

2004 ANNUAL REPORT





Lithia Motors, Inc. Board of Directors

Back Row (left to right):

Bill Young, Phil Romero, Jerry Taylor, Tom Becker, Brad Gray

Front Row (left to right):

Dick Heimann, Sid DeBoer

Compensation Committee

Tom Becker (*Chairman*), Jerry Taylor, Bill Young, Phil Romero

Audit Committee

Tom Becker (*Chairman*), Jerry Taylor, Bill Young

Corporate Governance Committee

Phil Romero (*Chairman*), Tom Becker, Jerry Taylor, Bill Young



March 8, 2005

TO OUR SHAREHOLDERS:

Dick and I want to thank our valued shareholders for your continued support of our company. Lithia was founded by a strong family of business people who have now grown to include not only the original family, who are still in charge of the company, but also a large family of over 5,000 employees and hundreds of dedicated shareholders. We take great pride in our successes and are pleased to report another successful year – the eighth for us as a public company. Lithia's performance in 2004 showed overall sales growth and margin improvements across all business lines, particularly in the used vehicle, parts and service businesses. The sales environment in 2004 showed mixed trends, however, we were still able to maximize our profits through many strategic initiatives. Earnings per share ended up being 17 cents higher than the high end of our original guidance for the year.

Nationally, new vehicle sales were volatile from month to month due to a fluctuating incentive environment. Used vehicle sales have remained slow for the past three years. While we have a good diversification of markets across thirteen states, a few of the markets where we operate remain depressed compared to prior years. We are encouraged by the fact that those markets appear to have stabilized, though at lower levels. Long-term, we believe that we are in some of the best markets in the country and that there is good potential for all of our markets to demonstrate healthy growth in the future.

Regardless of market conditions, Lithia's auto-retail model creates margin improvements even when facing a difficult sales environment. For the full-year 2004, we were able to increase margins across all business lines. Our year-over-year total gross margin improved 80 basis points to 16.8% and our SG&A as a percentage of gross profit improved 160 basis points to 76.1%. As a result, full-year 2004 operating margins improved 30 basis points to 3.5%. This is the third consecutive year of margin improvements for our company. Although same-store sales were down 2.7% for the year, total same-store gross profits improved 1.9%.

Industry observers are predicting an essentially flat new vehicle sales environment in 2005 with an improving used vehicle sales market. We did see some signs of the improved used vehicle market in the fourth quarter of 2004 with same-store sales improving 1.7%, and used vehicle margins improving 50 basis points from the fourth quarter of 2003.

The direction of the new and used vehicle market is difficult to predict accurately on a year-to-year basis. Lithia has a strong business model that allows the company to benefit regardless of the operating environment. The success of our business model was demonstrated in 2004 by total same-store pre-tax profits that improved 16% in an environment where total same-store sales were down for the company. For 2005, we believe we are in a good position to continue our growth as we execute our proven operating and acquisition strategy.

SIGNIFICANT EVENTS

During 2004, Lithia made some noteworthy accomplishments. We:

- Produced growth in net income from continuing operations of 19.5% to \$42.6 million;
- Completed the acquisition of 10 automotive retail stores and 21 franchises with annual revenues of approximately \$340 million. As of December 31, 2004, we operated 86 stores with 25 brands of new vehicles in 13 western states;
- Were named to *Fortune's* list of America's Most Admired Company survey, capturing the No. 2 ranking in the Automotive Retailing/Services category. The *Fortune* list ranked Lithia as the category leader in "social responsibility," one of eight key attributes used to measure each business against its competition.

FINANCIAL OVERVIEW

Total revenues for 2004 reached \$2.7 billion, growing 9% compared with \$2.5 billion in 2003. We have a very strong balance sheet. Our long-term debt-to-total-capitalization ratio remains low at 20%, which excludes cash, used vehicle flooring and real estate debt. Discontinued operations resulted in a one-cent gain, because the losses from these discontinued operations were more than offset by the gains from the sale of these stores. Since our IPO in December 1996, we have increased our revenues more than nineteen fold. Our book value per basic share has grown at a compounded annual rate of 26% from \$4.22 to \$21.62 as of December 31, 2004. The compounded annual growth rate (CAGR) in sales was 45% per year; net income 42% per year; and EPS 20% per year. Total same-store sales have grown at an average annual rate of 3.1%. These achievements are among the best of any public automotive retailer and demonstrate our position as a premier operator in our sector.

ACQUISITIONS

Lithia is a company that is dedicated to long-term growth. Our growth plan includes increases in same-store sales combined with additional revenues from acquisitions. We believe that we have the best acquisition team in the industry. In 2004, we added approximately \$340 million in annualized revenues to our base of total revenues of \$2.5 billion in 2003. This represents growth of nearly 14%. We anticipate continued long-term revenue growth from acquisitions to increase annualized revenues by 10 - 15% per year in the years to come. We target stores where we can improve operating performance that will be accretive to earnings per share in the first year. We focus on improving the operating performance of each store by utilizing standardized processes that deliver measurable results. Each new store is fully integrated into our system upon acquisition as a Lithia store. This is as close as we can get to opening or "greenfielding" new stores in what is a mature franchise system.

We continue to focus our growth in 70 markets west of the Mississippi, typically in locations with franchises that are exclusive in their market, or that have a dominant market share position. We have a goal to exceed the market share and customer satisfaction targets provided to us from the manufacturer, within the initial 36 months of ownership. We accomplish this by instituting Lithia's uniform processes guided by industry recognized in-store leadership. Building this way generally costs less than buying platform groups, but takes strong support and training.

Lithia has operational teams that are now capable of integrating up to 2 stores a month or 24 per year. These teams are comprised of some of the best people in the industry. We have a strong financial position with ample free cash flow, a 20% long-term debt to total capitalization ratio, and an acquisition

credit facility of \$150 million. Most of our growth is internally funded from free cash flow at the current time. We are in great shape to continue with our growth plans in the future.

LITHIA'S MISSION AND VISION STATEMENT

THE MISSION OF LITHIA, AMERICA'S CAR AND TRUCK STORE, IS TO BE THE PREFERRED PROVIDER OF CARS AND TRUCKS AND RELATED SERVICES IN NORTH AMERICA

Vision Statement - *A statement of what we are striving to be*

- Lithia envisions the future, develops and embraces a strategic plan, and ensures the success of the plan.
- We strive for strong, sustainable and profitable growth.
- We speak a common language and execute best-in-class processes in all of our operations.
- We have a dynamic and dedicated leadership committed to the standards and mission of Lithia.
- We provide opportunities for our people to excel and grow in a positive, respectful work environment.
- Our customers choose us because of our professionalism, consistency, and the extra effort we make to serve them.
- Our investors choose us because we are a sound investment.
- We hold ourselves to the highest ethical standards in how we treat our customers, our stakeholders and each other.

INTERNAL CONTROLS

Lithia committed a substantial amount of resources to the Sarbanes Oxley Section 404 certification process during 2004. Under Sarbanes Oxley, we are required to design, implement and test internal policies and procedures. Our disclosure controls also must be certified to ensure our financial statements are accurate. This examination was helpful in further refining our policies and procedures, and as a result, we have a much stronger audit and control process. We are proud to say that Lithia has received a clean bill of health with no identified material weaknesses or significant deficiencies.

CONCLUSION

Of the three original public auto retailers, who were the pioneers of public auto retailing in 1996, only Lithia remains under its original management and operating plan. Our plan is well designed to grow the company in a predictable and consistent manner. Our operating model has proven itself over the last eight years to be effective and reliable. Lithia's continued growth and margin improvements demonstrate the benefit of having strong operating systems and a group of employees that are dedicated to raising the performance of our stores. Our ability to integrate new stores, and improve the performance of existing stores is better today than ever before. We take our mission statement and the points in our vision statement seriously, and that is why we list them here. We are building Lithia for long-term success, and we will continue to execute our plan with an eye towards what is best for the long-term health of our company.

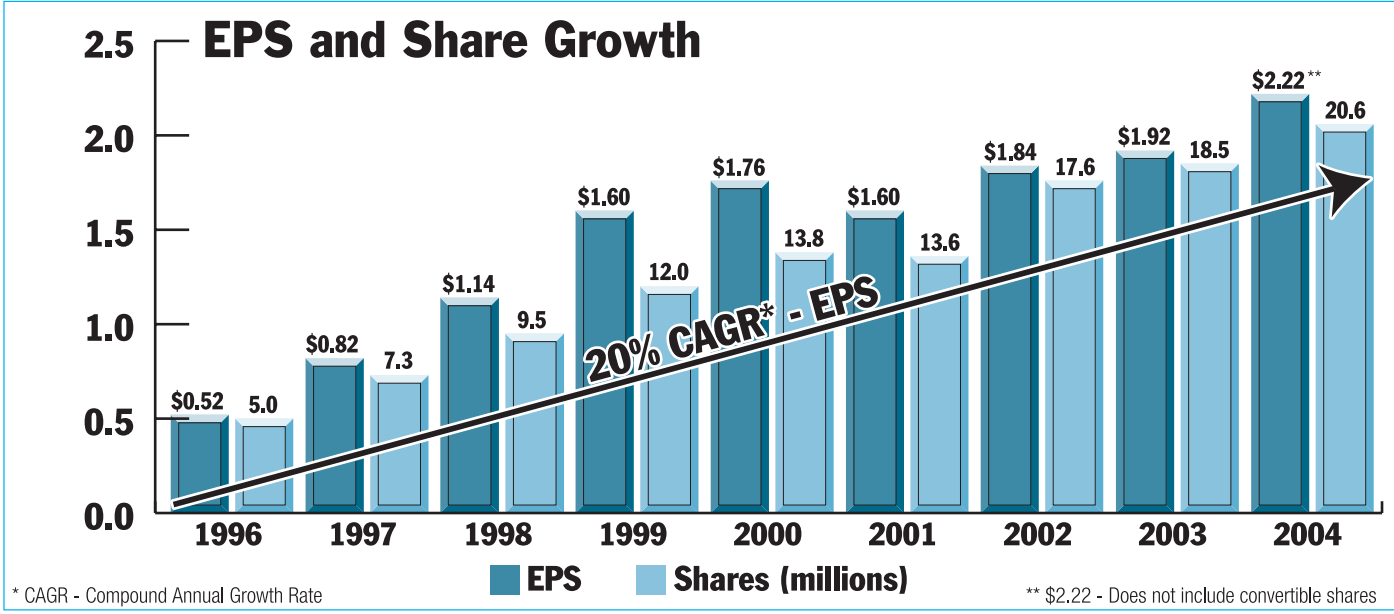
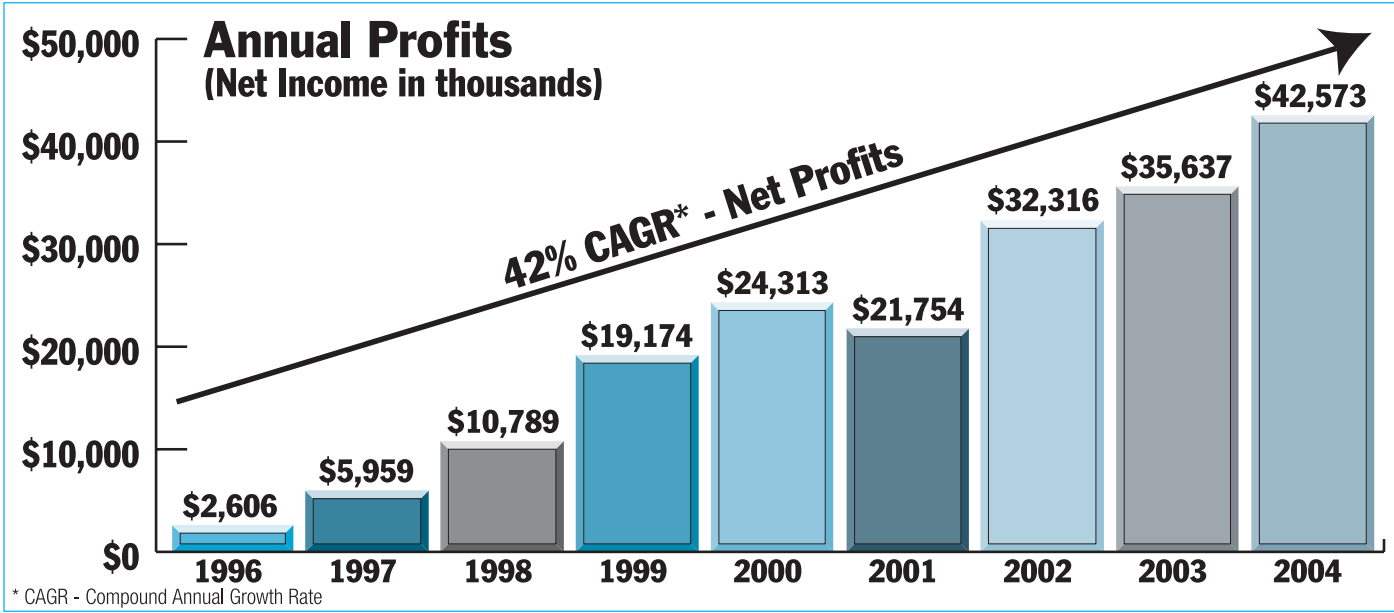
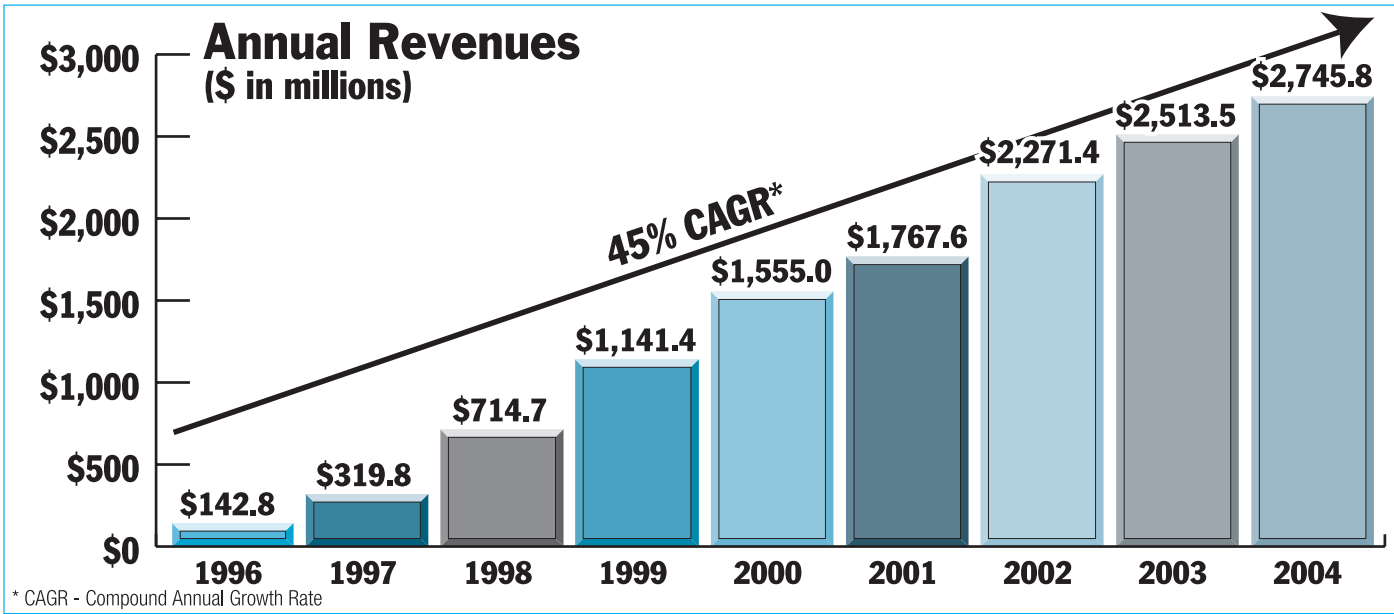
Sincerely,



