CALIFORNIA COASTAL COMMUNITIES INC
Form 10-Q
May 05, 2006

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended March 31, 2006

OR

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

For the transition period from to

Commission file number: 0-17189

CALIFORNIA COASTAL COMMUNITIES, INC.

(Exact name of registrant as specified in its charter)

Delaware (State or other jurisdiction of incorporation or organization)	**02-0426634** (I.R.S. Employer Identification No.)
6 Executive Circle, Suite 250 **Irvine, California** (Address of principal executive offices)	**92614** (Zip Code)

Registrant s telephone number, including area code: **(949) 250-7700**

Securities registered pursuant to Section 12(b) of the Act: **NONE**

Securities registered pursuant to Section 12(g) of the Act:

Common Stock, par value $.05 per share
(Title of Class)

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 ý NO o

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

Large accelerated filer o **Accelerated filer ý** **Non-accelerated filer o**

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act). YES o NO ý

The number of shares of Common Stock outstanding as of May 1, 2006 was 10,161,462.

CALIFORNIA COASTAL COMMUNITIES, INC.

FORM 10-Q

FOR THE QUARTER ENDED MARCH 31, 2006

I N D E X

CAUTIONARY STATEMENT ABOUT FORWARD-LOOKING STATEMENTS

This quarterly report on Form 10-Q contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1993 and Section 21E of the Securities Exchange Act of 1934 that relate to future events or our future financial performance. In addition, other statements we may make from time to time, such as press releases, oral statements made by Company officials and other reports that we file with the Securities and Exchange Commission, may also contain such forward-looking statements. Undue reliance should not be placed on these statements which involve known and unknown risks, uncertainties and other factors which may cause our actual results, performance or achievements to be materially different from any future results, performances or achievements expressed or implied by the forward-looking statements. In some cases, you can identify forward-looking statements by terminology such as may , will , should , expects , plans , anticipate believes , estimates , predicts , potential , continue , or the negative of such terms or other comparable terminology.

These forward-looking statements include, but are not limited to:

statements about our strategies, plans, objectives, goals, expectations and intentions;

information relating to anticipated operating results, financial resources, changes in revenues, changes in profitability, interest expense, growth and expansion, anticipated income to be realized from our investments in unconsolidated entities;

the impact of demographic trends and supply constraints on the demand for and supply of housing;

housing market conditions in the geographic markets in which we operate;

the number and types of homes and number of acres of land that we may develop and sell;

the ability to deliver homes from backlog;

the timing and outcomes of regulatory approval processes or administrative proceedings, which may result in delays in the land entitlement, development, construction, or the opening of new communities (including, but not limited to ongoing administrative proceedings related to our joint venture near Oxnard, California);

the ability to secure materials and subcontractors;

the ability to produce the liquidity and capital necessary to expand and take advantage of opportunities in the future;

our ability to realize the value of our net operating loss carry forwards;

our ability to continue relationships with current or future partners;

the effectiveness and adequacy of our disclosure and internal controls;

the impact of recent accounting pronouncements; and stock market valuations.

Any or all of the forward-looking statements included in this report and in any other reports or public statements made by us may turn out to be inaccurate. This can occur as a result of incorrect assumptions or as a consequence of known or unknown risks and uncertainties. Many factors mentioned in this report or in other reports or public statements made by us, such as government regulation and the competitive environment, will be important in determining our future performance. Consequently, actual results may differ materially from those that might be anticipated from our forward-looking statements. You should not place undue reliance on any of these forward-looking statements because they are based on current expectations or beliefs regarding future events or circumstances, which involve known and unknown risks, uncertainties and other factors which may cause our actual results, performance or achievements to be materially different from any future results, performances or achievements expressed or implied by these forward-looking statements.

Although we believe that our strategies, plans, objectives, goals, expectations and intentions reflected in, or suggested by these forward-looking statements are reasonable given current information available to us, we can give no assurance that any of them will be achieved.

These forward-looking statements should be considered in light of the information included in this report and our other filings with the Securities and Exchange Commission, including, without limitation, the Risk Factors, as well as the description of trends and other factors in Management s Discussion and Analysis of Financial Condition and Results of Operations, set forth in our Form 10-K for the year ended December 31, 2005. You should also read the following Management s Discussion and Analysis of Financial Condition and Results of Operations in conjunction with the unaudited condensed consolidated financial statements and the related notes that appear elsewhere in this report.

We assume no, and hereby disclaim any, obligation to update any of the foregoing or any other forward-looking statements. We nonetheless reserve the right to make such updates from time to time by press release, periodic report or other method of public disclosure without the need for specific reference to this Form 10-Q or any other report filed by us. No such update shall be deemed to indicate that other statements not addressed by such update remain correct or create an obligation to provide any other updates.

PART I. FINANCIAL INFORMATION

ITEM 1 FINANCIAL STATEMENTS

CALIFORNIA COASTAL COMMUNITIES, INC.

CONSOLIDATED BALANCE SHEETS

(unaudited)

(in millions)

	March 31, 2006	December 31, 2005
ASSETS		
Cash and cash equivalents	$ 4.6	$ 7.7
Short-term investments	22.5	30.3
Restricted cash	2.3	2.3
Real estate inventories	254.1	253.6
Deferred tax assets	34.5	35.4
Other assets	1.1	1.1
	$ 319.1	$ 330.4
LIABILITIES AND STOCKHOLDERS EQUITY		
Liabilities:		
Accounts payable and accrued liabilities	$ 12.1	$ 17.4
Project debt	50.2	57.9
Other liabilities	7.9	7.9
Total liabilities	70.2	83.2
Minority interest		.3
Commitments and contingencies		
Stockholders equity:		
Common Stock $.05 par value; 13,500,000 shares authorized; 10,160,212 and 10,130,212 shares issued and outstanding, respectively	.5	.5
Excess Stock $.05 par value; 11,000,000 shares authorized; no shares outstanding		
Capital in excess of par value	191.7	191.6
Retained earnings	58.5	56.6

Accumulated other comprehensive loss		(1.8)		(1.8)
Total stockholders equity		248.9		246.9
	$	319.1	$	330.4

See the accompanying notes to consolidated financial statements.

CALIFORNIA COASTAL COMMUNITIES, INC.

CONSOLIDATED STATEMENTS OF INCOME

(in millions, except per share amounts)

(unaudited)

	Three Months Ended March 31, 2006		Three Months Ended March 31, 2005	
Revenues:				
Homebuilding	$	27.9	$	6.5
Costs of sales:				
Homebuilding		23.2		4.8
Gross operating profit		4.7		1.7
Selling, general and administrative expenses		1.7		1.2
Other (income) expense, net		(.3)		.2
Income before income taxes		3.3		.3
Provision (benefit) for income taxes		1.4		(4.5)
Minority interest in income of consolidated joint venture				.1
Net income		1.9		4.7
Other comprehensive income, net of income taxes:				
Minimum pension liability income tax benefit				.9
Comprehensive income	$	1.9	$	5.6
Net earnings per common share:				
Basic	$	.19	$	.46
Diluted	$	.18	$	.43
Common equivalent shares:				
Basic		10.2		10.2
Diluted		10.5		10.9

See the accompanying notes to consolidated financial statements.

