006, among K. Hovnanian Enterprises, Inc., Hovnanian Enterprises, Inc., the other guarantors named therein and U. S. Bank National Association, as trustee, relating to the 8 5/8% Senior Notes due 2017 (including form of 8 5/8% Senior Notes due 2017). (11)

Exhibit 4(i) Certificate of Designations, Powers, Preferences and Rights of the 7.625% Series A Preferred Stock of Hovnanian Enterprises, Inc., dated July 12, 2005.(9)

Exhibit 10(a) Sixth Amended and Restated Credit Agreement dated May 31, 2006. (10)

Exhibit 10(b) Amended and Restated Guaranty and Suretyship Agreement, dated May 31, 2006. (10)

Exhibit 31(a) Rule 13a-14(a)/15d-14(a) Certification of Chief Executive Officer.

Exhibit 31(b) Rule 13a-14(a)/15d-14(a) Certification of Chief Financial Officer.

Exhibit 32(a) Section 1350 Certification of Chief Executive Officer.

Exhibit 32(b) Section 1350 Certification of Chief Financial Officer.

- (1) Incorporated by reference to Exhibits to Registration Statement (No. 2-85198) on Form S-1 of the Registrant.
- (2) Incorporated by reference to Exhibit 4.2 to Registration Statement (No. 333-106761) on Form S-3 of the Registrant.
- (3) Incorporated by reference to Exhibits to Quarterly Report on Form 10-Q of the Registrant for the quarter ended January 31, 2004.
- (4) Incorporated by reference to Exhibit 3.2 to Registration Statement (No. 1-08551) on Form 8-A of the Registrant.
- (5) Incorporated by reference to Exhibits to Registration Statement (No. 333-125738) on Form S-3 of the Registrant.
- (6) Incorporated by reference to Exhibits to Current Report of the Registrant on Form 8-K on November 7, 2003.
- (7) Incorporated by reference to Exhibits to Registration Statement (No. 333-131982) on Form S-3 of the Registrant.



- (8) Incorporated by reference to Exhibits to Current Report of the Registrant on Form 8-K filed on February 27, 2006.
  - (9) Incorporated by reference to Exhibits to Current Report on Form 8-K of the Registrant, filed on July 13, 2005.
  - (10) Incorporated by reference to Exhibits to Current Report on Form 8-K of the Registrant, filed on June 6, 2006.
  - (11) Incorporated by reference to Exhibits to Current Report on Form 8-K of the Registrant, filed on June 15, 2006.
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SIGNATURES

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

HOVNANIAN ENTERPRISES, INC.

(Registrant)

DATE: September 11, 2006  
/S/J. LARRY SORSBY  
J. Larry Sorsby,  
Executive Vice President and  
Chief Financial Officer

DATE: September 11, 2006  
/S/PAUL W. BUCHANAN  
Paul W. Buchanan,  
Senior Vice President  
Corporate Controller