Sidney B. DeBoer
Chairman and Chief Executive Officer

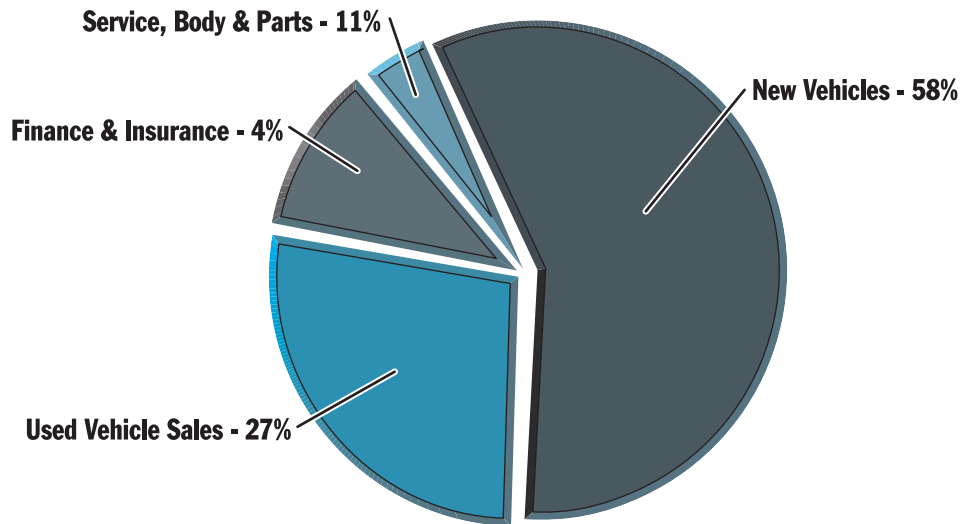


M. L. Dick Heimann
President and Chief Operating Officer



Total Sales Mix

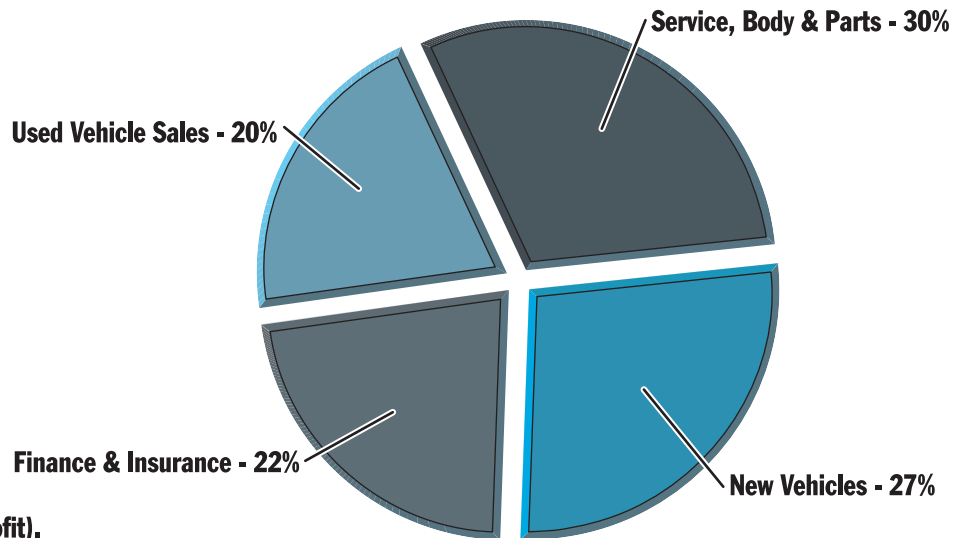
for the Full Year 2004



Excludes fleet sales (0.3% of total sales).

Total Gross Profit Mix

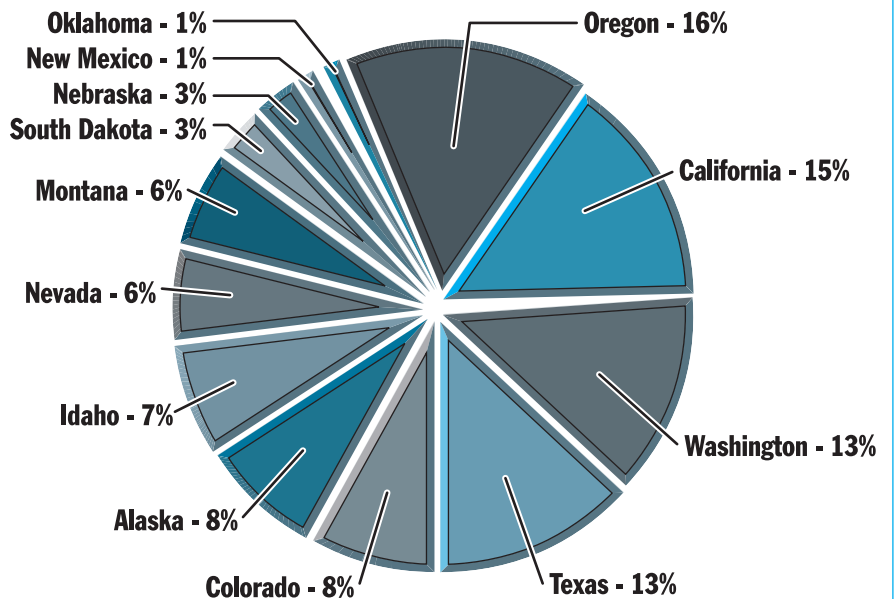
the Full Year 2004



Excludes fleet sales (0.3% of gross profit).
May not total 100% due to rounding.

Regional Revenue

Percent Share of Revenues By Region for the Full Year 2004



UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D. C. 20549
FORM 10-K

- ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE
SECURITIES EXCHANGE ACT OF 1934**
For the Fiscal Year Ended: December 31, 2004
OR
 **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE
SECURITIES EXCHANGE ACT OF 1934**

Commission File Number: 001-14733

LITHIA MOTORS, INC.
(Exact name of registrant as specified in its charter)

Oregon
(State or other jurisdiction of incorporation
or organization)

93-0572810
(I.R.S. Employer
Identification No.)

360 E. Jackson Street, Medford, Oregon
(Address of principal executive offices)

97501
(Zip Code)

541-776-6899
(Registrant's telephone number including area code)

Securities registered pursuant to Section 12(b) of the Act:
Class A common stock, without par value

Securities registered pursuant to Section 12(g) of the Act: **None**
(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 No

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of Registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K, or any amendment to this Form 10-K.

Indicate by check mark whether the Registrant is an accelerated filer (as defined in Rule 12b-2 of the Act).
Yes No

The aggregate market value of the voting and non-voting common equity held by non-affiliates of the Registrant was \$215,949,919, computed by reference to the last sales price (\$24.78) as reported by the New York Stock Exchange for the Registrant's Class A common stock, as of the last business day of the Registrant's most recently completed second fiscal quarter (June 30, 2004).

The number of shares outstanding of the Registrant's common stock as of March 8, 2005 was: Class A: 15,352,102 shares and Class B: 3,762,231 shares.

Documents Incorporated by Reference

The Registrant has incorporated into Part III of Form 10-K, by reference, portions of its Proxy Statement for its 2005 Annual Meeting of Shareholders.

LITHIA MOTORS, INC.
2004 FORM 10-K ANNUAL REPORT
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PART I

Item 1. Business

Forward Looking Statements and Risk Factors

Some of the statements under the sections entitled “Risk Factors,” “Management’s Discussion and Analysis of Financial Condition and Results of Operations” and “Business” and elsewhere in this Form 10-K constitute forward-looking statements. In some cases, you can identify forward-looking statements by terms such as “may,” “will,” “should,” “expect,” “plan,” “intend,” “forecast,” “anticipate,” “believe,” “estimate,” “predict,” “potential,” and “continue” or the negative of these terms or other comparable terminology. The forward-looking statements contained in this Form 10-K involve known and unknown risks, uncertainties and situations that may cause our actual results, level of activity, performance or achievements to be materially different from any future results, levels of activity, performance or achievements expressed or implied by these statements. Some of the important factors that could cause actual results to differ from our expectations are discussed in Exhibit 99.1 to this Form 10-K.

Although we believe that the expectations reflected in the forward-looking statements are reasonable, we cannot guarantee future results, levels of activity, performance or achievements. You should not place undue reliance on these forward-looking statements.

Where You Can Find More Information

We file annual, quarterly and special reports, proxy statements and other information with the Securities and Exchange Commission (“SEC”) under the Securities Exchange Act of 1934 as amended (the “Exchange Act”). You can inspect and copy our reports, proxy statements, and other information filed with the SEC at the offices of the SEC’s Public Reference Room in Washington, D.C. Please call the SEC at 1-800-SEC-0330 for further information on the Public Reference Room. The SEC maintains an Internet site at <http://www.sec.gov/> where you can obtain most of our SEC filings. We also make available, free of charge on our website at www.lithia.com, our annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and amendments to those reports filed or furnished pursuant to Section 13(a) or 15(d) of the Exchange Act as soon as reasonably practicable after they are filed electronically with the SEC. The information found on our website is not part of this Form 10-K. You can also obtain copies of these reports by contacting Investor Relations at 541-776-6591.

Compliance with Section 303A of the NYSE Listed Company Manual

We confirm that we submitted a Section 12(a) CEO certification to the NYSE in 2004. We also confirm that we filed with the SEC the Chief Executive Officer and Chief Financial Officer certifications required under Section 302 of the Sarbanes-Oxley Act in 2003.

Overview

We are a leading operator of automotive franchises and retailer of new and used vehicles and services. As of March 10, 2005, we offered 25 brands of new vehicles through 172 franchises in 87 stores in the Western United States and over the Internet. As of March 10, 2005, we operated 16 stores in Oregon, 11 in California, 11 in Washington, 9 in Texas, 7 in Idaho, 7 in Colorado, 7 in Alaska, 6 in Nevada, 6 in Montana, 2 in South Dakota, 3 in Nebraska, 1 in Oklahoma and 1 in New Mexico. We sell new and used cars and light trucks; sell replacement parts; provide vehicle maintenance, warranty, paint and repair services; and arrange related financing, service contracts, protection products and credit insurance for our automotive customers.

We achieve gross margins above industry averages by selling a higher ratio of retail used vehicles to new vehicles and by arranging finance and extended warranty contracts for a greater percentage of our customers. In 2004, we achieved a gross margin of 16.8%.

We were founded in 1946 and incorporated in 1968. Our two senior executives have managed the company for more than 30 years. Since our initial public offering in 1996, we have grown from 5 to 87 stores, primarily through an aggressive acquisition program, increasing annual revenues from \$143 million in 1996 to \$2.7 billion in 2004. In addition, since our initial public offering through December 31, 2004, we have achieved compound annual growth rates of 45% per year for revenues, 42% per year for net income and 20% per year for earnings per share, together with a 3.1% average annual same store sales increase.

The Industry

At approximately \$1.0 trillion in annual sales, automotive retailing is the largest retail trade sector in the United States and comprises roughly 10% of the GDP. The industry is highly fragmented with the 100 largest automotive retailers generating approximately 16% of total industry revenues in 2003. The number of franchised stores in the U.S. has declined in the last 20 years from approximately 25,000 stores in 1983 to approximately 21,650 in 2003. In addition to these new vehicle outlets, used vehicles are sold by approximately 53,000 independent used vehicle dealers and through casual (person to person) transactions. New vehicles can only be sold through automotive retail stores franchised by auto manufacturers. These franchise stores have designated trade territories under state franchise law protection, which limits the number of new stores that can be opened in any given area.

Consolidation is expected to continue as many smaller automotive retailers are now considering selling or joining forces with larger retailer groups, given the large capital requirements necessary to operate in today's retail environment. With many owners reaching retirement age, often without clear succession plans, larger, well-capitalized automotive retailers provide an attractive exit strategy. We believe these factors provide an attractive environment for continuing consolidation.

Unlike many other retailing segments, automotive manufacturers provide unparalleled support to the automotive retailer. Manufacturers often bear the burden of markdown risks on slow-moving inventory as they provide aggressive dealer and customer incentives to clear aged inventory in order to free the inventory pipeline for new purchases. In addition, an automotive retailer's cash investment in inventory is relatively small, given floorplan financing from manufacturers. Furthermore, manufacturers provide low-cost financing for working capital and acquisitions and credit to consumers to finance vehicle purchases, as well as pay retail prices to their dealers for servicing vehicles under manufacturers' warranties.

Sales in the automotive sector are affected by general economic conditions including rates of employment, income growth, interest rates and general consumer sentiment.

New vehicle sales usually decline during a weak economy; however, the higher margin service and parts business typically benefits in the same environment because consumers tend to keep their vehicles longer. Strong sales of new vehicles in recent years have provided a population of vehicles for future service and parts revenues. Automotive retailers benefit from their designation as an exclusive warranty and recall service provider of a manufacturer. For the typical manufacturer's warranty, this provides an automotive retailer with a period of at least 3 years of repeat business for service covered by warranty. Extended warranties can add two or more years to this repeat servicing period.

Profitability amongst automotive retailers can vary and depends in part on product mix, effective management of inventory, marketing, quality control and responsiveness to customers. In 2003, new vehicles accounted for an estimated 59.9% of industry revenues. The remaining 40.1% of revenues

were derived from used vehicles sales of 28.3% and service and parts sales of 11.8%. Finance and insurance sales are included in the new and used vehicle sales numbers. Industry gross margins on new vehicles were 5.4% in 2003.

Automotive retailers have much lower fixed overhead costs than automobile manufacturers and parts suppliers. Variable and discretionary costs, such as sales commissions and personnel, advertising and inventory finance expenses, can be adjusted to match new vehicle sales. Variable and discretionary costs account for an estimated 60-65% of the industry's total expenses. Moreover, an automotive retailer can enhance its profitability from sales of higher margin products and services. Gross margins for the parts and service business are significantly higher at approximately 46%, given the labor-intensive nature of the product category. Gross margins for finance and insurance are virtually 100% as they are fee driven income items. These supplemental, high margin products and services provide substantial incremental revenue and net income, decreasing reliance on the highly competitive new vehicle sales.

Store Operations

Each store is its own profit center and is managed by an experienced general manager who has primary responsibility for inventory, advertising, pricing and personnel. In order to provide additional support for improving performance, we make available to each store a team of specialists in new vehicle sales, used vehicle sales, finance and insurance, service and parts, and back-office administration.

The following tables set forth information about our stores as of March 10, 2005:

<u>State</u>	<u>Number of Stores</u>	<u>Number of Franchises</u>	<u>Percent of Total Annualized Revenue</u>
Oregon	16	35	16%
California	11	25	15
Texas	9	19	13
Washington	11	18	12
Colorado	7	14	8
Alaska	7	11	8
Idaho	7	12	7
Nebraska	3	6	6
Nevada	6	10	5
Montana	6	13	5
South Dakota	2	3	3
Oklahoma	1	2	1
New Mexico	1	4	1
Total	<u>87</u>	<u>172</u>	<u>100%</u>

<u>Location</u>	<u>Store</u>	<u>Franchises</u>	<u>Year Opened/ Acquired</u>
CALIFORNIA			
Concord	Lithia Chrysler Jeep Dodge of Concord	Dodge, Dodge Truck, Chrysler, Jeep	1997
Fresno	Lithia Ford of Fresno	Ford	1997
	Lithia Nissan Hyundai of Fresno	Nissan, Hyundai	1998
	Lithia Mazda Suzuki of Fresno	Mazda, Suzuki	1997
Redding	Lithia Chevrolet of Redding	Chevrolet	1998
	Lithia Toyota of Redding	Toyota, Scion	1998
Vacaville	Lithia Toyota of Vacaville	Toyota, Scion	1996
Burlingame	Lithia Chrysler Jeep Dodge of Burlingame	Chrysler, Dodge, Dodge Truck, Jeep	2002
Salinas	Chevrolet of Salinas	Chevrolet	2003
Santa Rosa	Lithia Chrysler Jeep Dodge of Santa Rosa	Chrysler, Dodge, Dodge Truck, Jeep	2003/2004
Fairfield	Lithia Dodge of Fairfield	Dodge, Dodge Truck	2003