CALIFORNIA COASTAL COMMUNITIES, INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS

(in millions)

(unaudited)

	Three Months Ended March 31, 2006	2005
Cash flows from operating activities:		
Net income	$ 1.9	$ 4.7
Adjustments to reconcile net income to cash used in operating activities:		
Non-cash benefit from reversal of deferred tax asset allowance		(4.7)
Gains on sales of real estate inventories	(4.7)	(1.7)
Stock-based compensation expense	.1	
Deferred taxes	.9	
Minority interest in income of consolidated joint venture		.2
Proceeds from asset sales, net	27.7	6.5
Investments in real estate inventories	(23.5)	(8.7)
Investments in land held for future development or sale		(.4)
Changes in assets and liabilities:		
Decrease (increase) in other assets	.1	(.2)
Decrease in accounts payable, accrued and other liabilities	(5.3)	(4.2)
Cash used in operating activities	(2.8)	(8.5)
Cash flows from investing activities:		
Sales of short-term investments	26.5	
Purchases of short-term investments	(18.7)	
Investments in unconsolidated joint ventures	(.1)	
Cash provided by investing activities	7.7	
Cash flows from financing activities:		
Borrowings of project debt	1.2	18.2
Repayments of project debt	(8.9)	(3.3)
Proceeds from exercise of stock options		.3
Minority interest distributions	(.3)	(.4)
Cash (used in) provided by financing activities	(8.0)	14.8
Net (decrease) increase in cash and cash equivalents	(3.1)	6.3
Cash and cash equivalents - beginning of period	7.7	9.0
Cash and cash equivalents - end of period	$ 4.6	$ 15.3

Supplemental disclosures of cash flow information:				
Cash paid (refunds received) during the period for income taxes, net of refunds received	$	4.6	$	(.8)

See the accompanying notes to consolidated financial statements.

CALIFORNIA COASTAL COMMUNITIES, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(UNAUDITED)

Note 1 - Basis of Presentation

The accompanying financial statements have been prepared by California Coastal Communities, Inc. and its consolidated subsidiaries (the Company), without audit, pursuant to the rules and regulations of the Securities and Exchange Commission. Certain information and footnote disclosures normally included in financial statements prepared in accordance with generally accepted accounting principles have been condensed or omitted pursuant to such rules and regulations. The Company believes that these unaudited consolidated financial statements reflect all material adjustments (consisting only of normal recurring adjustments) and disclosures necessary for the fair presentation of the results of operations and statements of financial position when read in conjunction with the Financial Statements and Notes thereto included in the Company s Annual Report on Form 10-K for the year ended December 31, 2005. Intercompany accounts and transactions have been eliminated. Certain prior year amounts have been reclassified to conform to the current year presentation.

The results for interim periods are not necessarily indicative of the results to be expected for the full year. This report contains forward-looking statements. Readers are cautioned that any such forward-looking statements are not guarantees of future performance and involve risks and uncertainties that actual events or results may differ materially from those described herein as a result of various factors, including without limitation, the factors discussed generally in this report.

Note 2 - Significant Accounting Policies

Consolidation of Variable Interest Entities

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 VIE, pursuant to Financial Interpretation FIN No. 46, Consolidation of Variable Interest Entities an interpretation of ARB No. 51 (FIN 46), an enterprise that has the majority of the variability in gains and losses of the VIE is considered to be the primary beneficiary and must consolidate the VIE. FIN 46 was effective immediately for VIEs created after January 31, 2003.

Based on the provisions of FIN 46, the Company has concluded that whenever it options land or lots from an entity and pays a non-refundable deposit, a VIE may be created under condition (ii)(b) and (c) of the previous paragraph. The Company may be 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, the Company will compute expected losses and residual returns based on the probability of future cash flows as outlined in FIN 46. If the Company is deemed to be the primary beneficiary of the VIE, the VIE will be consolidated on the Company s balance sheet.

The Company s exposure to loss as the result of a purchase contract with a VIE is limited to the amount of the non-refundable option deposit, which is generally 5% to 15% of the purchase price, not total assets on the balance sheet of the VIE. Therefore, the Company believes that consolidating the VIE does not reflect the economic realities or risks of owning and developing land. The Company has no material third party guarantees related to these contracts. Creditors of these VIEs, if any, have no recourse against the Company.

As of March 31, 2006, the Company has no deposits with VIEs. See Note 7 Real Estate Matters.

Real Estate

Real estate inventories primarily consists of homes under construction and lots under development and are carried at the lower of cost or fair value less costs to sell. The estimation process involved in the determination of fair value is inherently uncertain since it requires estimates as to future events and market conditions. Such estimation process assumes the Company s ability to complete development and dispose of its real estate properties in the ordinary course of business based on management s present plans and intentions. Economic, market, and environmental conditions may affect management s development and marketing plans. In addition, the implementation of such development and marketing plans could be affected by the availability of future financing for development and construction activities. Accordingly, the ultimate values of the Company s real estate properties are dependent upon future economic and market conditions, and the availability of financing.

The cost of sales of multi-unit projects is generally computed using the relative sales value method. Interest and other carrying costs are capitalized to real estate projects during their development and construction period.

Impairment of Long-Lived Assets

The Company assesses the impairment of real estate inventories and other long-lived assets in accordance with Statement of Financial Accounting Standards (SFAS) No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets , which requires that an impaired asset, for which costs cannot be recovered from estimated undiscounted future cash flows, be written down to fair value. Long-lived assets are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. As provided by SFAS No. 144, impairment is evaluated by comparing an asset s carrying value to the undiscounted estimated cash flows expected from the asset s operations and eventual disposition. If the sum of the undiscounted estimated future cash flows is less than the carrying value of the asset, an impairment loss is recognized based on the fair value of the asset. If impairment occurs, the fair value of an asset for purposes of SFAS No. 144 is deemed to be the amount a willing buyer would pay a willing seller for such asset in a current transaction.

In accordance with SFAS No. 144, in developing estimated future cash flows for impairment testing, the Company has incorporated its own market assumptions including those regarding home prices, infrastructure, home-building costs and financing costs regarding real estate inventories. Additionally, as appropriate, the Company identifies alternative courses of action to recover the carrying value of its long-lived assets and evaluates all likely alternatives under a probability-weighted approach as described in SFAS No. 144.

Earnings Per Common Share

Earnings per common share is accounted for in accordance with SFAS No. 128, Earnings Per Share . Basic earnings per common share is computed using the weighted-average number of common shares outstanding for the period. The weighted-average number of common shares outstanding was 10.2 million for the three months ended March 31, 2006 and 2005. The weighted average number of common shares, assuming dilution, was 10.5 million and 10.9 million for the three months ended March 31, 2006 and 2005, respectively. Diluted earnings per common share is computed using the weighted-average number of common shares outstanding and the dilutive effect of potential common shares outstanding. For the three months ended March 31, 2006 and 2005, the average market price of the Company s common stock exceeded the exercise price of outstanding stock options. Therefore, diluted earnings per share includes the dilutive effect of the weighted average number of common shares from potential exercise of approximately 700,000 options.