<u>Location</u>	<u>Store</u>	<u>Franchises</u>	<u>Year Opened/ Acquired</u>
OREGON			
Eugene	Lithia Chrysler Dodge of Eugene	Dodge, Dodge Truck, Chrysler	1996
	Lithia Nissan of Eugene	Nissan	1998
	Saturn of Eugene	Saturn	2000
Grants Pass	Lithia's Grants Pass Auto Center	Dodge, Dodge Truck, Chrysler, Jeep	Pre-IPO
Klamath Falls	Lithia Klamath Falls Auto Center	Toyota, Scion, Dodge, Dodge Truck, Chrysler, Jeep	1999
Medford	Lithia Chrysler Jeep Dodge	Dodge, Dodge Truck, Chrysler, Jeep	Pre-IPO
	Lithia Honda	Honda	Pre-IPO
	Lithia Nissan	Nissan	1998
	Medford BMW	BMW	1998
	Lithia Toyota	Toyota, Scion	Pre-IPO
	Lithia Volkswagen	Volkswagen	Pre-IPO
	Saturn of Southwest Oregon	Saturn	Pre-IPO
Oregon City (Portland)	Lithia Subaru of Oregon City	Subaru	2002
Roseburg	Lithia Ford Lincoln Mercury of Roseburg	Ford, Lincoln, Mercury	1999
	Lithia Chrysler Jeep Dodge of Roseburg	Dodge, Dodge Truck, Chrysler, Jeep	1999
Springfield (Eugene)	Lithia Toyota of Springfield	Toyota, Scion	1998
COLORADO			
Aurora (Denver)	Lithia Dodge of Cherry Creek	Dodge, Dodge Truck	1999
	Lithia Colorado Chrysler Jeep	Chrysler, Jeep	1999
Colorado Springs	Lithia Colorado Springs Jeep Chrysler	Jeep, Chrysler	1999
Englewood (Denver)	Lithia Centennial Chrysler Jeep	Chrysler, Jeep	1999
Fort Collins	Lithia Chrysler of Fort Collins	Dodge, Dodge Truck, Chrysler, Jeep	1999
	Lithia Hyundai of Fort Collins	Hyundai	1999
Thornton (Denver)	Lithia Volkswagen of Thornton	Volkswagen	2002
WASHINGTON			
Bellevue (Seattle)	Chevrolet Hummer of Bellevue	Chevrolet Hummer	2001 2002
Issaquah (Seattle)	Chevrolet of Issaquah	Chevrolet	2001
Kennewick	Honda of Tri-Cities	Honda	2000
	Lithia Dodge of Tri-Cities	Dodge, Dodge Truck	1999
Renton	Lithia Chrysler Jeep Dodge of Renton	Chrysler, Jeep, Dodge, Dodge Truck	2000
	Lithia Hyundai of Renton	Hyundai	2002
Richland	Lithia Ford of Tri-Cities	Ford	2000
Seattle	BMW Seattle	BMW	2001
Spokane	Lithia Camp Chevrolet	Chevrolet, Cadillac	1998
	Lithia Camp Imports	Subaru, BMW	1998
	Mercedes-Benz of Spokane	Mercedes	2003
IDAHO			
Boise	Lithia Ford of Boise	Ford	2000
	Chevrolet of Boise	Chevrolet	1999
	Lithia Lincoln-Mercury of Boise	Lincoln, Mercury	1999
Caldwell	Chevrolet of Caldwell	Chevrolet	2001
Pocatello	Honda of Pocatello	Honda	2001
	Lithia Chrysler Dodge Hyundai of Pocatello	Chrysler, Dodge, Dodge Truck, Hyundai	2001
Twin Falls	Chevrolet Cadillac of Twin Falls	Chevrolet, Cadillac	2003
NEVADA			
Reno	Lithia L/M/Audi Isuzu of Reno	Audi, Lincoln, Mercury, Isuzu	1997
	Lithia Hyundai of Reno	Hyundai	1997
	Lithia Reno Subaru	Subaru	1999
	Lithia Volkswagen of Reno	Volkswagen	1998
	Lithia Chrysler Jeep of Reno	Chrysler, Jeep	2004
Sparks	Lithia Sparks (satellite of Lithia Reno)	Suzuki, Lincoln, Mercury, Isuzu	1997

<u>Location</u>	<u>Store</u>	<u>Franchises</u>	<u>Year Opened/ Acquired</u>
SOUTH DAKOTA			
Sioux Falls	Chevrolet of Sioux Falls Lithia Dodge of Sioux Falls	Chevrolet Dodge, Dodge Truck	2000 2001
ALASKA			
Anchorage	Lithia Chrysler Jeep of Anchorage Lithia Dodge of South Anchorage Lithia Hyundai of Anchorage Chevrolet of South Anchorage BMW of Anchorage	Chrysler, Jeep Dodge, Dodge Truck Hyundai Chevrolet, Saab BMW	2001 2001 2003 2004 2004
Fairbanks	Chevrolet Cadillac of Fairbanks	Chevrolet, Cadillac	2003
Wasilla	Chevrolet of Wasilla	Chevrolet	2004
TEXAS			
San Angelo	All American Chrysler Jeep Dodge of San Angelo Honda of San Angelo All American Chevrolet of San Angelo	Dodge, Dodge Truck, Jeep, Chrysler Honda Chevrolet	2002 2002 2002
Odessa	All American Chrysler Jeep Dodge of Odessa All American Chevrolet of Odessa Lithia Toyota of Odessa	Dodge, Dodge Truck, Jeep, Chrysler Chevrolet Toyota, Scion	2002 2002 2004
Midland	All American Dodge-Hyundai of Midland All American Chevrolet of Midland	Dodge, Dodge Truck, Hyundai Chevrolet	2002 2002
Grapevine	Lithia Dodge of Grapevine	Dodge, Dodge Truck	2003
NEBRASKA			
Omaha	Lithia Ford of Omaha Mercedes-Benz of Omaha Lithia Chrysler Jeep Dodge of Omaha	Ford Mercedes Chrysler, Jeep, Dodge, Dodge Truck	2002 2002 2005
MONTANA			
Missoula	Lithia Auto Center of Missoula	Chrysler, Dodge, Dodge Truck	2003
Billings	Lithia Dodge of Billings	Dodge, Dodge Truck	2003
Helena	Chevrolet of Helena Lithia Chrysler Dodge of Helena	Chevrolet Chrysler, Dodge, Dodge Truck	2004 2004
Great Falls	Lithia Chrysler Jeep Dodge of Great Falls Honda of Great Falls	Dodge, Dodge Truck, Jeep Honda	2004 2004
OKLAHOMA			
Broken Arrow	Lithia Dodge of Broken Arrow	Dodge, Dodge Truck	2003
NEW MEXICO			
Santa Fe	Lithia Chrysler Jeep Dodge of Santa Fe	Chrysler, Jeep, Dodge, Dodge Truck	2004

New Vehicle Sales

In 2004, we sold 25 domestic and imported brands ranging from economy to luxury cars, sport utility vehicles, minivans and light trucks.

Manufacturer	Percent of Total Revenue	Percent of New Vehicle Sales in 2004
DaimlerChrysler (Chrysler, Dodge, Jeep, Dodge Trucks)	22.7%	39.6%
General Motors (Chevrolet, Saturn, Cadillac, Hummer)	14.0	24.1
Ford (Ford, Lincoln, Mercury)	4.9	8.5
Toyota, Scion	4.4	7.6
BMW	2.1	3.6
Hyundai	1.8	3.1
Nissan	1.8	3.0
Honda	1.7	2.9
Subaru	1.5	2.5
Volkswagen, Audi	1.4	2.4
Mercedes	0.7	1.3
Mazda	0.5	0.8
Suzuki	0.3	0.5
Isuzu	0.1	0.1
Volvo	*	*
Saab	*	*
	<u>57.9%</u>	<u>100.0%</u>

* Less than 0.1%

Our unit and dollar sales of new vehicles from continuing operations were as follows:

	Year Ended December 31,				
	2004	2003	2002	2001	2000
New vehicle units.....	56,529	53,804	46,929	37,190	34,349
New vehicle sales (in thousands).....	\$1,589,613	\$1,441,000	\$1,218,364	\$926,981	\$833,107
Average selling price.....	\$28,120	\$26,782	\$25,962	\$24,926	\$24,254

We purchase our new car inventory directly from manufacturers, who allocate new vehicles to stores based on the number of vehicles sold by the store on a monthly basis and by the store's market area. Accordingly, we rely on the manufacturers to provide us with vehicles that consumers desire and to supply us with such vehicles at suitable locations, quantities and prices. However, high demand vehicles often are in short supply. We attempt to exchange vehicles with other automotive retailers to accommodate customer demand and to balance inventory.

We post the manufacturer's suggested retail price (MSRP) on every vehicle, as required by law. We negotiate the final sales price of a new vehicle individually with the customer. We sell many of our higher volume vehicles under our "Promo Price" program. This program markets vehicles at an affordable price that is less than MSRP.

Used Vehicle Sales

At each new vehicle store, we also sell used vehicles. Used vehicle sales are an important part of our overall profitability. In 2004, retail used vehicle sales generated a gross margin of 14.3% compared with a gross margin of 7.8% for new vehicle sales. To enhance our sales efforts, we employ a used vehicle manager at each location.

Since the beginning of 2002, the used vehicle market has been negatively impacted by strong competition from the new vehicle market, with heavy manufacturer incentives in the form of cash rebates and low interest financing. This trend continued throughout most of 2004. Towards the end

of 2004, there were signs of an improvement in the pricing side of the used vehicle market as a result of decreased supply. Early indications are that this trend will continue into 2005.

We have implemented new procedures in the used vehicle business to help offset recent negative trends as follows:

- We have begun conducting our own local used vehicle auctions in select markets and managing the disposal of used vehicles at larger auctions. We no longer allow individual stores to dispose of their excess inventories on their own. The process is centralized and controlled at the management level.
- We have a “Used Vehicle Promo Pricing” strategy, which markets vehicles with a \$99 down payment and then groups vehicles by payment level. Vehicles are marked with clear and understandable pricing, which reduces haggling and speeds up the sale process. This strategy resolves the three biggest issues of price, down payment and monthly payment for our customers and our sales personnel in a simple way.

Our used vehicle operations give us an opportunity to:

- generate sales to customers financially unable or unwilling to purchase a new vehicle;
- increase new and used vehicle sales by aggressively pursuing customer trade-ins; and
- increase service contract sales and provide financing to used vehicle purchasers.

In 2004, we sold approximately 74 retail used vehicles for every 100 new vehicles sold.

In addition to selling late model used cars, as do other new vehicle dealers, our stores emphasize sales of used vehicles three to ten years old. These vehicles sell for lower prices, but normally generate greater margins. We believe that selling a larger number of used vehicles makes us less susceptible to the effects of changes in the volume of new vehicle sales that result from economic conditions.

We acquire most of our used vehicles through customer trade-ins, but we also buy them at “closed” auctions, attended only by new vehicle automotive retailers with franchises for the brands offered. These auctions offer off-lease, rental and fleet vehicles. We also buy used vehicles at “open” auctions of repossessed vehicles and vehicles being sold by other automotive retailers.

In addition to selling used vehicles to retail customers, we wholesale to other automotive retailers and to other wholesalers used vehicles in poor condition and vehicles that have not sold promptly.

Our used vehicle sales from continuing operations were as follows:

	Year Ended December 31,				
	<u>2004</u>	<u>2003</u>	<u>2002</u>	<u>2001</u>	<u>2000</u>
Retail used vehicle units.....	41,802	41,451	40,781	35,845	29,866
Retail used vehicle sales (in thousands).....	\$630,910	\$603,096	\$594,256	\$480,848	\$392,017
Average selling price.....	\$15,093	\$14,550	\$14,572	\$13,415	\$13,126
Wholesale used vehicle units	23,137	25,982	24,475	18,081	15,967
Wholesale used vehicle sales (in thousands).....	\$124,912	\$122,451	\$121,504	\$83,201	\$70,055
Average selling price.....	\$5,399	\$4,713	\$4,964	\$4,602	\$4,387
Total used vehicle units	64,939	67,433	65,256	53,926	45,833
Total used vehicle sales (in thousands).....	\$755,822	\$725,547	\$715,760	\$564,049	\$462,072
Average selling price.....	\$11,639	\$10,760	\$10,968	\$10,460	\$10,082

Vehicle Financing, Extended Warranty and Insurance

We believe that arranging financing is critical to our ability to sell vehicles and related products and services. We provide a variety of financing and leasing alternatives to meet customer needs. Offering customer financing on a “same day” basis gives us an advantage, particularly over smaller competitors who do not generate enough sales to attract our breadth of finance sources.

Because of greater profit margins from sales of finance and insurance products, we try to arrange financing for every vehicle we sell. Our finance and insurance managers possess extensive knowledge of available financing alternatives and receive training in determining each customer’s financing needs so that the customer can purchase or lease a vehicle. The finance and insurance managers work closely with financing sources to quickly determine a customer’s credit status and to confirm the type and amount of financing available to each customer.

In 2004, we had finance and insurance penetration for 81% of our new vehicle sales and 72% of our retail used vehicle sales. Our average finance and insurance revenue per retail vehicle totaled \$1,031 in 2004.

We earn a portion of the financing charge by discounting each finance contract we write and subsequently sell to a lender. In 2004, many automobile manufacturers continued to offer zero percent financing as sales incentives to new vehicle purchasers. Zero percent financing reduces, but does not eliminate, our per unit fee income from arranging financing, as we receive a fixed payment from the manufacturers in connection with such financing. Many customers do not qualify for zero percent financing, either because of their credit standing or because they require longer financing terms than offered for zero percent financing. Incentive financing programs, including zero percent programs, usually offer cash rebates as an alternative to reduced interest rates. A majority of eligible customers elect to receive cash rebates instead of incentive financing, usually using the cash rebate as a down payment to complete the purchase of a new vehicle with little or no cash out of pocket. We have been able to increase finance and insurance revenue per vehicle, despite zero percent financing, due to higher penetration of other finance and insurance products.

We usually arrange financing for customers by selling the contracts to outside sources on a non-recourse basis to avoid the risk of default. During 2004, we directly financed less than 0.01% of our vehicle sales.

Our finance and insurance managers also market third-party extended warranty contracts and insurance contracts to our new and used vehicle buyers. These products and services yield higher profit margins than vehicle sales and contribute significantly to our profitability. Extended warranty contracts provide additional coverage for new vehicles beyond the duration or scope of the manufacturer’s warranty. The service contracts we sell to used vehicle buyers provide coverage for certain major repairs.

We also offer our customers third party credit life and health and accident insurance when they finance an automobile purchase. We receive a commission on each policy sold. We also offer other products, such as protective coatings and automobile alarms.

Service, Body and Parts

Our automotive service, body and parts operations are an integral part of establishing customer loyalty and contribute significantly to our overall revenue and profits. We provide parts and service primarily for the new vehicle brands sold by our stores, but we also service other vehicles. In 2004, our service, body and parts operations generated \$290.4 million in revenues, or 10.6% of total revenues. We set prices to reflect the difficulty of the types of repair and the cost and availability of parts.

The service, body and parts businesses provide important repeat revenues to the stores. We market our parts and service products by notifying the owners of vehicles when their vehicles are due for periodic service. This encourages preventive maintenance rather than post-breakdown repairs. We offer a lifetime oil and filter service, which, in 2004, was purchased by 36% of our new and used vehicle buyers. This service helps us retain customers, and provides opportunities for repeat parts and service business. Revenues from the service, body and parts departments are important during economic downturns as owners tend to repair their existing used vehicles rather than buy new vehicles during such periods. This limits the effects of a drop in new vehicle sales that may occur in a slow economic environment.

We operate eighteen collision repair centers: four in Texas, three in Oregon and two each in Idaho, South Dakota and Alaska and one each in Washington, Montana, Colorado, Nevada, and Nebraska.

Marketing

We market ourselves as “America’s Car & Truck Store” and as “Driving America.” We use most types of advertising, including television, newspaper, radio, direct mail, and an Internet web site. Advertising expense, net of manufacturer credits, was \$18.3 million during 2004, with 40% of the total amount used for print media, 17% for television, 13% for radio, 11% for Internet and 19% for direct mail and other sources. We advertise to develop our image as a reputable automotive retailer, offering quality service, affordable automobiles and financing for all buyers. The automobile manufacturers pay for many of our advertising and marketing expenditures. The manufacturers also provide us with market research, which assists us in developing our own advertising and marketing campaigns. In addition, our stores advertise discounts or other promotions to attract customers. By owning a cluster of stores in a particular market, we save money from volume discounts and other media concessions. We also participate as a member of advertising cooperatives and associations, whose members pool their resources and expertise with manufacturers to develop advertising campaigns.

We maintain a web site (www.lithia.com) that generates leads and provides information for our customers. We use the Internet site as a marketing tool to familiarize customers with us, our stores and the products we sell, rather than to complete purchases. Although many customers use the Internet to research information about new vehicles, nearly all ultimately visit a store to complete the sale and take delivery of the vehicle. Our web site enables a customer to:

- locate our stores and identify the new vehicle brands sold at each store;
- view new and used vehicle inventory;
- schedule service appointments;
- view Kelley Blue Book values;
- visit our investor relations site; and
- view employment opportunities.