The table below sets forth the reconciliation of the denominator of the earnings per share calculation (in millions):

	March 31,	
	2006	**2005**
Shares used in computing basic earnings per common share	10.2	10.2

Dilutive effect of stock options	.3	.7
Shares used in computing diluted earnings per common share	10.5	10.9

Recent Accounting Pronouncements

In December 2004, the Financial Accounting Standards Board (FASB) issued SFAS No. 123 (revised 2004), Share-Based Payment (SFAS 123(R)). This Statement replaces SFAS 123, Accounting for Stock-Based Compensation and supersedes Accounting Principles Board (APB) Opinion No. 25. Accounting for Stock Issued to Employees. SFAS 123(R) addresses the accounting for share-based payment transactions in which an enterprise receives employee services in exchange for (a) equity instruments of the enterprise or (b) liabilities that are based on the fair value of the enterprise s equity instruments or that may be settled by the issuance of such equity instruments. SFAS 123(R) eliminates the ability to account for share-based compensation transactions using the intrinsic value method under APB No. 25, and generally would require instead that such transactions be accounted for using a fair-value-based method. The Company adopted SFAS 123(R) in the first quarter of 2006 using the modified prospective method, which requires that compensation is recognized on or after the required effective date for the portion of outstanding awards for which the requisite service has not yet been rendered, based on the grant-date fair value of those awards calculated under SFAS 123 for either recognition or pro forma disclosures. The Company previously adopted the fair value recognition provisions of SFAS 123 in 2003. The adoption of SFAS 123(R) did not have a material impact on the Company s consolidated financial position, results of operations, or cash flows.

In December 2004, the FASB issued SFAS No. 153, Exchanges of Nonmonetary Assets An amendment of APB 29, Accounting for Nonmonetary Transactions (SFAS 153). This statement amends APB No. 29 to eliminate the exception for nonmonetary exchanges of similar productive assets and replaces it with a general exception for exchanges of nonmonetary assets that do not have commercial substance. A nonmonetary exchange has commercial substance if the future cash flows of the entity are expected to change significantly as a result of the exchange. This statement was effective beginning in the Company s first quarter of 2006. The adoption of SFAS 153 did not have a material impact on the Company s consolidated financial position, results of operations, or cash flows.

In May 2005, the FASB issued SFAS No. 154, Accounting Changes and Error Corrections (SFAS 154). This statement replaces APB Opinion No. 20, Accounting Changes and SFAS No. 3, Reporting Accounting Changes in Interim Financial Statements, and changes the requirements for the accounting for and reporting of a change in accounting principle. SFAS 154 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. This statement was effective beginning in the Company s first quarter of 2006. The adoption of SFAS 154 did not have a material impact on the Company s consolidated financial position, results of operations, or cash flows.

In June 2005, the Emerging Issues Task Force (EITF) reached a final consensus on 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 affects the consolidation of entities in which a general partner or managing member is presumed to control a partnership or limited liability company. EITF 04-5 was effective for the Company beginning in the first quarter of 2006. The adoption of EITF 04-5 did not have a material impact on the Company s consolidated financial position, results of operations, or cash flows upon initial adoption. EITF 04-5 may materially impact the Company s consolidated financial position, results of operations, or cash flows in future periods should the Company form new limited partnerships or modify existing limited partnerships such that the Company is deemed to control the limited partnership. Under those circumstances, the Company may be required by EITF 04-5 to consolidate the limited partnership.

Note 3 Real Estate Inventories

Real estate inventories primarily consist of homes under construction and lots under development in communities in five Southern California counties. At March 31, 2006, real estate inventories include 889 lots and homes under construction, and five completed homes. Approximately $132.8 million of real estate inventories at March 31, 2006 reflects the 105-acre parcel of land on a mesa north of the Bolsa Chica wetlands (Upper Mesa), which is planned for 356 homes as discussed below. In addition, the balance includes approximately 51 acres nearby which have been offered for dedication to the County of Orange for inclusion in the Harriet M. Weider Linear Park in conjunction with the development of the Upper Mesa, and 51 additional acres which are subject to a conservation easement. The Company capitalizes direct carrying costs including interest and property taxes, as well as direct construction costs, to real estate inventories.

The planned community on the Upper Mesa, known as Brightwater, will offer a broad mix of home choices, averaging 2,850 square feet and ranging in size from 1,700 square feet to 4,100 square feet. The plan also includes 37 acres of open space and conservation area. With 349 homes permitted on 68 acres of the Upper Mesa, the resulting low-density plan equates to approximately five homes per acre, consistent and compatible with the neighboring Huntington Beach communities. In addition, the Company owns land adjacent to the planned Brightwater development, on which it intends to process permits to build seven additional homes which will be included in the Brightwater community. The

Company expects to (i) begin grading in June 2006, (ii) begin building model homes during the fourth quarter of 2006, (iii) start selling homes during the second quarter of 2007, and (iv) begin delivering homes during the fourth quarter of 2007. However, there can be no assurance in that regard, or as to the absence of further administrative or construction delay.

The estimation process involved in the determination of value is inherently uncertain since it requires estimates as to future events and market conditions. Such estimation process assumes the Company s ability to complete development and disposition of its real estate properties in the ordinary course of business based on management s present plans and intentions. Economic, and market conditions may affect management s development and marketing plans. In addition, the implementation of such development and marketing plans could be affected by the availability of future financing for development and construction activities. Accordingly, the amount ultimately realized from such project may differ materially from current estimates and the project s carrying value.

Capitalized interest is allocated to real estate inventories when incurred and charged to cost of sales when the related property is delivered. Certain information regarding interest follows (in millions):

	March 31,	
	2006	2005
Capitalized interest, beginning of period	$ 6.1	$ 1.3
Interest incurred and capitalized	1.1	.5
Charged to cost of sales	(1.1)	(.1)
Capitalized interest, end of period	$ 6.1	$ 1.7

Note 4 Project Debt

In conjunction with the acquisition of single-family residential lots, the Company s homebuilding subsidiary, Hearthside Homes, Inc. and its subsidiaries, enter into construction loan agreements with commercial banks. These loan facilities finance a portion of the land acquisition and the majority of the construction of infrastructure and homes. Each loan facility requires a guaranty of project completion and an environmental indemnity. The loans secured by first trust deeds bear an interest rate of prime plus three-fourths percent (8.5% at March 31, 2006), and some of these loan facilities have a minimum interest rate ranging from 5.75% to 7.5%. During the three months ended March 31, 2006, Hearthside Homes, Inc. entered into no new loan facilities. The following amounts were available and outstanding under these loan facilities as of March 31, 2006 and December 31, 2005 ($ in millions):

				Outstanding at	
	Amount of Facility	Number of Lots	Maturity Date	March 31, 2006	December 31, 2005
Rancho Santa Fe	$ 15.4	18	3/27/06	$	$ 8.5
Lancaster	9.5	10	5/10/06		.2
Rancho Santa Fe	1.8	2	9/13/06	1.7	1.7
Ontario	11.7	26	10/19/06	4.7	4.6
Corona	1.9	4	10/26/06	1.8	1.8
Corona	14.8	36	10/26/06	7.2	7.0
Lancaster	1.0	3	11/17/06	1.0	1.0
Lancaster	10.5	36	11/17/06	3.6	3.6
Corona	41.1	151	1/7/07	19.2	18.8
Beaumont	20.7	102	2/17/07	7.8	7.6
Lancaster	17.7	77	7/1/07	3.2	3.1
				$ 50.2	$ 57.9

Note 5 - Other Liabilities

Other liabilities were comprised of the following (in millions):

	March 31, 2006	December 31, 2005
Accrued pensions and benefits	$ 4.7	$ 4.8
Home warranty reserves	2.2	2.1
Contingent indemnity and environmental obligations	1.5	1.5
Unamortized discount	(.5)	(.5)
	$ 7.9	$ 7.9

Contingent indemnity and environmental obligations primarily reflect reserves before related discount (recorded pursuant to Fresh-Start Reporting) for contingent indemnity obligations for businesses disposed of by former affiliates and unrelated to the Company s current operations.

Home Warranty Reserve

The Company provides a home warranty reserve to reflect its contingent obligation for product liability. The Company generally records a provision as homes are delivered, based upon historical and industry experience, for the items listed in the homeowner warranty manual, which does not include items that are covered by manufacturers warranties or items that are not installed by the Company s employees or contractors. The home warranty reserve activity is presented below (in millions):

	Three Months Ended March 31, 2006		Three Months Ended March 31, 2005	
Balance at beginning of period	$	2.1	$	1.6
Provision		.2		.1
Payments		(.1)		(.1)
Balance at end of period	$	2.2	$	1.6

Note 6 - Income Taxes

The following is a summary of the tax provision (benefit):

	Three Months Ended March 31, 2006		Three Months Ended March 31, 2005	
Current taxes	$	.5	$	.1
Deferred taxes		.9		.1
Reversal of valuation allowance on deferred tax assets				(4.7)
Provision (benefit) for income taxes	$	1.4	$	(4.5)

Deferred tax benefits resulting from reductions in the deferred tax asset valuation allowance on NOLs are recorded when the Company concludes that it is more likely than not that it will utilize additional NOLs to offset future taxable income. As a result of the California Coastal Commission s approval of the Company s development plan for the Bolsa Chica Upper Mesa on April 14, 2005, the Company concluded that it is more likely than not that it will utilize all of its deferred tax assets. Therefore, during the three months ended March 31, 2005, the Company recorded a reversal of valuation allowance on post-reorganization NOLs and other deferred tax assets of approximately $4.7 million, which is reflected in the tax benefit. Pursuant to Fresh Start Reporting, also during the three months ended March 31, 2005, a reversal of valuation allowance on federal Pre-reorganization NOLs of approximately $38.5 million was reflected by increasing the Company s capital in excess of par value.

The Internal Revenue Code (the Code) generally limits the availability of NOLs if an ownership change occurs within any three-year period under Section 382. If the Company were to experience an ownership change of more than 50%, the use of all remaining NOLs would generally be subject to an annual limitation equal to the value of the Company s equity before the ownership change, multiplied by the long-term tax-exempt rate. The Company estimates that after giving effect to various transactions by stockholders who hold a 5% or greater interest in the Company, it has experienced a three-year cumulative ownership shift of approximately 40% as of April 25, 2006.

The federal NOLs available as of March 31, 2006 were approximately $124 million. The amount of federal NOLs which expire if not utilized is zero for 2006, 2007 and 2008 and $8 million, $49 million, and $67 million for 2009, 2010 and thereafter, respectively.

In October 1999, in response to an unsolicited written consent from a majority of its stockholders, the Company amended its certificate of incorporation in order to protect the ability of the Company to utilize its tax loss carryforwards. Since the Company s use of its NOLs would be severely restricted if it experiences an ownership change of more than

50%, the Company s majority stockholders requested that the Board of Directors enact the amendments, which were determined to be in the best interest of the Company and its stockholders. The amendments prohibit future purchases of the Company s common stock by persons who would become new 5% holders, and also prohibit current holders of over 5% from increasing their positions, except in certain permissible circumstances which would not jeopardize the Company s ability to use its NOLs. While these amendments reduced the Company s risk of an ownership change occurring due to the acquisition of shares by 5% stockholders, the risk remains that an ownership change could result from the sale of shares by existing 5% stockholders. The Company s Board of Directors evaluates requests to purchase any amounts in excess of 5% of the Company s common stock and authorizes such transactions which are not expected to jeopardize the Company s ability to use its NOLs.

Note 7 - Commitments and Contingencies

Real Estate Matters

The Company is subject to the usual obligations associated with entering into contracts for the purchase of land and improved home sites. The purchase of properties under these contracts is generally contingent upon satisfaction of certain requirements by the sellers, including obtaining applicable property entitlements. The Company also utilizes option contracts with third-party land sellers and financial entities as a method of acquiring land in staged takedowns and minimizing the use of funds from other corporate financing sources. These option contracts also help to manage the financial and market risk associated with land holdings. Option contracts generally require the payment of a non-refundable cash deposit of 5% to 15% of the purchase price for the right to acquire lots over a specified period of time (usually one to two years) at predetermined prices. The Company has the right at its discretion to terminate its obligations under these land purchase and option agreements by forfeiting the cash deposit with no further financial responsibility. As of March 31, 2006 and December 31, 2005, the Company had no land option deposits. However, our unconsolidated Oxnard joint venture does have land deposits (discussed below).

In February 2003, the Company entered into two option contracts to acquire land adjacent to the City of Oxnard in Ventura County, California aggregating approximately 168 acres. The Company is in the process of developing a land plan for the area, which also includes an additional 149 acres owned by other landowners, with the intention of entitling the property for residential development and annexing it into Oxnard. During October 2003, the Company entered into a limited liability company joint venture agreement with a major financial partner to pursue the Oxnard development opportunity. The Company assigned the land purchase option contracts to the Oxnard limited liability company. Hearthside Homes, Inc., the Company s homebuilding subsidiary, is the managing member of the Oxnard joint venture, and made an initial contribution of $500,000. The non-managing member also made an initial contribution of $500,000 to the joint venture and, as of December 31, 2005, had made an aggregate of $4 million of first tier additional contributions. The members have agreed to provide a second tier of additional capital contributions of up to $2 million, as necessary, to complete the business plan. For contributions in excess of $5 million, the first $500,000 is to be contributed equally by the Company and the Company s partner. At our discretion, the Company could continue to contribute equally to the next $500,000. Thereafter, the next $1 million is to be contributed equally between the members. During the fourth quarter of 2005 and the first quarter of 2006, the members each contributed approximately $160,000 and $100,000, respectively, of the additional $2 million. The Company expects to make additional aggregate capital contributions of approximately $675,000 to the joint venture during the next 15 months, bringing the Company s total expected investment in the project to $1.4 million.