We emphasize customer satisfaction and strive to develop a reputation for quality and fairness. We train our sales personnel to identify an appropriate vehicle for each of our customers at an affordable price.

We believe that our “Driving America” customer-oriented plan differentiates us from other automotive retail stores.

Management Information System

We consolidate, process and maintain financial information, operational and accounting data, and other related statistical information on centralized computers at our headquarters. We have a fully operational intranet with each store directly connected to headquarters. Our systems are based on an ADP platform for the main database, and information is processed and analyzed utilizing customized

financial reporting software from Hyperion Solutions. Senior management can access detailed information from all of our locations regarding:

- inventory;
- cash balances;
- total unit sales and mix of new and used vehicle sales;
- lease and finance transactions;
- sales of ancillary products and services;
- key cost items and profit margins; and
- the relative performance of the stores.

Each store's general manager has access to this same information. With this information, we can quickly analyze the results of operations, identify trends and focus on areas that require attention or improvement. Our management information system also allows our general managers to respond quickly to changes in consumer preferences and purchasing patterns, maximizing our inventory turnover.

Our management information system is particularly important to successfully operating new stores. Following each acquisition, we immediately install our management information system at each location. This quickly makes financial, accounting and other operational data easily available throughout the company. With this information, we can more efficiently execute our operating strategy at the new store.

Franchise Agreements

Each of our store subsidiaries signs a franchise (or dealer sales and service) agreement with each manufacturer of the new vehicles it sells.

The typical automobile franchise agreement specifies the locations within a designated market area at which the store may sell vehicles and related products and perform certain approved services. The designation of such areas and the allocation of new vehicles among stores are at the discretion of the manufacturer. Franchise agreements do not guarantee exclusivity within a specified territory, but do have some protection under state laws.

A franchise agreement may impose requirements on the store with respect to:

- the showroom;
- service facilities and equipment;
- inventories of vehicles and parts;
- minimum working capital;
- training of personnel; and
- performance standards for sales volume and customer satisfaction.

Each manufacturer closely monitors compliance with these requirements and requires each store to submit monthly and annual financial statements. Franchise agreements also grant a store the right to use and display manufacturers' trademarks, service marks and designs in the manner approved by each manufacturer.

Most franchise agreements are generally renewed after one to five years, and, in practice, have indefinite lives. Some franchise agreements, including those with DaimlerChrysler, have no termination date. Historically, all of our agreements have been renewed and we expect that manufacturers will continue to renew them in the future. In addition, state franchise laws limit the ability of manufacturers to terminate or fail to renew automotive franchises. Each franchise agreement authorizes at least one person to manage the store's operations.

The typical franchise agreement provides for early termination or non-renewal by the manufacturer upon:

- a change of management or ownership without manufacturer consent;
- insolvency or bankruptcy of the dealer;
- death or incapacity of the dealer/manager;
- conviction of a dealer/manager or owner of certain crimes;
- misrepresentation of certain information by the store, dealer/manager or owner to the manufacturer;
- failure to adequately operate the store;
- failure to maintain any license, permit or authorization required for the conduct of business; or
- poor sales performance or low customer satisfaction index scores.

We sign master framework agreements with most manufacturers that impose additional requirements on our stores. See Exhibit 99.1 “Risk Factors” for further details.

Competition

The retail automotive business is highly competitive, consisting of a large number of independent operators, many of whom are individuals, families and small retail groups. We compete primarily with other automotive retailers, both publicly and privately-held, near our store locations. In addition, regional and national car rental companies operate retail used car lots to dispose of their used rental cars.

Vehicle manufacturers have designated specific marketing and sales areas within which only one dealer of a vehicle brand may operate. In addition, our franchise agreements typically limit our ability to acquire multiple dealerships of a given brand within a particular market area. Certain state franchise laws also restrict us from relocating our dealerships or establishing new dealerships of a particular brand within any area that is served by another dealer with the same brand. Accordingly, to the extent that a market has multiple dealers of a particular brand, as many of our key markets do, we are subject to significant intra-brand competition.

We are larger and have more financial resources than most private automotive retailers with which we currently compete in most of our regional markets. We compete directly with retailers like ourselves in our metropolitan markets like Denver, Colorado, Seattle, Washington and Concord, California. As we enter other markets, we may face competitors that are larger or have access to greater financial resources. We do not have any cost advantage in purchasing new vehicles from manufacturers. We rely on advertising and merchandising, sales expertise, service reputation and location of our stores to sell new vehicles.

In addition to competition for the sale of vehicles, we expect increased competition for the acquisition of other stores. With respect to each brand of vehicles we market, we have faced only limited competition with respect to our acquisitions to date, primarily from privately-held automotive retailers. Other publicly-owned automotive retailers with significant capital resources may enter our current and targeted market areas in the future.

Regulation

Our business is subject to extensive regulation, supervision and licensing under federal, state and local laws, ordinances and regulations. State and federal regulatory agencies, such as the Department of Motor Vehicles, the Occupational Safety and Health Administration, the EEOC (Equal Employment Opportunity Commission) and the U.S. Environmental Protection Agency, have jurisdiction over the operation of our stores, service centers, collision repair shops and other operations. They regulate matters such as consumer protection, workers’ safety and air and water quality.

Laws also protect franchised automotive retailers from the unequal bargaining power held by the manufacturers. Under those laws, a manufacturer may not:

- terminate or fail to renew a franchise without good cause; or
- prevent any reasonable changes in the capital structure or financing of a store.

Manufacturers may object to a sale of a store or change of management based on character, financial ability or business experience of the proposed new operator.

Automotive retailers and manufacturers are also subject to laws to protect consumers, including so-called "Lemon Laws." Most "Lemon Laws" require a manufacturer to replace a new vehicle or accept it for a full refund within a set time period after initial purchase if:

- the vehicle does not conform to the manufacturer's express warranties; and
- the automotive retailer or manufacturer, after a reasonable number of attempts, is unable to correct or repair a defect.

We must provide written disclosures on new vehicles of mileage and pricing information. Financing and insurance activities are subject to credit reporting, debt collection, truth-in-lending and insurance industry regulation.

Our business, particularly parts, service and collision repair operations, involves hazardous or toxic substances or wastes, such as motor oil, waste motor oil and filters, transmission fluid, antifreeze, Freon, waste paint and lacquer thinner, batteries, solvents, lubricants, degreasing agents, gasoline and diesel fuels. Federal, state and local authorities establishing health and environmental quality standards regulate the handling, storage, treatment, recycling and disposal of hazardous substances and wastes and remediation of contaminated sites, both at our facilities and at sites to which we send hazardous or toxic substances or wastes for treatment, recycling or disposal. We are aware of limited contamination at certain of our current and former facilities, and we are in the process of conducting investigations and/or remediation at some of these properties. Based on our current information, any costs or liabilities relating to such contamination, other environmental matters or compliance with environmental regulations are not expected to have a material adverse effect on our results of operations or financial condition. There can be no assurances, however, that (i) additional environmental matters will not arise or that new conditions or facts will not develop in the future at our current or formerly owned or operated facilities, or at sites that we may acquire in the future, or that (ii) these matters, conditions or facts will not result in a material adverse effect on our results of operations or financial condition.

Employees

As of December 31, 2004, we employed approximately 5,187 persons on a full-time equivalent basis. Employees in the service and parts department at our Dodge store in Concord, California are represented by a union collective bargaining agreement. We believe we have good relationships with our employees.

Item 2. Properties

Our stores and other facilities consist primarily of automobile showrooms, display lots, service facilities, eighteen collision repair and paint shops, rental agencies, supply facilities, automobile storage lots, parking lots and offices. We believe our facilities are currently adequate for our needs and are in good repair. We own some of our properties, but also lease many properties, providing future flexibility to relocate our retail stores as demographics change. Most leases give us the option to renew the lease for one or more lease extension periods. We also hold some undeveloped land for future expansion.

Item 3. Legal Proceedings

We are party to numerous legal proceedings arising in the normal course of our business. While we cannot predict with certainty the outcomes of these matters, we do not anticipate that the resolution of these proceedings will have a material adverse effect on our business, results of operations, financial condition, or cash flows.

On April 28, 2004, a lawsuit was filed against us in the United States District Court for the District of Oregon: Robert Allen, et al., vs. Lithia Motors, Inc., et al., Civil Case No. 04-03032-CO. The complaint seeks money damages from us for alleged federal and state RICO violations, violation of Oregon's Unlawful Trade Practices Act and fraud, with respect to arranging the financing of vehicles. Each of the 23 Allen plaintiffs seeks stated actual damages ranging from \$733 to \$20,859, damages for mental distress ranging from \$10,000 to \$250,000, and punitive damages of \$1,500,000. With statutory penalties, the Allen plaintiffs seek actual damages that total less than \$250,000, trebled, approximately \$3.0 million in mental distress claims and punitive damages of \$34.5 million. Management believes that if damages were assessed, most would be covered by insurance. The case is still in its pleading stage and no depositions or document production has yet occurred. We intend to vigorously defend this matter and management believes that the likelihood of a judgment for the amount of damages sought is remote.

Item 4. Submission of Matters to a Vote of Security Holders

No matters were submitted to a vote of our shareholders during the quarter ended December 31, 2004.

PART II

Item 5. Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities

Our Class A common stock trades on the New York Stock Exchange under the symbol LAD. The following table presents the high and low sale prices for our Class A common stock, as reported on the New York Stock Exchange Composite Tape for each of the quarters in 2003 and 2004:

2004	High	Low
Quarter 1	\$ 30.79	\$ 24.60
Quarter 2	28.86	23.29
Quarter 3	24.93	20.55
Quarter 4	26.95	20.04
2003		
Quarter 1	\$ 16.05	\$ 10.92
Quarter 2	17.35	10.81
Quarter 3	24.20	15.55
Quarter 4	25.95	19.75

The number of shareholders of record and approximate number of beneficial holders of Class A common stock at March 8, 2005 was 1,536 and 3,300, respectively. All shares of Lithia's Class B common stock are held by Lithia Holding Company LLC.

We declared and paid a dividend of \$0.07 per share of Class A and Class B common stock for each of the second, third and fourth quarters of 2003 and the first quarter of 2004, totaling approximately \$1.3 million each quarter. In addition, we declared and paid a dividend of \$0.08 per share of Class A and Class B common stock for each of the second, third and fourth quarters of 2004, totaling approximately \$1.5 million per quarter.

We currently intend to continue paying quarterly dividends similar to those paid in 2004. The payment of any dividends is subject to the discretion of our Board of Directors. Pursuant to our \$150 million credit agreement with DaimlerChrysler Services North America LLC and Toyota Motor Credit Corporation, total dividends and repurchases of our common stock cannot exceed \$18.0 million over

the term of the agreement. To date, over the term of the agreement, we have paid dividends and repurchased stock totaling \$8.4 million. This credit agreement expires May 1, 2007. We did not repurchase any shares of our common stock during the fourth quarter of 2004.

Information regarding securities authorized for issuance under equity compensation plans is included in Item 12.

Item 6. Selected Financial Data

You should read the Selected Financial Data in conjunction with Item 7. "Management's Discussion and Analysis of Financial Condition and Results of Operations," our Consolidated Financial Statements and Notes thereto and other financial information contained elsewhere in this Annual Report on Form 10-K.

(In thousands, except per share amounts)	Year Ended December 31,				
	2004	2003	2002	2001	2000
Consolidated Statement of Operations Data:					
Revenues:					
New vehicle	\$ 1,589,613	\$ 1,441,000	\$ 1,218,364	\$ 926,981	\$ 833,107
Used vehicle	755,822	725,547	715,760	564,049	462,072
Finance and insurance	290,386	251,316	216,382	173,114	149,963
Service, body and parts	101,374	89,982	77,776	62,856	52,394
Fleet and other	8,592	5,657	43,114	40,593	57,491
Total revenues	<u>2,745,787</u>	<u>2,513,502</u>	<u>2,271,396</u>	<u>1,767,593</u>	<u>1,555,027</u>
Cost of sales	<u>2,285,851</u>	<u>2,110,393</u>	<u>1,913,704</u>	<u>1,478,528</u>	<u>1,303,800</u>
Gross profit	459,936	403,109	357,692	289,065	251,227
Selling, general and administrative	349,946	313,289	280,310	224,501	182,591
Depreciation and amortization	13,143	9,593	7,192	8,690	7,125
Income from operations	96,847	80,227	70,190	55,874	61,511
Floorplan interest expense	(16,702)	(13,997)	(10,775)	(13,652)	(16,532)
Other interest expense	(9,174)	(6,081)	(5,985)	(7,546)	(7,629)
Other income (expense), net	(1,520)	(951)	(589)	(298)	803
Income from continuing operations before income taxes	69,451	59,198	52,841	34,378	38,153
Income taxes	(26,878)	(23,561)	(20,480)	(13,270)	(14,690)
Income from continuing operations	42,573	35,637	32,361	21,108	23,463
Income (loss) from discontinued operations, net of tax	98	(90)	(45)	646	850
Net income	<u>\$ 42,671</u>	<u>\$ 35,547</u>	<u>\$ 32,316</u>	<u>\$ 21,754</u>	<u>\$ 24,313</u>
Basic income per share from continuing operations	\$ 2.27	\$ 1.95	\$ 1.88	\$ 1.58	\$ 1.72
Basic income (loss) per share from discontinued operations	0.00	(0.01)	0.00	0.05	0.06
Basic net income per share	<u>\$ 2.27</u>	<u>\$ 1.94</u>	<u>\$ 1.88</u>	<u>\$ 1.63</u>	<u>\$ 1.78</u>
Shares used in basic per share	<u>18,773</u>	<u>18,289</u>	<u>17,233</u>	<u>13,371</u>	<u>13,652</u>
Diluted income per share from continuing operations	\$ 2.12	\$ 1.92	\$ 1.84	\$ 1.55	\$ 1.70
Diluted income per share from discontinued operations	0.01	0.00	0.00	0.05	0.06
Diluted net income per share	<u>\$ 2.13</u>	<u>\$ 1.92</u>	<u>\$ 1.84</u>	<u>\$ 1.60</u>	<u>\$ 1.76</u>
Shares used in diluted per share	<u>20,647</u>	<u>18,546</u>	<u>17,598</u>	<u>13,612</u>	<u>13,804</u>

(In thousands)	As of December 31,				
	2004	2003	2002	2001	2000
Consolidated Balance Sheet Data:					
Working capital	\$ 126,177	\$ 160,066	\$ 126,308	\$ 104,834	\$ 98,917
Inventories	536,653	445,281	445,908	275,398	314,290
Total assets	1,256,904	1,102,782	942,049	662,944	628,003
Flooring notes payable	450,859	435,228	427,635	280,947	314,137
Current maturities of long-term debt	6,565	14,299	4,466	10,203	5,342
Long-term debt, less current maturities	267,310	178,467	104,712	95,830	72,586
Total stockholders' equity	405,946	358,926	319,993	203,497	181,775

Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations

You should read the following discussion in conjunction with Item 1. "Business," our Consolidated Financial Statements and Notes thereto and Exhibit 99.1 "Risk Factors."

Overview

Our auto-retail model is focused on acquiring average performing new vehicle franchised stores and then integrating and improving them. Our goal is to maximize the operations of all four departments of every store we acquire. We have had success with this strategy since our initial public offering in late 1996. While our strategy has not changed over the last eight years, our ability to integrate and improve the stores that we acquire has increased dramatically. We have also developed a better process for identifying acquisition targets that fit our operating model. Our cash position, substantial lines of credit, plus an experienced and well-trained staff are all available to facilitate our continued growth as the opportunities develop.

In keeping with this model, we acquired 10 stores with 21 franchises during 2004 with total estimated annual revenues of approximately \$340 million.

Historically, new vehicle sales have accounted for over half of our total revenues but less than one-third of total gross profit. We use a volume-based strategy for new vehicle sales that was initiated in 2002. This strategy complements the goal of most auto manufacturers, which have continued to offer a high level of cash or other incentives on purchases.

For 2005, we expect that manufacturers will continue to offer incentives on new vehicle sales through a combination of rebates and low interest rate loans to consumers.

Since the beginning of 2002, the used vehicle market has been negatively impacted by strong competition from the new vehicle market, with heavy manufacturer incentives in the form of cash rebates and low interest financing. This trend in weak used vehicle unit demand continued throughout 2004. We have implemented new procedures in the used vehicle business to help offset recent negative trends as follows:

- We have begun conducting our own local used vehicle auctions in select markets and managing the disposal of used vehicles at larger auctions. We no longer allow individual stores to dispose of their excess inventories on their own. The process is centralized and controlled at the management level.
- We utilize a "Used Vehicle Promo Pricing" strategy, which markets vehicles with a \$99 down payment and then groups vehicles by payment level. Vehicles are marked with clear and understandable pricing, which reduces haggling and speeds up the sale process. This strategy resolves the three biggest issues of price, down payment and monthly payment for our customers and our sales personnel in a simple way.

In addition, as a complement to our ongoing used vehicle operation at each store, we use specialists in our support services group to increase the acquisition of used vehicles. We believe that this will help bolster sales volumes in the 3 to 7 year old vehicle range.

Results of Continuing Operations

Certain revenue, gross margin and gross profit information by product line was as follows for 2004, 2003 and 2002:

<u>2004</u>	<u>Percent of Total Revenues</u>	<u>Gross Margin</u>	<u>Percent of Total Gross Profit</u>
New vehicles	57.9%	7.8%	27.0%
Used vehicles	27.5	12.4	20.3
Finance and insurance ⁽¹⁾	3.7	99.6	22.0
Service, body and parts	10.6	48.1	30.4
Fleet and other.....	0.3	14.0	0.3

<u>2003</u>	<u>Percent of Total Revenues</u>	<u>Gross Margin</u>	<u>Percent of Total Gross Profit</u>
New vehicles	57.3%	7.7%	27.4%
Used vehicles	28.9	11.5	20.6
Finance and insurance ⁽¹⁾	3.6	99.7	22.3
Service, body and parts	10.0	47.2	29.4
Fleet and other.....	0.2	19.1	0.3

<u>2002</u>	<u>Percent of Total Revenues</u>	<u>Gross Margin</u>	<u>Percent of Total Gross Profit</u>
New vehicles	53.6%	8.5%	28.9%
Used vehicles	31.6	10.1	20.1
Finance and insurance ⁽¹⁾	3.4	99.4	21.6
Service, body and parts	9.5	48.0	29.1
Fleet and other.....	1.9	2.1	0.3

⁽¹⁾ Reported net of anticipated cancellations.

The following table sets forth selected condensed financial data expressed as a percentage of total revenues for the periods indicated below.

<u>Lithia Motors, Inc.</u> ⁽¹⁾	<u>Year Ended December 31,</u>		
	<u>2004</u>	<u>2003</u>	<u>2002</u>
Revenues:			
New vehicle	57.9%	57.3%	53.6%
Used vehicle	27.5	28.9	31.6
Finance and insurance	3.7	3.6	3.4
Service, body and parts	10.6	10.0	9.5
Fleet and other	0.3	0.2	1.9
Total revenues	100.0%	100.0%	100.0%
Gross profit	16.8	16.0	15.7
Selling, general and administrative expenses	12.7	12.5	12.3
Depreciation and amortization	0.5	0.4	0.3
Income from operations	3.5	3.2	3.1
Floorplan interest expense	0.6	0.6	0.5
Other interest expense	0.3	0.2	0.3
Other expense, net	0.1	0.0	0.0
Income from continuing operations before taxes	2.5	2.4	2.3
Income tax expense	1.0	0.9	0.9
Income from continuing operations	1.6%	1.4%	1.4%

⁽¹⁾ The percentages may not add due to rounding.

The following tables set forth the changes in our operating results from continuing operations in 2004 compared to 2003 and in 2003 compared to 2002:

(In Thousands)	Year Ended December 31,		Increase (Decrease)	% Increase (Decrease)
	2004	2003		
Revenues:				
New vehicle	\$ 1,589,613	\$ 1,441,000	\$ 148,613	10.3%
Used vehicle	755,822	725,547	30,275	4.2
Finance and insurance	101,374	89,982	11,392	12.7
Service, body and parts	290,386	251,316	39,070	15.5
Fleet and other	8,592	5,657	2,935	51.9
Total revenues	2,745,787	2,513,502	232,285	9.2
Cost of sales	2,285,851	2,110,393	175,458	8.3
Gross profit	459,936	403,109	56,827	14.1
Selling, general and administrative	349,946	313,289	36,657	11.7
Depreciation and amortization	13,143	9,593	3,550	37.0
Income from operations	96,847	80,227	16,620	20.7
Floorplan interest expense	(16,702)	(13,997)	2,705	19.3
Other interest expense	(9,174)	(6,081)	3,093	50.9
Other expense, net	(1,520)	(951)	569	59.8
Income from continuing operations before income taxes	69,451	59,198	10,253	17.3
Income tax expense	26,878	23,561	3,317	14.1
Income from continuing operations	\$ 42,573	\$ 35,637	\$ 6,936	19.5%

	Year Ended December 31,		Increase (Decrease)	% Increase (Decrease)
	2004	2003		
New units sold	56,529	53,804	2,725	5.1%
Average selling price per new vehicle	\$ 28,120	\$ 26,782	\$ 1,338	5.0%
Used units sold	64,939	67,433	(2,494)	(3.7)%
Average selling price per used vehicle	\$ 11,639	\$ 10,760	\$ 879	8.2%
Finance and insurance sales per retail unit	\$ 1,031	\$ 945	\$ 86	9.1%

(In thousands)	Year Ended December 31,		Increase (Decrease)	% Increase (Decrease)
	2003	2002		
Revenues:				
New vehicle	\$ 1,441,000	\$ 1,218,364	\$ 222,636	18.3%
Used vehicle	725,547	715,760	9,787	1.4
Finance and insurance	89,982	77,776	12,206	15.7
Service, body and parts	251,316	216,382	34,934	16.1
Fleet and other	5,657	43,114	(37,457)	(86.9)
Total revenues	2,513,502	2,271,396	242,106	10.7
Cost of sales	2,110,393	1,913,704	196,689	10.3
Gross profit	403,109	357,692	45,417	12.7
Selling, general and administrative	313,289	280,310	32,979	11.8
Depreciation and amortization	9,593	7,192	2,401	33.4
Income from operations	80,227	70,190	10,037	14.3
Floorplan interest expense	(13,997)	(10,775)	3,222	29.9
Other interest expense	(6,081)	(5,985)	96	1.6
Other expense, net	(951)	(589)	362	61.5
Income from continuing operations before income taxes	59,198	52,841	6,357	12.0
Income tax expense	23,561	20,480	3,081	15.0
Income from continuing operations	\$ 35,637	\$ 32,361	\$ 3,276	10.1%

	Year Ended December 31,		Increase (Decrease)	% Increase (Decrease)
	2003	2002		
New units sold	53,804	46,929	6,875	14.6%
Average selling price per new vehicle	\$ 26,782	\$ 25,962	\$ 820	3.2%
Used units sold	67,433	65,256	2,177	3.3%
Average selling price per used vehicle	\$ 10,760	\$ 10,968	\$ (208)	(1.9)%
Finance and insurance sales per retail unit	\$ 945	\$ 887	\$ 58	6.5%

Revenues

Total revenues increased 9.2% and 10.7%, respectively, in 2004 compared to 2003 and in 2003 compared to 2002, primarily as a result of acquisitions. In addition, increases in the average new and used vehicle sales prices in 2004 compared to 2003 and in the average new vehicle sales prices in 2003 compared to 2002 contributed to the revenue increases. The 2004 increase was offset by a same-store sales decline of 2.4%, while 2003 had a 1.2% same-store sales increase. Same-store sales percentage increases (decreases) were as follows:

	2004 compared to 2003	2003 compared to 2002
New vehicles	(2.4)%	6.2%
Used vehicles	(5.7)	(8.8)
Finance and insurance	1.9	5.1
Service, body and parts	3.0	0.7
Total sales	(2.4)	1.2

Same-store sales are calculated by dealership comparing only those months that contain full-month operating data.

The automotive retailing industry reported an increase in new vehicle sales of approximately 1.5% in 2004 and a decline of 1.0% in 2003.

Our new vehicle same store sales were down in 2004 because of a slower sales environment in our markets and a difficult comparison from the prior year of up 6.2%. Used vehicle same store sales were negatively affected in both 2004 and 2003 because of continued manufacturer incentives on new vehicles which led to continued weakness in the used vehicle market.

Penetration rates for certain products were as follows:

	2004	2003	2002
Finance and insurance	77%	75%	75%
Service contracts	43	41	40
Lifetime oil change and filter	36	34	30

The improvements in same-store service, body and parts revenue in 2004 compared to 2003 and in 2003 compared to 2002 were a result of our continued focus on service-advisor training and our Lifetime Oil Program. We continue to experience positive same-store sales growth in the customer-pay side of the business. Conversely, improvements in the quality of Chrysler, General Motors, Ford and Toyota vehicles, which comprise approximately 80% of our total new vehicle sales, have resulted in declines in warranty work for these brands. Other brands continue to demonstrate increases in same-store warranty sales.

Fleet and other sales include both fleet sales and fees received for delivering vehicles on behalf of the manufacturer, the U.S. military, rent-a-car companies or leasing companies.

Gross Profit

Gross profit increased \$56.8 million in 2004 compared to 2003 and increased \$45.4 million in 2003 compared to 2002 due primarily to increased total revenues, as well as increases in our overall gross margin. Gross margins achieved were as follows:

	<u>Year Ended December 31,</u>		<u>Lithia Margin Change*</u>
	<u>2004</u>	<u>2003</u>	
New vehicles	7.8%	7.7%	10bp
Retail used vehicles.....	14.3	13.8	50
Wholesale used vehicles	2.9	(0.2)	310
Finance and insurance	99.6	99.7	(10)
Service and parts.....	48.1	47.2	90
Overall	16.8	16.0	80

	<u>Year Ended December 31,</u>		<u>Lithia Margin Change*</u>
	<u>2003</u>	<u>2002</u>	
New vehicles.....	7.7%	8.5%	(80)bp
Retail used vehicles.....	13.8	12.5	130
Wholesale used vehicles	(0.2)	(1.7)	150
Finance and insurance	99.7	99.4	30
Service and parts.....	47.2	48.0	(80)
Overall	16.0	15.7	30

* "bp" stands for basis points (one hundred basis points equals one percent).

The increase in the overall gross profit margin in 2004 compared to 2003 was a result of improvements in the margins achieved on our new and used vehicle businesses as well as on our service and parts business. Additionally, the increase in our high-margin service and parts revenue as a percentage of total revenue also positively affected our gross margins.

Because of the slower new vehicle sales environment in 2004, we implemented internal directives aimed at generating more gross profit per vehicle sold. We were able to achieve improved margins on our new vehicles in 2004 compared to 2003. This compares to a higher volume, lower margin strategy that was in place in 2003.

In 2004, we have been able to improve the margins on our used vehicle sales primarily because of the strategies discussed above regarding the auctioning of undesired used vehicles and our "Used Vehicle Promo Pricing" for our retail sales.

Our focus on service advisor training, which has led to gains in sales of higher margin service items, and cost saving initiatives across all service, parts and body shop business lines has resulted in improved gross margins in this area in 2004 compared to 2003.

Our overall gross margin increased in 2003 compared to 2002 primarily because of increases in margins achieved on used vehicle sales as a result of selling older aged vehicles which carry a higher margin and improved inventory management. The increase in the used vehicle gross margin also contributed to a same store increase in total gross profit dollars per used vehicle sold.

The improvements in our gross margin in 2003 were offset by the following factors:

- A significant shift towards our lowest margin new vehicle business as a result of the strong incentive environment;
- Lower floorplan interest credits from the manufacturers on new vehicles due to lower market rates; and
- Aggressive pricing of new vehicles in order to gain market share, which resulted in lower new vehicle margins.

Selling, General and Administrative Expense

Selling, general and administrative expense includes salaries and related personnel expenses, facility lease expense, advertising (net of manufacturer cooperative advertising credits), legal, accounting, professional services and general corporate expenses. Selling, general and administrative expense increased \$36.7 million in 2004 compared to 2003 and increased \$33.0 million in 2003 compared to 2002. The increases in dollars spent are due to increased selling, or variable, expenses related to the increases in revenues and the number of locations, as well as increases related to compliance with the Sarbanes-Oxley Act of 2002. SG&A as a percentage of sales will increase when the service and parts revenue contribution increases relative to total sales due to its higher SG&A component. Because of this, a better gauge is the trend of SG&A as a percentage of gross profit. SG&A as a percentage of gross profit improved 160 and 70 basis points, respectively, in 2004 compared to 2003 and in 2003 compared to 2002. The increase as a percentage of revenue in 2003 compared to 2002 was also due partially to higher advertising and sales compensation expenses related to our aggressive new vehicle marketing during 2003.

Depreciation and Amortization

Depreciation and amortization increased \$3.6 million and \$2.4 million, respectively, in 2004 compared to 2003 and in 2003 compared to 2002 due to the addition of property and equipment related to our acquisitions, as well as leasehold improvements to existing facilities.

Income from Operations

Operating margins in 2004 improved by 30 basis points to 3.5% compared to 3.2% in 2003 and by 10 basis points in 2003 from 3.1% in 2002. The increases are primarily because of improved overall gross profit margin as discussed above, partially offset by an increase in operating expenses.

Floorplan Interest Expense

The \$2.7 million increase in floorplan interest expense in 2004 compared to 2003 resulted primarily from a \$62.3 million increase in the average outstanding balances of our floorplan facilities, mainly due to acquisitions, and an increase of \$473,000 resulting from our interest rate swaps. In addition an increase in the average interest rates charged on our floorplan facilities increased floorplan interest expense by \$468,000.

The \$3.2 million increase in floorplan interest expense in 2003 compared to 2002 resulted primarily from an approximately \$2.8 million increase in expense as a result of an increase in the average outstanding balances of our floorplan facilities, mainly because of acquisitions. In addition, increased expense from interest rate swaps was responsible for \$1.1 million of the increase. These increases were offset in part by a decrease in the LIBOR and the prime rates in 2003 compared to 2002.

Other Interest Expense

Other interest expense includes interest on our convertible notes, debt incurred related to acquisitions, real estate mortgages, our used vehicle line of credit and equipment related notes.

Other interest expense increased \$3.1 million in 2004 compared to 2003. Changes in the weighted average interest rate on our debt in 2004 compared to 2003 increased other interest expense by approximately \$753,000 and changes in the average outstanding balances resulted in an increase of approximately \$2.3 million. Interest expense related to the \$85.0 million of convertible notes that were issued in May 2004 totals approximately \$764,000 per quarter, which consists of \$611,000 of contractual interest and \$153,000 of amortization of debt issuance costs.

Changes in the weighted average interest rate on our debt in 2003 compared to 2002 decreased other interest expense by \$259,000. Changes in the average outstanding balances in 2003 compared to 2002 resulted in increases to other interest expense of \$355,000.

Income Tax Expense

Our effective tax rate was 38.7% in 2004 compared to 39.8% in 2003 and 38.8% in 2002. Our effective tax rate may be affected in the future by the mix of asset acquisitions compared to corporate acquisitions, as well as by the mix of states where our stores are located.

Income from Continuing Operations

Income from continuing operations as a percentage of revenue increased in 2004 compared to 2003 as a result of improvements in gross margins that were partially offset by increased operating expenses and interest expense as discussed above.

Income from continuing operations as a percentage of revenue remained flat in 2003 compared to 2002 as a result of improvements in gross margins being offset by increased operating expenses.

Discontinued Operations

During 2003, we decided to sell certain stores and related franchises. We recognized a net gain on the sale of one of our stores classified as discontinued operations totaling \$374,000, net of tax, in 2003, which is netted with loss from discontinued operations on our consolidated statement of operations. During the third quarter of 2004, we disposed of one of the franchises included with the store we had held for sale, which resulted in a gain of \$212,000, net of tax. In the fourth quarter of 2004, we disposed of the remaining franchise, which resulted in a loss of \$20,000, net of tax. In addition, in 2004, we recognized losses from operations of the discontinued operations of \$88,000 and a \$6,000 loss from discontinued operations that were disposed of in 2003. At December 31, 2004, we did not have any assets held for sale related to discontinued operations.

We continually monitor the performance of each of our stores and make determinations to sell based on return on capital criteria.

Interest expense is allocated to stores classified in discontinued operations for actual flooring interest expense directly related to the new vehicles in the store. Interest expense related to the used vehicle line of credit is allocated based on total used vehicle inventory of the store, and interest expense related to the equipment line of credit is allocated based on the amount of fixed assets.

Selected Consolidated Quarterly Financial Data

The following tables set forth our unaudited quarterly financial data⁽¹⁾.