The Company has outstanding performance and surety bonds, for the benefit of city and county jurisdictions, related principally to its obligations for site improvements at various projects. The Company does not believe that draws upon these bonds, if any, will have a material effect on the Company s financial position, results of operations or cash flows.

Legal Proceedings

There are various lawsuits and claims pending against the Company and certain subsidiaries. In the opinion of the Company s management, ultimate liability, if any, will not have a material adverse effect on the Company s financial condition or results of operations.

See Note 5 for a discussion of other contingencies.

Corporate Indemnification Matters

The Company and its former affiliates have, through a variety of transactions effected since 1986, disposed of several assets and businesses, many of which are unrelated to the Company s current operations. By operation of law or contractual indemnity provisions, the Company may have retained liabilities relating to certain of these assets and businesses. There is generally no maximum obligation or amount of indemnity provided for such liabilities. A portion of such liabilities is supported by insurance or by indemnities from certain of the Company s previously affiliated companies. The Company believes its consolidated balance sheet reflects adequate reserves for these matters.

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

Overview of California Coastal Communities, Inc.

We are a residential land development and homebuilding company with properties owned or controlled in six Southern California counties (Los Angeles, Orange, Riverside, San Bernardino, San Diego and Ventura). Our principal activities include:

obtaining zoning and other entitlements for land we own or control through purchase options or joint ventures;

improving the land for residential development; and

designing, constructing and selling single-family homes in Southern California.

Once our residential land is entitled, we may build homes, sell unimproved land to other developers or homebuilders, sell improved land to homebuilders, or participate in joint ventures with other developers, investors or homebuilders to finance and construct infrastructure and homes. The majority of these homes are designed to appeal to move-up homebuyers and are generally offered for sale in advance of their construction. During the next 12 months, we will focus our primary efforts to:

begin grading and building model homes for our Brightwater project located on 105 acres of the Bolsa Chica mesa in Orange County, California in accordance with the Coastal Development Permit for 349 homes issued by the California Coastal Commission in December 2005;

complete the entitlement process for a 168-acre joint venture project near Oxnard, California; and

increase deliveries, revenues and profitability of our homebuilding operations throughout Southern California.

However, we are also considering other strategic opportunities as discussed below; and there can be no assurance that we will accomplish, in whole or in part, all or any of these strategic goals.

Our total revenues for the three months ended March 31, 2006 and 2005 were $27.9 million and $6.5 million, respectively. For the three months ended March 31, 2006 and 2005, we delivered 49 and 10 homes, respectively. Our total assets as of March 31, 2006 and December 31, 2005 were $319.1 million and $330.4 million, respectively. Over the last ten years, we have delivered over 1,900 homes to families throughout Southern California.

We were formed in 1988 and our executive offices are located at 6 Executive Circle, Suite 250, Irvine, California 92614. Our telephone number is (949) 250-7700.

Strategic Alternatives

The Board of Directors and management of the Company have always been and continue to be committed to enhancing value for all stockholders. In that regard, we continue to evaluate strategic alternatives. From time to time we have considered the various strategic alternatives available to us with respect to our businesses, assets, operations and available cash. We have engaged investment bankers and other advisors for this purpose, with a view towards assessing alternatives which would enhance the value of our current businesses, create additional business opportunities, or otherwise maximize the value of our Company for our stockholders. Included in this process has been an exploration of merger, acquisition and disposition possibilities; analysis of equity and debt financings; open market and other repurchases of our stock; dividends to our stockholders; and combinations of these alternatives.

Prior to obtaining the Coastal Development Permit for our Brightwater project in December 2005, we have historically maintained a minimal amount of leverage. We currently have $50 million of project-specific debt against $249 million of book equity and a $377 million equity market capitalization as of March 31, 2006. The Bolsa Chica

Mesa is unencumbered by debt. We are in the process of seeking debt financing for our Brightwater project which may also provide additional cash that could be available for a potential special dividend to our stockholders, open market or other repurchases of our stock, or combinations of these alternatives. We will continue to evaluate our strategy to maximize value to our stockholders.

Our Current and Future Homesites

We currently have on-going Southern California homebuilding projects in:

- Riverside County near the cities of Corona and North Corona, and in the City of Beaumont;
- San Bernardino County in the City of Ontario;
- Northern Los Angeles County in the City of Lancaster; and
- San Diego County in the Rancho Santa Fe area.

We expect to begin grading our Brightwater development project during May 2006 and plan to process permits for seven homes on adjacent parcels, which would bring the total unit count up to 356. The following chart describes our current projects, their location and our lot inventories as of March 31, 2006:

Project	**Location**	**Lot Inventory**
Chandler Ranch	North Corona	45
Alisal at Ontario	Ontario	26
Woodhaven	Beaumont	102
Hearthside Lane	Corona	151
	Subtotal Inland Empire	324
Alisal at Lancaster	Lancaster	39
Lancaster II	Lancaster	72
Quartz Hill	Lancaster	77
	Subtotal - Lancaster	188
Cancion	Rancho Santa Fe	26
Brightwater	Bolsa Chica	356
		894

These homebuilding projects are currently expected to generate cash flows and gross operating margins through mid-2009. Up to approximately 555 additional single-family lots would be available for homebuilding operations if we obtain entitlements for our Oxnard project; however, the exact number of homes will be dependent upon the final outcome of the entitlement process.

Brightwater at Bolsa Chica

The Bolsa Chica upper mesa is the largest property in our portfolio, representing 42% of our total assets as of March 31, 2006. The Bolsa Chica upper mesa is one of the last large undeveloped coastal properties in Southern California, and is located in Orange County, approximately 35 miles south of downtown Los Angeles. Bolsa Chica is bordered on the north and east by residential development in the City of Huntington Beach and Huntington Harbor, to the south by open space and the Bolsa Chica wetlands, and to the west by open space, Pacific Coast Highway, Bolsa Chica State Beach, and the Pacific Ocean. Our holdings include 68 acres of developable land on the Bolsa Chica upper mesa planned for a residential community known as Brightwater, 37 acres of open space and conservation area in the planned community, five acres in the City of Huntington Beach which are currently zoned agricultural, and approximately 104 non-developable acres on, or adjacent to, the Huntington Mesa. We are analyzing development alternatives for the 5-acre Huntington Beach parcel and expect to submit a proposed site plan to the City of Huntington Beach later this year.

On December 15, 2005, we received a permit from the California Coastal Commission for development of the 349-home Brightwater residential community, which will offer a broad mix of home choices averaging 2,850 square feet and ranging in size from 1,700 square feet to 4,100 square feet. We currently expect to:

begin grading in June 2006,

begin building model homes during the fourth quarter of 2006, and

start selling homes during the second quarter of 2007.

However, there can be no assurance in that regard, or as to the absence of any delays.

Our Brightwater plan also includes 37 acres of open space and conservation area. With 349 homes on 68 acres of the upper mesa, the resulting low-density plan equates to approximately five homes per acre, consistent and compatible with the neighboring Huntington Beach communities. In addition, we own land adjacent to the planned Brightwater development, for which we intend to process permits to build seven additional homes which would be included in the Brightwater community. Approximately 51 acres of land on the Huntington Mesa have been offered for dedication to the County of Orange for inclusion in the Harriet M. Weider Linear Park in conjunction with the development of Brightwater.

During the first quarter of 2005, following the Coastal Commission s conditional approval of our permit to develop Brightwater, we concluded that it is more likely than not that we will utilize all of our deferred tax assets, including net operating losses, to offset future taxable income. As a result, we recorded a $4.7 million reversal of valuation allowance on post-reorganization net operating losses and other deferred tax assets and a $38.5 million reversal of valuation allowance on federal pre-reorganization net operating losses. See Note 6 in our Consolidated Financial Statements.

We used the following facts and assumptions in evaluating the value that we expect to receive from the Brightwater development project:

The Brightwater development permit provides for 349 homes aggregating approximately 995,000 square feet.

We own land adjacent to Brightwater, for which we intend to process permits to build seven additional homes which would be included in the Brightwater community.

Development at Brightwater is projected to take approximately six months for infrastructure, approximately eight months to build 14 model homes, and two to three years for home construction.

We are currently planning to: (i) begin grading during June 2006, (ii) begin building model homes during the fourth quarter of 2006, (iii) start selling homes during the second quarter of 2007, and (iv) start delivering homes in the fourth quarter of 2007.

As of January 2006, new home prices approximated $650 per square foot, including view and other premiums, in the local residential market (coastal Huntington Beach).

The finished lot component of home prices ranges from 60% to 65%.

Costs to improve the lots from their raw condition to finished lots, including building permits and city fees, approximate $140,000 per lot.

Home prices in the coastal Huntington Beach area (as well as other Orange County coastal areas) appreciated approximately 20% during 2005. While demand continues to exceed the supply of housing, pressure for continued appreciation of home prices may be reduced by any significant increases in interest rates.

The estimation process involved in the determination of value is inherently uncertain because it requires estimates as to future events and market conditions. This estimation process assumes our ability to complete development and disposition of our real estate properties in the ordinary course of business based on management s present plans and intentions. Economic, market, and environmental conditions may affect our development and marketing plans. In addition, the implementation of such development and marketing plans could be affected by the availability of future financing for development and construction activities. The development of Brightwater is dependent upon various economic factors. Accordingly, the amount ultimately realized from the Brightwater project may differ materially from our current estimates and the project s carrying value.

Oxnard Land Development - Unconsolidated Joint Venture

In February 2003, we entered into two option contracts to acquire land adjacent to the City of Oxnard in Ventura County, California aggregating approximately 168 acres. We are in the process of developing a land plan for the area, which also includes an additional 149 acres owned by other landowners, with the intention of entitling the property for residential development and annexing it into Oxnard. We currently expect the residential development plan to include approximately 800 single-family detached lots and approximately 750 attached family residential units (townhomes, condominiums, and apartments); however, these numbers are subject to change during the course of the entitlement process. Approximately 555 of the single-family lots and 490 of the attached units would be developed on the 168 acres of optioned land that we currently expect to purchase. The option contracts give us two years, plus up to three additional years through the exercise of extensions, to complete these entitlement activities before purchasing the land. We have the right to terminate these option agreements by forfeiting the cash deposits. We are striving to obtain approval of our plan from the Oxnard City Council by the end of 2006 and approval of annexation into the City of Oxnard from the Local Agency Formation Commission in the first half of 2007; however, delays could be encountered. We exercised six-month extensions in January and July 2005, and in January 2006.

During October 2003, we entered into a limited liability company joint venture agreement with a major financial partner to pursue the Oxnard development opportunity. We assigned the land purchase option contracts to the Oxnard limited liability company. Hearthside Homes, Inc., our homebuilding subsidiary, is the managing member of the Oxnard joint venture, and made an initial contribution of $500,000. The non-managing member also made an initial contribution of $500,000 to the joint venture and, as of December 31, 2005, had made an aggregate of $4 million of first tier additional contributions. The members have agreed to provide a second tier of additional capital contributions of up to $2 million, as necessary, to complete the business plan. For contributions in excess of $5 million, the first $500,000 is to be contributed equally by us and our partner. At our discretion, we could continue to contribute equally to the next $500,000. Thereafter, the next $1 million is to be contributed equally between us. During the fourth quarter of 2005 and the first quarter of 2006, we each contributed approximately $160,000 and $100,000, respectively, of the additional $2 million. We expect to make additional aggregate capital contributions of approximately $675,000 to the joint venture during the next 15 months, bringing our total expected investment in the project to $1.4 million. After payment of a 10% preferred return on invested capital to us and our partner, first tier profits are generally allocated 75% to our partner and 25% to us and second tier profits and losses over $5 million are generally allocated on a 50/50 basis. The first $5 million of losses are generally allocated 80% to our partner and 20% to us. While we exert a large degree of influence over the joint venture, our partner does have various substantive participating rights such as approval rights with regard to the majority of business decisions, including approval of project budgets.

Homebuilding

We acquired no single-family residential lots during the first quarter of 2006. Although home prices in Southern California have increased 20% to 30% annually over the last few years, we do not expect appreciation to continue at that rate, but rather expect modest, if any, increases over the next year. We delivered 49 homes during the first quarter of 2006, compared to 10 deliveries during the comparable period in 2005. The record rainfall during the fourth quarter of 2004 and the first quarter of 2005 negatively impacted our construction schedule and contributed to our lower number of home deliveries in the first quarter of 2005.

Our homebuilding projects are described below:

	Location	Land Acquisition	Commenced Construction	Commenced Sales	Deliveries Quarter Ended March 31, 2006	2005
Completed Projects	Various	n/a	n/a	n/a	1	10
Active Projects						
Chandler Ranch	North Corona	2004	2005	2005	38	
Cancion	Rancho Santa Fe	2003-2005	2005	2005		
Alisal at Lancaster	Lancaster	2004	2004	2005	10	
Alisal at Ontario	Ontario	2005	2005	2006		
Woodhaven	Beaumont	2005	2005	2006		
Hearthside Lane	Corona	2005	2005	2006(a)		
Quartz Hill	Lancaster	2005	2006(a)	2006(a)		
Brightwater	Bolsa Chica	1970	2006(a)	2007(a)		
					49	10

(a) Pending

Rancho Santa Fe. In October 2003, we entered into an agreement to acquire 32 lots in a luxury golf community known as Crosby Estates in the Rancho Santa Fe area of San Diego County in California. We acquired the lots during the period from October 2003 to March 2005. During 2005, two model homes averaging approximately 3,370 square feet were completed and six homes were delivered at an average price of $1,223,000. As of April 24, 2006, 22 homes are in escrow at an average price of $1,396,000, and three additional homes are under construction and held for sale.