	Three Months Ended,			
	March 31	June 30	September 30	December 31
	(in thousands, except per share data)			
2004				
Revenues:				
New vehicle	\$353,601	\$400,217	\$451,005	\$384,790
Used vehicle	189,906	184,186	198,534	183,196
Finance and insurance	23,385	24,744	28,029	25,216
Service, body and parts	69,426	71,753	74,617	74,590
Fleet and other	<u>1,531</u>	<u>1,367</u>	<u>3,708</u>	<u>1,986</u>
Total revenues	637,849	682,267	755,893	669,778
Cost of sales	<u>531,615</u>	<u>566,328</u>	<u>631,327</u>	<u>556,581</u>
Gross profit	106,234	115,939	124,566	113,197
Selling, general and administrative	85,187	88,565	90,362	85,832
Depreciation and amortization	<u>2,954</u>	<u>3,089</u>	<u>3,254</u>	<u>3,846</u>
Income from operations	18,093	24,285	30,950	23,519
Floorplan interest expense	(3,616)	(4,123)	(4,498)	(4,465)
Other interest expense	(1,740)	(2,157)	(2,464)	(2,813)
Other, net	<u>(339)</u>	<u>(358)</u>	<u>(502)</u>	<u>(321)</u>
Income from continuing operations before income taxes	12,398	17,647	23,486	15,920
Income taxes	<u>(4,836)</u>	<u>(6,882)</u>	<u>(9,159)</u>	<u>(6,001)</u>
Income before discontinued operations	7,562	10,765	14,327	9,919
Discontinued operations, net of tax	<u>(83)</u>	<u>75</u>	<u>143</u>	<u>(37)</u>
Net income	<u>\$ 7,479</u>	<u>\$ 10,840</u>	<u>\$ 14,470</u>	<u>\$ 9,882</u>
Basic income per share from continuing operations	\$ 0.41	\$ 0.57	\$ 0.76	\$ 0.52
Basic income (loss) per share from discontinued operations	<u>(0.01)</u>	<u>0.01</u>	<u>0.01</u>	<u>0.00</u>
Basic net income per share	<u>\$ 0.40</u>	<u>\$ 0.58</u>	<u>\$ 0.77</u>	<u>\$ 0.52</u>
Diluted income per share from continuing operations	\$ 0.40	\$ 0.54	\$ 0.69	\$ 0.48
Diluted income (loss) per share from discontinued operations	<u>(0.01)</u>	<u>0.00</u>	<u>0.01</u>	<u>0.00</u>
Diluted net income per share	<u>\$ 0.39</u>	<u>\$ 0.54</u>	<u>\$ 0.70</u>	<u>\$ 0.48</u>

	Three Months Ended,			
	March 31	June 30	September 30	December 31
	(in thousands except per share data)			
2003				
Revenues:				
New vehicle	\$308,494	\$363,845	\$411,358	\$357,303
Used vehicle	172,096	191,092	196,280	166,079
Finance and insurance	20,410	22,478	25,071	22,023
Service, body and parts	56,485	61,032	67,849	65,950
Fleet and other	<u>2,075</u>	<u>1,865</u>	<u>882</u>	<u>835</u>
Total revenues	559,560	640,312	701,440	612,190
Cost of sales	<u>471,073</u>	<u>538,573</u>	<u>588,636</u>	<u>512,111</u>
Gross profit	88,487	101,739	112,804	100,079
Selling, general and administrative	74,229	79,585	83,904	75,571
Depreciation and amortization	<u>2,131</u>	<u>2,254</u>	<u>2,504</u>	<u>2,704</u>
Income from operations	12,127	19,900	26,396	21,804
Floorplan interest expense	(3,546)	(3,672)	(3,324)	(3,455)
Other interest expense	(1,388)	(1,564)	(1,496)	(1,633)
Other, net	<u>(147)</u>	<u>(255)</u>	<u>(243)</u>	<u>(306)</u>
Income from continuing operations before income taxes	7,046	14,409	21,333	16,410
Income taxes	<u>(2,731)</u>	<u>(5,808)</u>	<u>(8,491)</u>	<u>(6,531)</u>
Income before discontinued operations	4,315	8,601	12,842	9,879
Discontinued operations, net of tax	<u>(150)</u>	<u>(82)</u>	<u>39</u>	<u>103</u>
Net income	<u>\$ 4,165</u>	<u>\$ 8,519</u>	<u>\$ 12,881</u>	<u>\$ 9,982</u>
Basic income per share from continuing operations	\$ 0.24	\$ 0.47	\$ 0.70	\$ 0.54
Basic loss per share from discontinued operations	<u>(0.01)</u>	<u>0.00</u>	<u>0.00</u>	<u>0.00</u>
Basic net income per share	<u>\$ 0.23</u>	<u>\$ 0.47</u>	<u>\$ 0.70</u>	<u>\$ 0.54</u>
Diluted income per share from continuing operations	\$ 0.24	\$ 0.47	\$ 0.69	\$ 0.52
Diluted income (loss) per share from discontinued operations	<u>(0.01)</u>	<u>(0.01)</u>	<u>0.00</u>	<u>0.01</u>
Diluted net income per share	<u>\$ 0.23</u>	<u>\$ 0.46</u>	<u>\$ 0.69</u>	<u>\$ 0.53</u>

(1) Quarterly data may not add to yearly totals due to rounding.

Seasonality and Quarterly Fluctuations

Historically, our sales have been lower in the first and fourth quarters of each year due to consumer purchasing patterns during the holiday season, inclement weather in certain of our markets and the reduced number of business days during the holiday season. As a result, financial performance is expected to be lower during the first and fourth quarters than during the other quarters of each fiscal year. We believe that interest rates, levels of consumer debt and consumer confidence, as well as general economic conditions, also contribute to fluctuations in sales and operating results. Acquisitions have also been a contributor to fluctuations in our operating results from quarter to quarter.

Liquidity and Capital Resources

Our principal needs for capital resources are to finance acquisitions and capital expenditures, as well as for working capital. We have relied primarily upon internally generated cash flows from operations, borrowings under our credit agreements and the proceeds from public equity and private debt offerings to finance operations and expansion. In addition, in May 2004, we closed an \$85.0 million private debt offering. We believe that our available cash, cash equivalents, available lines of credit, cash received from our debt offering in May 2004 and cash flows from operations will be sufficient to meet our anticipated operating expenses and capital requirements for at least 24 to 36 months from December 31, 2004.

Our inventories increased to \$536.7 million at December 31, 2004 from \$445.3 million at December 31, 2003 due primarily to acquisitions and our decision to purchase a greater stock of 2005 vehicles in December of 2004. This was a strategic decision designed to strengthen our ties with our manufacturer partners, get a better allocation of popular models and have good inventories going into the spring selling season so we can take advantage of anticipated strong incentives. Our new and used flooring notes payable increased to \$450.9 million at December 31, 2004 from \$435.2 million at December 31, 2003 due to acquisitions and higher new vehicle days supply, partially offset by the use of the proceeds from our \$85.0 million convertible notes to pay down used vehicle flooring. New vehicles are financed at approximately 100% and used vehicles are financed at approximately 80% of cost. Our days supply of new vehicles increased by approximately 12 days at December 31, 2004 compared to December 31, 2003. Our days supply of used vehicles increased by approximately 1 day at December 31, 2004 compared to December 31, 2003. We believe that our new and used vehicle inventories are at appropriate levels at this time.

Assets held for sale of \$135,000 at December 31, 2004 relate to a building held for sale.

As a result of the acquisition of 12 stores in 2004, our goodwill and other intangibles increased \$53.2 million to \$289.2 million at December 31, 2004, compared to \$236.0 million at December 31, 2003. Cash paid for acquisitions, net of cash received, in 2004 was \$79.4 million.

Our Board of Directors declared a dividend on our Class A and Class B common stock of \$0.07 per share for both the fourth quarter of 2003 and the first quarter of 2004, both of which were paid in 2004 and totaled approximately \$1.3 million each. Our Board of Directors also declared a dividend on our Class A and Class B common stock of \$0.08 per share for each of the second, third and fourth quarters of 2004, two of which were paid in 2004 and one in March 2005, and totaled approximately \$1.5 million each. We anticipate recommending to the Board of Directors the approval of a cash dividend each quarter.

In June 2000, our Board of Directors authorized the repurchase of up to 1,000,000 shares of our Class A common stock. Through December 2004, we have purchased a total of 60,000 shares under this program and may continue to do so from time to time in the future as conditions warrant. However, the recent change in the tax law tends to equalize the benefits of dividends and share repurchases as a means to return capital or earnings to shareholders. As a result, we believe it is now advantageous to shareholders to have a dividend in place. With the dividend, we are able to offer an immediate and

tangible return to our shareholders without reducing our already limited market float, which occurs when we repurchase shares.

We have a working capital and used vehicle flooring credit facility with DaimlerChrysler Services North America LLC and Toyota Motor Credit Corporation, as amended in June 2004, totaling up to \$150 million, which expires May 1, 2007 with an option for the lenders to extend to May 1, 2008, with interest due monthly. This credit facility is cross-collateralized and secured by cash and cash equivalents, new and used vehicles on a subordinated basis to the extent not specifically financed by other lenders, parts inventories, accounts receivable, intangible assets and equipment. We pledged to DaimlerChrysler Services and Toyota Motor Credit the stock of all of our dealership subsidiaries except entities operating BMW, Honda, Nissan or Toyota stores.

The financial covenants in our agreement with DaimlerChrysler Services and Toyota Motor Credit require us to maintain compliance with, among other things, (i) a specified current ratio; (ii) a specified fixed charge coverage ratio; (iii) a specified interest coverage ratio; (iv) a specified adjusted leverage ratio; and (v) certain working capital levels. At December 31, 2004, we were in compliance with all of the covenants of this agreement.

Ford Motor Credit, General Motors Acceptance Corporation and Volkswagen Credit have agreed to floor all of our new vehicles for their respective brands with DaimlerChrysler Services North America LLC and Toyota Motor Credit Corporation serving as the primary lenders for substantially all other brands. These new vehicle lines are secured by new vehicle inventory of the relevant brands.

We also have a revolving credit real estate line with Toyota Motor Credit totaling \$40 million, which expires in May 2005. The advances are secured by the real estate financed under this line of credit.

We have a credit facility with U.S. Bank N.A., which provides for a \$50.0 million revolving line of credit for leased vehicles and equipment purchases and expires April 30, 2006. The financial covenants in our agreement with U.S. Bank N.A. require us to maintain compliance with, among other things, (i) a specified current ratio; (ii) a specified fixed charge coverage ratio; (iii) a minimum total net worth; and (iv) a minimum tangible net worth. At December 31, 2004, we were in compliance with all of the covenants of this agreement.

Interest rates on all of the above facilities ranged from 4.05% to 5.15% at December 31, 2004. Amounts outstanding on the lines at December 31, 2004 together with amounts remaining available under such lines were as follows (in thousands):

	<u>Outstanding at December 31, 2004</u>	<u>Remaining Availability as of December 31, 2004</u>
New and program vehicle lines	\$450,859	\$ *
Working capital and used vehicle line	-	150,000
Real estate line	-	40,000
Equipment/leased vehicle line	<u>40,686</u>	<u>9,314</u>
	<u>\$491,545</u>	<u>\$199,314</u>

* There are no formal limits on the new and program vehicle lines with certain lenders.

In May 2004, we sold \$85.0 million of 2.875% senior subordinated convertible notes due 2014 through a Rule 144A offering to qualified institutional buyers. We will also pay contingent interest on the notes during any six-month interest period beginning May 1, 2009, in which the trading price of the notes for a specified period of time equals or exceeds 120% of the principal amount of the notes. Net proceeds from this offering were approximately \$82.5 million and were used to pay down our working capital and used vehicle line and new vehicle flooring notes payable. The notes are convertible into shares of our Class A common stock at a price of \$37.69 per share upon the satisfaction of certain conditions and upon the occurrence of certain events as follows:

- if, prior to May 1, 2009, and during any calendar quarter, the closing sale price of our common stock exceeds 120% of the conversion price for at least 20 trading days in the 30 consecutive trading days ending on the last trading day of the preceding calendar quarter;
- if, after May 1, 2009, the closing sale price of our common stock exceeds 120% of the conversion price;
- if, during the five business day period after any five consecutive trading day period in which the trading price per \$1,000 principal amount of notes for each day of such period was less than 98% of the product of the closing sale price of our common stock and the number of shares issuable upon conversion of \$1,000 principal amount of the notes;
- if the notes have been called for redemption; or
- upon certain specified corporate events.

Any declaration and payment of a dividend in excess of \$0.08 per share per quarter will result in an adjustment in the conversion rate for the notes.

The notes are redeemable at our option beginning May 6, 2009 at the redemption price of 100% of the principal amount plus any accrued interest. The holders of the notes can require us to repurchase all or some of the notes on May 1, 2009 and upon certain events constituting a fundamental change or a termination of trading. A fundamental change is any transaction or event in which all or substantially all of our common stock is exchanged for, converted into, acquired for, or constitutes solely the right to receive, consideration that is not all, or substantially all, common stock that is listed on, or immediately after the transaction or event, will be listed on, a United States national securities exchange. A termination of trading will have occurred if our common stock is not listed for trading on a national securities exchange or the NASDAQ stock market.

We filed a registration statement on Form S-3 with the Securities and Exchange Commission on July 26, 2004 covering the resale of the notes and the common stock issuable upon conversion of the notes. The registration statement was declared effective by the Securities and Exchange Commission in October 2004.

Contractual Payment Obligations

A summary of our contractual commitments and obligations as of December 31, 2004 is as follows (in thousands):

Contractual Obligation	Payments Due By Period				
	Total	2005	2006 and 2007	2008 and 2009	2010 and beyond
Floorplan Notes	\$ 450,859	\$ 450,859	\$ -	\$ -	\$ -
Lines of Credit and Long-Term Debt	273,875	6,565	58,222	59,761	149,327
Interest on Scheduled Debt Payments	63,214	10,345	20,195	13,903	18,771
Capital Commitments	14,662	14,662	-	-	-
Operating Leases	120,359	18,656	33,813	28,520	39,370
	<u>\$ 922,969</u>	<u>\$ 501,087</u>	<u>\$ 112,230</u>	<u>\$ 102,184</u>	<u>\$ 207,468</u>

Our capital commitments of \$14.7 million at December 31, 2004 were for the construction of five new facilities, additions to three existing facilities and the remodel of one facility. The new facilities will be for our Chevrolet dealership in Fairbanks, Alaska, our Toyota dealership in Springfield, Oregon, our Chevrolet and Hyundai dealerships in Odessa, Texas and a body shop also in Odessa, Texas. We have already incurred \$11.5 million for these projects and anticipate incurring the remaining \$14.7 million in 2005. We expect to pay for the construction out of existing cash balances until completion of the projects, at which time we anticipate securing long-term financing and general borrowings from third party lenders for 70% to 90% of the amounts expended.

In addition, we have recorded a reserve for our estimated contractual obligations related to potential charge-backs for vehicle service contracts, lifetime oil change contracts and other various insurance contracts that are terminated early by the customer. At December 31, 2004, this reserve totaled \$11.8 million. Based on past experience, we estimate that the \$11.8 million will be paid out as follows: \$6.9 million in 2005; \$3.2 million in 2006; \$1.2 million in 2007; \$0.4 million in 2008; and \$0.1 million thereafter.

Critical Accounting Policies and Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires us to make certain estimates, judgments and assumptions that affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities and reported amounts of revenues and expenses at the date of the financial statements. Some of our accounting policies require us to make difficult and subjective judgments on matters that are inherently uncertain. The following accounting policies involve critical accounting estimates because they are particularly dependent on assumptions made by management. While we have made our best estimates based on facts and circumstances available to us at the time, different estimates could have been used in the current period. Changes in the accounting estimates we used are reasonably likely to occur from period to period, which may have a material impact on the presentation of our financial condition and results of operations.

Our most critical accounting estimates include service contract and lifetime oil contract income recognition, finance fee income recognition, workers' compensation insurance premium accrual, executive bonus accrual, assessment of recoverability of goodwill and other intangible assets, and used vehicle inventory valuations. We also have other key accounting policies, such as our policies for valuation of accounts receivable, expense accruals and other revenue recognition. However, these policies either do not meet the definition of critical accounting estimates described above or are not currently material items in our financial statements. We review our estimates, judgments and assumptions periodically and reflect the effects of revisions in the period that they are deemed to be necessary. We believe that these estimates are reasonable. However, actual results could differ from these estimates.