Lancaster. We acquired 104 lots in the City of Lancaster in northern Los Angeles County during May 2004. We began construction of model homes averaging approximately 2,800 square feet during the third quarter of 2004 and opened for home sales in January 2005. During 2005, we delivered 55 homes at an average price of $406,000. We delivered 10 homes during the first quarter of 2006 at an average price of $417,000 and, as of April 24, 2006, 25 homes are in escrow at an average price of $445,000, and nine homes are under construction and held for sale. In April 2005, we acquired an additional 72 unentitled lots in Lancaster. We are completing the entitlement process and plans for the project and expect to begin construction during the fourth quarter of 2006.

In December 2005, we acquired 77 additional lots in an area known as Quartz Hill in the City of Lancaster. The homes in this community will be on 10,000 square foot lots and will average 3,642 square feet. We expect to begin construction of models and open for sales during the second quarter of 2006.

Corona. We acquired 83 lots in North Corona in May 2004. Following construction of infrastructure, during April 2005, we began construction of homes averaging 3,160 square feet. We opened for sales during the third quarter of 2005 and delivered 38 homes during the first quarter of 2006 at an average price of $603,000 and delivered two homes in early April. As of April 24, 2006, nine homes are in escrow at an average price of $607,000, and seven additional homes are under construction and have been released for sale.

During April 2005, we acquired 151 lots in Corona. Following construction of infrastructure, construction of homes averaging 3,583 square feet on lots of approximately 7,200 square feet is expected to begin during the second quarter of 2006.

Ontario. During April 2005, we acquired 26 lots in the City of Ontario in Riverside County, California. This small community of homes, planned to average 3,380 square feet, is an infill site situated very close to the projects we recently completed in the City of Chino. Construction began during the fourth quarter of 2005, and we opened for sales during March 2006. As of April 24, 2006, four homes are in escrow at an average price of $693,000, and nine additional homes are under construction and have been released for sale.

Beaumont. We acquired 102 lots in the City of Beaumont during the third quarter of 2005. Following construction of infrastructure, construction of homes averaging 2,500 square feet began during the first quarter of 2006, and sales commenced during March 2006. As of April 24, 2006, 10 homes are under construction and have been released for sale.

Impact of Inflation; Changing Prices and Economic Conditions

Real estate and residential housing prices are affected by inflation, which can cause increases in the price of land, raw materials and subcontracted labor. Unless these increased costs are recovered through higher sales prices, gross margin from home sales would decrease. If interest rates increase, construction and financing costs would also increase, which can also result in lower gross margin from home sales. The volatility of interest rates could have an adverse effect on our future operations and liquidity. Among other things, these conditions may affect adversely the demand for housing and the availability of mortgage financing and may reduce the credit facilities we offer.

In general, while these price increases have been greater than the general rate of inflation in our housing markets, they 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 home costs, including land and interest costs, will substantially outpace increases in the income of potential purchasers. Inflation has a lesser short-term effect on us because we generally negotiate fixed-price contracts with our subcontractors and material suppliers for the construction of our homes. These prices are generally applicable for a specified number of homes.

There can be no assurance regarding the continued health of the Southern California residential real estate market. In particular, (i) the significant increases in home prices over the last six years and the related decline in the affordability of new homes in Southern California, (ii) the state of the national economy, continued increases in interest rates by the Federal Reserve Board and the possibility of a recession in the future, and (iii) the volatility in the stock market, collectively may exert recessionary pressures on the California economy and may have a negative impact on the Southern California housing market.

While low mortgage rates have sustained housing demand to date, interest rates have been rising and any significant future increase in mortgage rates or significant loss of jobs in Southern California would most likely slow demand for new homes. Increases in home mortgage interest rates make it more difficult for our customers to qualify for home mortgage loans, potentially decreasing home sales volume and prices. The tight supply of available homes in Southern California has resulted in significant home price increases over the last six years. As a result, the affordability of new homes has been declining and could jeopardize future demand. The percentage of home buyers utilizing variable-rate and/or interest only mortgages to afford Southern California new home prices has been increasing. These buyers may be more sensitive to increases in interest rates and may encounter difficulty in making increased mortgage payments on their homes in the future. This could have negative consequences on the demand for new homes if it results in reduced buyer confidence and an increase in secondary market homes available for sale, competing with sales of new homes.

Approximately 36% (based on number of lots) of our active homebuilding projects are located in the Inland Empire area of Southern California, which includes Riverside and San Bernardino counties; however, in 2006 we will also be actively developing our 349-home Brightwater community adjacent to Huntington Beach, California. The Inland Empire has experienced significant population and job growth in the past decade. While continued population growth and demand for new homes are expected to continue, partially due to the limited supply of affordably priced housing in coastal areas such as Orange County, there can be no assurance that economic, demographic or other factors will not slow, diminish or cause such growth to diminish or cease.

During the year ended December 31, 2005, the homebuilding environment remained strong due to a positive supply/demand relationship in Southern California, as well as relatively low interest rates. We have seen signs that the housing market in Southern California has slowed during the first quarter of 2006. For the first quarter of 2006, our net new orders decreased by 35 homes compared with the same period last year (29 for the first quarter of 2006 compared with 64 for the first quarter of 2005). The decrease was partially due to one less active selling community as well as a return to a more moderate level of orders from record first quarter orders last year. At the same time, however, backlog as of quarter end was comparable (60 as of March 31, 2006 compared with 61 as of March 31, 2005). Although the homebuilding business historically has been cyclical, it has not undergone an economic down cycle in a number of years. Further, during 2005, home prices rose significantly in all of our markets. This has led some people to assert that the prices of land, new homes and the stock prices of homebuilding companies may be inflated and may decline if the demand for new homes weakens. A decline in the prices for new homes could adversely affect both our revenues and margins. A decline in our stock price could make raising capital through stock issuances more difficult and expensive.

Critical Accounting Policies

In the preparation of the Consolidated Financial Statements, we applied accounting principles generally accepted in the United States of America. The application of generally accepted accounting principles may require management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying results. Listed below are those policies and estimates that we believe are critical and require the use of complex judgment in their application. In particular, our critical accounting policies and estimates include the evaluation of the impairment of long-lived assets and the evaluation of the probability of being able to realize the future benefits indicated by our significant federal tax net operating losses, as discussed further in Notes 2 and 6 to the Consolidated Financial Statements.

Impairment of Long-Lived Assets

We assess the impairment of real estate inventories and other long-lived assets in accordance with Statement of Financial Accounting Standards (SFAS) No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets, which requires that an impaired asset, for which costs cannot be recovered from estimated undiscounted future cash flows, be written down to fair value. Long-lived assets are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. As provided by SFAS No. 144, impairment is evaluated by comparing an asset s carrying value to the undiscounted estimated cash flows expected from the asset s operations and eventual disposition. If the sum of the undiscounted estimated future cash flows is less than the carrying value of the asset, an impairment loss is recognized based on the fair value of the asset. If impairment occurs, the fair value of an asset for purposes of SFAS No. 144 is deemed to be the amount a willing buyer would pay a willing seller for such asset in a current transaction. These assets are carried at cost, unless the carrying amount of the parcel or subdivision is determined not to be fully recoverable, in which case the impaired real estate is written down to fair value. Given the significance of the carrying value of real estate inventories, the application of SFAS No. 144 in evaluating any potential impairment is critical to our consolidated financial statements, as discussed further in Note 2 to the Consolidated Financial Statements.

The Bolsa Chica property is our largest asset. Prior to the December 2005 receipt of our Brightwater permit, the property was included in land held for future development or sale. In December 2005, we sold approximately 146 acres of the property to the State. Beginning in December 2005, the remaining portion consisting of approximately 214 acres is included in real estate inventories.

In accordance with SFAS No. 144, in developing estimated future cash flows for impairment testing, we incorporated our own market assumptions including those regarding home prices, infrastructure, home-building costs, and financing costs regarding real estate inventories. Additionally, as appropriate, we identify alternative courses of action to recover the carrying value of our long-lived assets and evaluate all likely alternatives under a probability-weighted approach as described in SFAS No. 144.

The estimation process involved in the determination of value is inherently uncertain because it requires estimates as to future events and market conditions. Such estimation process assumes our ability to complete development and disposition of our real estate properties in the ordinary course of business based on management s present plans and intentions. Economic, market, and environmental conditions may affect management s development and marketing plans. In addition, the implementation of such development and marketing plans could be affected by the availability of future financing for development and construction activities. The development of our Brightwater project is dependent upon various economic factors. Accordingly, the amount ultimately realized from such project may differ materially from current estimates and the project s carrying value.

Basis of Consolidation

Certain of our wholly-owned subsidiaries are members in joint ventures involved in the development and sale of residential projects and residential loan production. Our consolidated statements include our accounts and all of our majority-owned and controlled subsidiaries and joint ventures. The financial statements of joint ventures in which we generally have a controlling or majority economic interest (and thus are controlled by us) are consolidated with our financial statements. Minority interest represents the equity interest of our joint venture partner for one consolidated venture. Our investments in unconsolidated joint ventures are accounted for using the equity method when we do not have voting or economic control of the venture operations.

Income Taxes

We account for income taxes on the liability method. Deferred income taxes are determined based on the difference between the financial statement and tax bases of assets and liabilities. The liability method requires an evaluation of the probability of being able to realize the future benefits indicated by deferred tax assets, such as tax net operating losses. A valuation allowance related to the deferred tax asset is recorded when it is more likely than not that some portion or all of the deferred tax asset will not be realized. Given the significance of our historical federal tax net operating losses, as discussed in Note 6 to the Consolidated Financial Statements, the application of our policy in evaluating the expected future benefit of net operating losses is critical. In applying those policies, estimates and judgments affect the amounts at which certain assets and liabilities are recorded. We apply our accounting policies on a consistent basis. As circumstances change, they are considered in our estimates and judgments, and future changes in circumstances could result in changes in amounts at which assets and liabilities are recorded.

We remain subject to the general rules of Section 382, which limit the availability of net operating losses if an ownership change occurs. If we were to experience another ownership change, the amount of net operating losses available would generally be limited to an annual amount equal to (i) the value of our equity immediately before the ownership change, multiplied by the long-term tax-exempt rate (4.26% as of April 2006) plus (ii) recognized built-in-gains, defined as those gains recognized within five years of the ownership change subject to an overall limitation of the net unrealized built-in gains existing as of the ownership change date. We believe we have net unrealized built-in gains sufficient to allow utilization of the entire net operating loss, assuming that we are able to recognize these gains within the five-year time limitation. We estimate that as of April 25, 2006, we have experienced a three-year cumulative ownership shift of approximately 40%, as computed in accordance with Section 382.

Homebuilding Revenues and Cost of Sales

Our homebuilding operation generates revenues from the sale of homes to homebuyers. The majority of these homes are designed to appeal to move-up homebuyers and the homes are generally offered for sale in advance of their construction. Sales contracts are usually subject to certain contingencies such as the buyer s ability to qualify for financing. Revenue from the sale of homes is recognized at closing when title passes to the buyer, and the earnings process is complete. As a result, our revenue recognition process does not involve significant judgments or estimates. However, we do rely on certain projections and estimates to determine the related construction costs and resulting gross margins associated with revenues recognized. The cost of sales is recorded based upon total estimated costs within a subdivision and allocated using the relative sales value method. Our construction costs are comprised of direct and allocated costs, including estimated costs for future warranties and indemnities. Our estimates are based on historical results, adjusted for current factors.

Litigation Reserves

We and certain of our subsidiaries have been named as defendants in various cases arising in the normal course of business and regarding assets and businesses disposed of by us or our former affiliates. See Notes 5 and 7 to the Consolidated Financial Statements. We have reserved for costs expected to be incurred with respect to these cases based upon information provided by our legal counsel. There can be no assurance that total litigation costs actually incurred will not exceed the amount of such reserve.

Recent Accounting Pronouncements

See discussion regarding recent accounting pronouncements in Note 2 to the Consolidated Financial Statements.

Results of Operations

The nature of our business, including our limited inventory of buildable lots, is such that status of each project often causes significant fluctuations in operating results from quarter-to-quarter and year-to-year.

Three Months Ended March 31, 2006 Compared with the Three Months Ended March 31, 2005

The Company reported revenues of $27.9 million and gross operating profit of $4.7 million for the first quarter of 2006, compared with $6.5 million in revenues and gross operating profit of approximately $1.7 million for the first quarter of 2005. Revenues in the current period reflect deliveries of 49 homes, including 38 homes at the Chandler Ranch project in North Corona, 10 homes at the Alisal project in Lancaster, and one home at the Jasper Ranch project in Riverside. The comparable period of the prior year reflects deliveries of 10 homes, including six homes at the Riverside project and four homes at the Chino project. The current quarter s gross margin of 16.8% is lower than the prior period gross margin of 26.2% due to the lower profitability of the Lancaster and North Corona (Chandler Ranch) homes delivered during the current quarter as compared with the Riverside (Jasper Ranch) and Chino homes delivered during the comparable period of the prior year. This decrease reflects the lower price level of homes in Lancaster compared with homes in the Inland Empire, a higher-end product delivered at our Chino and Jasper Ranch projects in 2005, and lower levels of price appreciation resulting from shorter holding periods for the land underlying the homes delivered during the three months ended March 31, 2006.

The $500,000 increase in selling, general and administrative expenses during the first quarter of 2006, as compared with the first quarter of 2005, primarily reflects an increased accrual for incentive bonuses related to the increased profitability of our homebuilding business.

The $500,000 increase in other (income) expense during the first quarter of 2006 compared with the first quarter of 2005 primarily reflects interest income on short-term investments during the 2006 period.

During the three months ended March 31, 2005, the Company recorded a reversal of valuation allowance on post-reorganization NOLs of $4.7 million following the Coastal Commission s approval of the development plan for 349 homes on the Bolsa Chica Upper Mesa (see Note 6).

Payments Under Contractual Obligations

We have entered into certain contractual obligations to make future payments for items such as project debt and lease agreements. A summary of the payments due under specified contractual obligations, aggregated by category of contractual obligation, for specified time periods is presented below as of March 31, 2006 (in millions):