Service Contract and Lifetime Oil Change Contract Income Recognition

We receive fees from the sale of vehicle service contracts and lifetime oil contracts to customers. The contracts are sold through an unrelated third party, but we may be charged back for a portion of the fees in the event of early termination of the contracts by customers. We have established a reserve for estimated future charge-backs based on an analysis of historical charge-backs in conjunction with termination provisions of the applicable contracts. At December 31, 2004 and 2003, this reserve totaled \$11.2 million and \$9.8 million, respectively, and is included in accrued liabilities and other long-term liabilities on our consolidated balance sheets. We may also participate in future underwriting profit, pursuant to retrospective commission arrangements, that would be recognized as income upon receipt.

Finance Fee Income Recognition

We receive finance fees from various financial institutions when we arrange financing for our customers on a non-recourse basis. We may be charged back for a portion of the financing fee income when the customer pays off their loan prior to the guidelines agreed to by the various financial institutions. We have established a reserve for potential net charge-backs and cancellations based on historical experience, which typically result if the customer pays off their loan during the 90 to 180 days after receiving financing. At December 31, 2004 and 2003, this reserve totaled \$258,000 and \$403,000, respectively, and is included in accrued liabilities on our consolidated balance sheets.

Workers' Compensation Insurance Premium Accrual

Insurance premiums are paid for under a three-year retrospective cost policy, whereby premium cost depends on experience. We accrue premiums based on our historical experience rating, although the actual experience can be something greater or less than the anticipated claims experience and, as of December 31, 2004, the accrual was \$2.5 million. We expect that the retrospective cost policy, as opposed to a guaranteed cost with a flat premium, will be the most cost efficient over time.

Executive Bonuses

We make certain estimates, judgments and assumptions regarding the likelihood of our attainment, and the level thereof, of the annual bonus criteria under our Discretionary Executive Bonus Program in order to record bonus expense on a quarterly basis. We accrue the estimated year-end expense on a pro-rata basis throughout the year based on bonus attainment expectations. These estimates, judgments and assumptions are made quarterly based on available information and take into consideration the historical seasonality of our business and current trends. If actual year-end results differ materially from our estimates, the amount of bonus expense recorded in a particular quarter could be significantly over or under estimated. The bonus accrual at the end of any given year is accurate and reflective of actual results attained.

Intangible Assets

We review our goodwill and other identifiable non-amortizable intangible assets for impairment at least annually by applying a fair-value based test using discounted estimated cash flows. Discounted future cash flows are prepared by applying a growth rate to historical revenues. Growth rates are calculated individually for each region with data derived from the U.S. Census Bureau on population growth and the U.S. Department of Labor, Bureau of Labor Statistics for historical consumer price index data. The discount rate applied to the future cash flows is derived from a Capital Asset Pricing Model which factors in an equity risk premium and a risk free rate. The review is conducted more frequently than annually if events or circumstances occur that warrant a review. Our other identifiable intangible assets primarily include the franchise value of the business units, which is considered to have an indefinite life and not subject to amortization, but rather is included in the fair-value based testing. Impairment could occur if the operating business unit does not meet the determined fair-value testing. At such point, an impairment loss would be recognized to the extent that the carrying amount exceeds the assets' fair value. During 2004 and 2003, we concluded that there was no impairment. At December 31, 2004 and 2003, goodwill and other identifiable non-amortizable intangible assets totaled \$289.2 million and \$236.0 million, respectively.

Used Vehicle Inventory

Used vehicle inventories are stated at cost plus the cost of any equipment added, reconditioning and transportation. We select a sampling of dealerships throughout the year to perform quarterly testing of book values against market valuations utilizing the Kelly Blue Book and NADA guidelines. Used vehicle inventory values are cyclical and could experience impairment when market valuations are significantly below inventory costs. Historically, we have not experienced significant write-downs on our used vehicle inventory.

Recent Accounting Pronouncements

See Note 19 of Notes to Consolidated Financial Statements.

Off-Balance Sheet Arrangements

We do not have any off-balance sheet arrangements that have or are reasonably likely to have a material current or future effect on our financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources.

Item 7A. Quantitative and Qualitative Disclosures About Market Risk

Variable Rate Debt

We use variable-rate debt to finance our new and program vehicle inventory and certain real estate holdings. The interest rates on our variable rate debt are tied to either the one or three-month LIBOR or the prime rate. These debt obligations therefore expose us to variability in interest payments due to changes in these rates. The flooring debt is based on open-ended lines of credit tied to each individual store from the various manufacturer finance companies. If interest rates increase, interest expense increases. Conversely, if interest rates decrease, interest expense decreases.

Our variable-rate flooring notes payable, variable rate mortgage notes payable and other credit line borrowings subject us to market risk exposure. At December 31, 2004, we had \$546.5 million outstanding under such agreements at interest rates ranging from 4.05% to 6.44% per annum. A 10% increase in interest rates would increase annual interest expense by approximately \$887,000, net of tax, based on amounts outstanding at December 31, 2004.

Fixed Rate Debt

The fair market value of our long-term fixed interest rate debt is subject to interest rate risk. Generally, the fair market value of fixed interest rate debt will increase as interest rates fall because we could refinance for a lower rate. Conversely, the fair value of fixed interest rate debt will decrease as interest rates rise. The interest rate changes affect the fair market value but do not impact earnings or cash flows.

Based on open market trades, we determined that our \$85.0 million of long-term convertible fixed interest rate debt issued in May 2004 had a fair market value of approximately \$84.7 million at December 31, 2004. In addition, at December 31, 2004, we had \$93.3 million of other long-term fixed interest rate debt outstanding with maturity dates of between November 2005 and May 2022. Based on discounted cash flows, we have determined that the fair market value of this long-term fixed interest rate debt was approximately \$89.3 million at December 31, 2004.

Hedging Strategies

We believe it is prudent to limit the variability of a portion of our interest payments. Accordingly, we have entered into interest rate swaps to manage the variability of our interest rate exposure, thus leveling a portion of our interest expense in a rising or falling rate environment.

We have effectively changed the variable-rate cash flow exposure on a portion of our flooring debt to fixed-rate cash flows by entering into receive-variable, pay-fixed interest rate swaps. Under the interest rate swaps, we receive variable interest rate payments and make fixed interest rate payments, thereby creating fixed rate flooring debt.

We do not enter into derivative instruments for any purpose other than to manage interest rate exposure. That is, we do not speculate using derivative instruments.

As of December 31, 2004, we have outstanding the following interest rate swaps with U.S. Bank Dealer Commercial Services:

- effective September 1, 2000 – a five year, \$25 million interest rate swap at a fixed rate of 6.88% per annum, variable rate adjusted on the 1st and 16th of each month
- effective January 26, 2003 – a five year, \$25 million interest rate swap at a fixed rate of 3.265% per annum, variable rate adjusted on the 26th of each month
- effective February 18, 2003 – a five year, \$25 million interest rate swap at a fixed rate of 3.30% per annum, variable rate adjusted on the 1st and 16th of each month
- effective November 18, 2003 – a five year, \$25 million interest rate swap at a fixed rate of 3.65% per annum, variable rate adjusted on the 1st and 16th of each month
- effective November 26, 2003 – a five year, \$25 million interest rate swap at a fixed rate of 3.63% per annum, variable rate adjusted on the 26th of each month

- effective March 9, 2004 – a five year, \$25 million interest rate swap at a fixed rate of 3.25% per annum, variable rate adjusted on the 1st and 16th of each month;
- effective March 18, 2004 – a five year, \$25 million interest rate swap at a fixed rate of 3.10% per annum, variable rate adjusted on the 1st and 16th of each month.

We earn interest on all of the interest rate swaps at the one-month LIBOR rate. The one-month LIBOR rate at December 31, 2004 was 2.40% per annum.

The fair value of our interest rate swap agreements represents the estimated receipts or payments that would be made to terminate the agreements. These amounts are recorded as deferred gains or losses in our consolidated balance sheet with the offset recorded in accumulated other comprehensive income, net of tax. The amount of deferred gains and (losses) at December 31, 2004 were \$1.9 million and \$(644,000), respectively. The difference between interest earned and the interest obligation results in a monthly settlement which is reclassified from accumulated other comprehensive income to the statement of operations as incremental flooring interest expense. The resulting cash settlement reduces the amount of deferred gains and losses. Because the critical terms of the interest rate swaps and the underlying debt obligations are the same, there was no ineffectiveness recorded in interest expense.

If, in the future, the interest rate swap agreements were determined to be ineffective or were terminated before the contractual termination date, or if it became probable that the hedged variable cash flows associated with the variable rate borrowings would stop, we would be required to reclassify into earnings all or a portion of the deferred gains or losses on cash flow hedges included in accumulated other comprehensive income.

Incremental flooring interest expense recognized, net of tax, related to the reclassification of amounts in accumulated other comprehensive income was \$2.5 million, \$2.2 million and \$1.5 million, respectively, in 2004, 2003 and 2002. Interest expense savings, net of tax, on un-hedged debt as a result of decreasing interest rates, based on interest rates effective as of January 1, 2002 was approximately \$853,000, \$1.4 million and \$189,000, respectively, in 2004, 2003 and 2002. Interest expense savings, net of tax, on un-hedged debt as a result of decreasing interest rates, based on interest rates effective as of January 1 of each year was \$383,000 and \$189,000, respectively, in 2003 and 2002. Interest expense, net of tax, on un-hedged debt increased during 2004 by approximately \$571,000 as a result of increasing interest rates during 2004. As of December 31, 2004, approximately 51% of our total debt outstanding was subject to un-hedged variable rates of interest.

At current interest rates, we estimate that we will incur additional interest expense, net of tax, of approximately \$1.6 million related to our interest rate swaps during 2005.

Risk Management Policies

We assess interest rate cash flow risk by continually identifying and monitoring changes in interest rate exposures that may adversely impact expected future cash flows and by evaluating hedging opportunities.

We maintain risk management control systems to monitor interest rate cash flow attributable to both our outstanding and forecasted debt obligations as well as our offsetting hedge positions. The risk management control systems involve the use of analytical techniques, including cash flow sensitivity analysis, to estimate the expected impact of changes in interest rates on our future cash flows.

Item 8. Financial Statements and Supplementary Financial Data

The financial statements and notes thereto required by this item begin on page F-1 as listed in Item 15 of Part IV of this document. Quarterly financial data for each of the eight quarters in the two-year period ended December 31, 2004 is included in Item 7.

Item 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure

None.

Item 9A. Controls and Procedures

Management's Report on Internal Controls Over Financial Reporting

Our management is responsible for establishing and maintaining adequate internal controls over financial reporting, as such term is defined in Exchange Act Rules 13a –15(f). Under the supervision and with the participation of our management, including our principal executive officer and principal financial officer, we conducted an evaluation of the effectiveness of our internal controls over financial reporting based on the framework in *Internal Control – Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission. Based on our evaluation under the framework in *Internal Control – Integrated Framework*, our management concluded that our internal controls over financial reporting were effective as of December 31, 2004.

Management's assessment of the effectiveness of our internal controls over financial reporting as of December 31, 2004, as well as our consolidated financial statements, have been audited by KPMG LLP, an independent registered public accounting firm, as stated in their reports, which are included herein.

Internal Control Over Financial Reporting

There has been no change in our internal control over financial reporting that occurred during our last fiscal quarter that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

Disclosure Controls and Procedures

Our management has evaluated, under the supervision and with the participation of our Chief Executive Officer, our Chief Financial Officer and our Chief Accounting Officer, the effectiveness of our disclosure controls and procedures as of the end of the period covered by this report pursuant to Rule 13a-15(b) under the Securities Exchange Act of 1934 (the "Exchange Act"). Based on that evaluation, our Chief Executive Officer and Chief Financial Officer have concluded that, as of the end of the period covered by this report, our disclosure controls and procedures are effective in ensuring that information required to be disclosed in our Exchange Act reports is (1) recorded, processed, summarized and reported in a timely manner, and (2) accumulated and communicated to our management, including our Chief Executive Officer, our Chief Financial Officer and our Chief Accounting Officer, as appropriate to allow timely decisions regarding required disclosure.

Item 9B. Other Information

We reported in a timely manner all events required to be reported on Form 8-K in the fourth quarter of 2004.

PART III

Item 10. Directors and Executive Officers of the Registrant

Information required by this item will be included under the captions *Election of Directors, Meetings and Committees of the Board of Directors, Audit Committee Financial Expert, Code of Ethics, Executive Officers* and *Section 16(a) Beneficial Ownership Reporting Compliance* in our Proxy Statement for our 2005 Annual Meeting of Shareholders and is incorporated herein by reference.

Item 11. Executive Compensation

The information required by this item will be included under the captions *Director Compensation, Executive Compensation* and *Compensation Committee Interlocks and Insider Participation* in our Proxy Statement for our 2005 Annual Meeting of Shareholders and is incorporated herein by reference.

Item 12. Security Ownership of Certain Beneficial Owners and Management

The information required by this item will be included under the captions *Security Ownership of Certain Beneficial Owners and Management* and *Equity Compensation Plan Information* in our Proxy Statement for our 2005 Annual Meeting of Shareholders and is incorporated herein by reference.

Item 13. Certain Relationships and Related Transactions

The information required by this item will be included under the caption *Certain Relationships and Related Transactions* in our Proxy Statement for our 2005 Annual Meeting of Shareholders and is incorporated herein by reference.

Item 14. Principal Accountant Fees and Services

Information required by this item will be included under the caption *Independent Auditors* in the Proxy Statement for our 2005 Annual Meeting of Shareholders and is incorporated herein by reference.

PART IV

Item 15. Exhibits and Financial Statement Schedules

Except for exhibits 31.1, 31.2, 32.1 and 32.2, this section has been intentionally omitted.

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) 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.

Date: March 15, 2005

LITHIA MOTORS, INC.

By /s/ SIDNEY B. DEBOER
Sidney B. DeBoer
Chairman of the Board and
Chief Executive Officer

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the Registrant and in the capacities indicated on March 15, 2005:

<u>Signature</u>	<u>Title</u>
<u>/s/ SIDNEY B. DEBOER</u> Sidney B. DeBoer	Chairman of the Board and Chief Executive Officer (Principal Executive Officer)
<u>/s/ JEFFREY B. DEBOER</u> Jeffrey B. DeBoer	Senior Vice President and Chief Financial Officer (Principal Financial Officer)
<u>/s/ LINDA A. GANIM</u> Linda A. Ganim	Vice President and Chief Accounting Officer (Principal Accounting Officer)
<u>/s/ M. L. DICK HEIMANN</u> M. L. Dick Heimann	Director, President and Chief Operating Officer
<u>/s/ R. BRADFORD GRAY</u> R. Bradford Gray	Director and Executive Vice President
<u>/s/ THOMAS BECKER</u> Thomas Becker	Director
<u>/s/ PHILIP J. ROMERO</u> Philip J. Romero	Director
<u>/s/ GERALD F. TAYLOR</u> Gerald F. Taylor	Director
<u>/s/ WILLIAM J. YOUNG</u> William J. Young	Director

**CERTIFICATION OF CHIEF EXECUTIVE OFFICER
PURSUANT TO RULE 13a-14(a) OR RULE 15d-14(a)
OF THE SECURITIES EXCHANGE ACT OF 1934**

I, Sidney B. DeBoer, certify that:

1. I have reviewed this annual report on Form 10-K of Lithia Motors, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
 - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
 - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: March 15, 2005

/s/Sidney B. DeBoer
Sidney B. DeBoer
Chairman of the Board,
Chief Executive Officer and Secretary
Lithia Motors, Inc.

**CERTIFICATION OF CHIEF FINANCIAL OFFICER
PURSUANT TO RULE 13a-14(a) OR RULE 15d-14(a)
OF THE SECURITIES EXCHANGE ACT OF 1934**

I, Jeffrey B. DeBoer, certify that:

1. I have reviewed this annual report on Form 10-K of Lithia Motors, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
 - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
 - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: March 15, 2005

/s/Jeffrey B. DeBoer
Jeffrey B. DeBoer
Senior Vice President
and Chief Financial Officer
Lithia Motors, Inc.

**CERTIFICATION OF CHIEF EXECUTIVE OFFICER
PURSUANT TO RULE 13a-14(b) OR RULE 15d-14(b)
OF THE SECURITIES EXCHANGE ACT OF 1934 AND 18 U.S.C. SECTION 1350**

In connection with the Annual Report of Lithia Motors, Inc. (the "Company") on Form 10-K for the year ended December 31, 2004 as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, Sidney B. DeBoer, Chairman of the Board, Chief Executive Officer and Secretary of the Company, certify, pursuant to 18 U.S.C. § 1350, as adopted pursuant to § 906 of the Sarbanes-Oxley Act of 2002, that:

(1) The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and

(2) The information contained in the Report fairly presents, in all material respects, the financial condition and result of operations of the Company.

/s/ Sidney B. DeBoer

Sidney B. DeBoer
Chairman of the Board,
Chief Executive Officer and Secretary
Lithia Motors, Inc.
March 15, 2005

**CERTIFICATION OF CHIEF FINANCIAL OFFICER
PURSUANT TO RULE 13a-14(b) OR RULE 15d-14(b)
OF THE SECURITIES EXCHANGE ACT OF 1934 AND 18 U.S.C. SECTION 1350**

In connection with the Annual Report of Lithia Motors, Inc. (the "Company") on Form 10-K for the year ended December 31, 2004 as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, Jeffrey B. DeBoer, Senior Vice President and Chief Financial Officer of the Company, certify, pursuant to 18 U.S.C. § 1350, as adopted pursuant to § 906 of the Sarbanes-Oxley Act of 2002, that:

(1) The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and

(2) The information contained in the Report fairly presents, in all material respects, the financial condition and result of operations of the Company.

/s/ Jeffrey B. DeBoer

Jeffrey B. DeBoer
Senior Vice President
and Chief Financial Officer
Lithia Motors, Inc.
March 15, 2005

Report of Independent Registered Public Accounting Firm

The Board of Directors and Shareholders
Lithia Motors, Inc. and subsidiaries:

We have audited the accompanying consolidated balance sheets of Lithia Motors, Inc. and subsidiaries as of December 31, 2004 and 2003, and the related consolidated statements of operations, changes in stockholders' equity and comprehensive income and cash flows for each of the years in the three-year period ended December 31, 2004. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the consolidated financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall consolidated financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Lithia Motors, Inc. and subsidiaries as of December 31, 2004 and 2003, and the results of their operations and their cash flows for each of the years in the three-year period ended December 31, 2004, in conformity with U.S. generally accepted accounting principles.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of Lithia Motors, Inc.'s internal control over financial reporting as of December 31, 2004, based on criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), and our report dated March 11, 2005 expressed an unqualified opinion on management's assessment of, and the effective operation of, internal control over financial reporting.

/s/ KPMG LLP

Portland, Oregon
March 11, 2005

Report of Independent Registered Public Accounting Firm

The Board of Directors and Shareholders
Lithia Motors, Inc. and Subsidiaries:

We have audited management's assessment, included in the accompanying *Management's Report on Internal Controls Over Financial Reporting*, that Lithia Motors, Inc. and subsidiaries maintained effective internal control over financial reporting as of December 31, 2004, based on criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Lithia Motors, Inc.'s management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on management's assessment and an opinion on the effectiveness of the Company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, management's assessment that Lithia Motors, Inc. maintained effective internal control over financial reporting as of December 31, 2004, is fairly stated, in all material respects, based on criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Also, in our opinion, Lithia Motors, Inc. maintained, in all material respects, effective internal control over financial reporting as of December 31, 2004, based on criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets of Lithia Motors, Inc. and subsidiaries as of December 31, 2004 and 2003, and the related consolidated statements of operations, changes in shareholders' equity and comprehensive income and cash flows for each of the years in the three-year period ended December 31, 2004, and our report dated March 11, 2005 expressed an unqualified opinion on those consolidated financial statements.

/s/ KPMG LLP

Portland, Oregon
March 11, 2005

LITHIA MOTORS, INC. AND SUBSIDIARIES
Consolidated Balance Sheets
(In thousands)

	December 31,	
	2004	2003
Assets		
Current Assets:		
Cash and cash equivalents	\$ 29,264	\$ 74,408
Contracts in transit	42,913	44,709
Trade receivables, net of allowance for doubtful accounts of \$436 and \$462	41,576	42,407
Inventories, net	536,653	445,281
Vehicles leased to others, current portion	5,494	5,747
Prepaid expenses and other	6,840	3,392
Assets held for sale	135	20,408
Deferred income taxes	-	585
Total Current Assets	662,875	636,937
Land and buildings, net of accumulated depreciation of \$8,110 and \$5,683	226,356	164,676
Equipment and other, net of accumulated depreciation of \$25,922 and \$18,315	73,275	62,637
Goodwill	244,532	207,027
Other intangible assets, net of accumulated amortization of \$63 and \$39	44,649	28,946
Other non-current assets	5,217	2,559
Total Assets	\$ 1,256,904	\$ 1,102,782
Liabilities and Stockholders' Equity		
Current Liabilities:		
Flooring notes payable	\$ 450,859	\$ 378,961
Current maturities of long-term debt	6,565	14,299
Trade payables	26,821	24,402
Accrued liabilities	52,043	46,164
Liabilities held for sale	-	13,045
Deferred income taxes	410	-
Total Current Liabilities	536,698	476,871
Used vehicle flooring facility	-	56,267
Real estate debt, less current maturities	139,702	80,159
Other long-term debt, less current maturities	127,608	98,308
Other long-term liabilities	10,611	8,110
Deferred income taxes	36,339	24,141
Total Liabilities	850,958	743,856
Stockholders' Equity:		
Preferred stock - no par value; authorized 15,000 shares; none outstanding	-	-
Class A common stock - no par value; authorized 100,000 shares; issued and outstanding 15,142 and 14,693	215,333	208,187
Class B common stock - no par value authorized 25,000 shares; issued and outstanding 3,762 and 3,762	468	468
Additional paid-in capital	1,811	1,231
Accumulated other comprehensive income (loss)	789	(1,468)
Retained earnings	187,545	150,508
Total Stockholders' Equity	405,946	358,926
Total Liabilities and Stockholders' Equity	\$ 1,256,904	\$ 1,102,782

See accompanying notes to consolidated financial statements.

LITHIA MOTORS, INC. AND SUBSIDIARIES
Consolidated Statements of Operations
(In thousands, except per share amounts)

	Year Ended December 31,		
	2004	2003	2002
Revenues:			
New vehicle	\$ 1,589,613	\$ 1,441,000	\$ 1,218,364
Used vehicle	755,822	725,547	715,760
Finance and insurance	101,374	89,982	77,776
Service, body and parts	290,386	251,316	216,382
Fleet and other	8,592	5,657	43,114
Total revenues	<u>2,745,787</u>	<u>2,513,502</u>	<u>2,271,396</u>
Cost of sales	<u>2,285,851</u>	<u>2,110,393</u>	<u>1,913,704</u>
Gross profit	459,936	403,109	357,692
Selling, general and administrative	349,946	313,289	280,310
Depreciation - buildings	2,847	2,096	2,405
Depreciation and amortization - other	10,296	7,497	4,787
Income from operations	<u>96,847</u>	<u>80,227</u>	<u>70,190</u>
Other income (expense):			
Floorplan interest expense	(16,702)	(13,997)	(10,775)
Other interest expense	(9,174)	(6,081)	(5,985)
Other expense, net	(1,520)	(951)	(589)
	<u>(27,396)</u>	<u>(21,029)</u>	<u>(17,349)</u>
Income from continuing operations before income taxes	69,451	59,198	52,841
Income taxes	<u>(26,878)</u>	<u>(23,561)</u>	<u>(20,480)</u>
Income before discontinued operations	42,573	35,637	32,361
Income (loss) from discontinued operations, net of income taxes (benefit) of \$62, \$(59) and \$(29)	98	(90)	(45)
Net income	<u>\$ 42,671</u>	<u>\$ 35,547</u>	<u>\$ 32,316</u>
Basic income per share from continuing operations	\$ 2.27	\$ 1.95	\$ 1.88
Basic income (loss) per share from discontinued operations	0.00	(0.01)	0.00
Basic net income per share	<u>\$ 2.27</u>	<u>\$ 1.94</u>	<u>\$ 1.88</u>
Shares used in basic per share calculations	<u>18,773</u>	<u>18,289</u>	<u>17,233</u>
Diluted income per share from continuing operations	\$ 2.12	\$ 1.92	\$ 1.84
Diluted income per share from discontinued operations	0.01	0.00	0.00
Diluted net income per share	<u>\$ 2.13</u>	<u>\$ 1.92</u>	<u>\$ 1.84</u>
Shares used in diluted per share calculations	<u>20,647</u>	<u>18,546</u>	<u>17,598</u>

See accompanying notes to consolidated financial statements.

LITHIA MOTORS, INC. AND SUBSIDIARIES
Consolidated Statements of Changes in Stockholders' Equity and Comprehensive Income
For the years ended December 31, 2002, 2003 and 2004
(In thousands, except share data)

	Series M Preferred Stock		Common Stock				Additional Paid In Capital	Accumulated Other Compre- hensive Income (Loss)	Retained Earnings	Total Stockholders' Equity
	Shares	Amount	Class A Shares	Class A Amount	Class B Shares	Class B Amount				
Balance at December 31, 2001	9,676	\$ 5,806	8,894,107	\$ 113,563	4,039,719	\$ 502	\$ 507	\$ (2,091)	\$ 85,220	\$ 203,497
Comprehensive income:										
Net income	-	-	-	-	-	-	-	-	32,316	32,316
Unrealized gain on investments, net	-	-	-	-	-	-	-	3	-	3
Cash flow hedges:										
Net derivative losses, net of tax effect of \$1,234	-	-	-	-	-	-	-	(1,948)	-	(1,948)
Reversal of net derivative losses previously recorded due to their recognition in our statement of operations as incremental interest expense, net of tax effect of \$(963)	-	-	-	-	-	-	-	1,519	-	1,519
Total comprehensive income	-	-	-	-	-	-	-	-	-	31,890
Issuance of stock in connection with public offering	-	-	4,500,000	77,198	-	-	-	-	-	77,198
Issuance of stock in connection with acquisition	-	-	25,000	475	-	-	-	-	-	475
Issuance of stock in connection with employee stock plans	-	-	352,836	5,067	-	-	-	-	-	5,067
Conversion and redemption of Series M Preferred Stock	(9,676)	(5,806)	249,311	7,250	-	-	(11)	-	-	1,433
Conversion of Class B Common Stock	-	-	277,488	34	(277,488)	(34)	-	-	-	-
Compensation for stock option issuances and tax benefits from option exercises	-	-	-	-	-	-	433	-	-	433
Balance at December 31, 2002	-	-	14,298,742	203,577	3,762,231	468	929	(2,517)	117,536	319,993
Comprehensive income:										
Net income	-	-	-	-	-	-	-	-	35,547	35,547
Unrealized gain on investments, net	-	-	-	-	-	-	-	8	-	8
Cash flow hedges:										
Net derivative losses, net of tax effect of \$933	-	-	-	-	-	-	-	(1,140)	-	(1,140)
Reversal of net derivative losses previously recorded due to their recognition in our statement of operations as incremental interest expense, net of tax effect of \$(1,442)	-	-	-	-	-	-	-	2,181	-	2,181
Total comprehensive income	-	-	-	-	-	-	-	-	-	36,596
Issuance of stock in connection with employee stock plans	-	-	413,485	4,825	-	-	-	-	-	4,825
Compensation for stock option issuances and tax benefits from option exercises	-	-	-	-	-	-	302	-	-	302
Dividends paid	-	-	-	-	-	-	-	-	(2,575)	(2,575)
Repurchase of Class A common stock	-	-	(19,400)	(215)	-	-	-	-	-	(215)
Balance at December 31, 2003	-	-	14,692,827	208,187	3,762,231	468	1,231	(1,468)	150,508	358,926
Comprehensive income:										
Net income	-	-	-	-	-	-	-	-	42,671	42,671
Cash flow hedges:										
Net derivative losses, net of tax effect of \$116	-	-	-	-	-	-	-	(254)	-	(254)
Reversal of net derivative losses previously recorded due to their recognition in our statement of operations as incremental interest expense, net of tax effect of \$(1,585)	-	-	-	-	-	-	-	2,511	-	2,511
Total comprehensive income	-	-	-	-	-	-	-	-	-	44,928
Issuance of stock in connection with employee stock plans	-	-	449,847	7,159	-	-	-	-	-	7,159
Repurchase of Class A common stock	-	-	(600)	(13)	-	-	-	-	-	(13)
Compensation for stock option issuances and tax benefits from option exercises	-	-	-	-	-	-	580	-	-	580
Dividends paid	-	-	-	-	-	-	-	-	(5,634)	(5,634)
Balance at December 31, 2004	-	\$ -	15,142,074	\$ 215,333	3,762,231	\$ 468	\$ 1,811	\$ 789	\$ 187,545	\$ 405,946

See accompanying notes to consolidated financial statements.

LITHIA MOTORS, INC. AND SUBSIDIARIES
Consolidated Statements of Cash Flows
(In thousands)

	Year Ended December 31,		
	2004	2003	2002
Cash flows from operating activities:			
Net income	\$ 42,671	\$ 35,547	\$ 32,316
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization	13,143	9,593	7,192
Depreciation and amortization from discontinued operations	-	702	621
Compensation expense related to stock issuances	240	185	169
(Gain) loss on sale of assets	889	(586)	77
Loss on sale of vehicles leased to others	125	127	58
Gain on sale of franchise	(883)	(919)	(50)
Deferred income taxes	12,139	10,235	4,963
Equity in (income) loss of affiliate	-	13	(4)
(Increase) decrease, net of effect of acquisitions:			
Trade and installment contract receivables, net	1,178	(641)	(3,228)
Contracts in transit	1,796	(3,080)	1,626
Inventories	(23,601)	38,466	(107,126)
Prepaid expenses and other	(1,480)	2,794	(1,126)
Other non-current assets	(509)	552	1,421
Increase (decrease), net of effect of acquisitions:			
Floorplan notes payable	17,881	(12,390)	106,583
Trade payables	2,266	4,785	2,032
Accrued liabilities	7,299	6,586	2,539
Other long-term liabilities and deferred revenue	2,393	(3,397)	835
Net cash provided by operating activities	<u>75,547</u>	<u>88,572</u>	<u>48,898</u>
Cash flows from investing activities:			
Principal payments received on notes receivable	585	-	-
Capital expenditures:			
Non-financeable	(13,156)	(10,678)	(5,691)
Financeable	(40,931)	(32,448)	(32,792)
Proceeds from sale of assets	2,124	441	1,672
Proceeds from sale of vehicles leased to others	1,552	920	2,219
Expenditures for vehicles leased to others	(7,733)	(6,650)	(7,372)
Cash paid for other investments	-	-	(384)
Cash paid for acquisitions, net of cash acquired	(79,395)	(63,799)	(81,698)
Proceeds from sale of franchises	8,756	3,542	535
Distribution from affiliate	-	33	-
Net cash used in investing activities	<u>(128,198)</u>	<u>(108,639)</u>	<u>(123,511)</u>
Cash flows from financing activities:			
Net borrowings (repayments) on lines of credit	(120,332)	58,317	(28,000)
Principal payments on long-term debt and capital leases	(13,326)	(4,631)	(11,223)
Proceeds from issuance of long-term debt	142,279	22,845	33,055
Debt issuance costs	(2,550)	-	-
Repurchase of common stock	(13)	(215)	-
Redemption of Series M Preferred Stock	-	-	(4,366)
Proceeds from issuance of common stock	7,083	4,802	82,265
Dividends paid	(5,634)	(2,575)	-
Net cash provided by financing activities	<u>7,507</u>	<u>78,543</u>	<u>71,731</u>
Increase (decrease) in cash and cash equivalents	<u>(45,144)</u>	<u>58,476</u>	<u>(2,882)</u>
Cash and cash equivalents at beginning of period	74,408	15,932	18,814
Cash and cash equivalents at end of period	<u>\$ 29,264</u>	<u>\$ 74,408</u>	<u>\$ 15,932</u>
Supplemental disclosures of cash flow information:			
Cash paid during the period for interest	\$ 25,499	\$ 20,733	\$ 17,395
Cash paid during the period for income taxes	18,775	9,596	16,541
Supplemental schedule of noncash investing and financing activities:			
Stock issued in connection with acquisitions	\$ -	\$ -	\$ 475
Debt issued in connection with acquisitions	12,000	324	3,314
Flooring debt assumed in connection with acquisitions	51,884	45,884	49,225
Acquisition of capital lease	540	-	-
Assets acquired with debt	3,680	-	-
Assets acquired through real estate exchange	-	1,987	-
Debt extinguished through refinancing	-	12,350	4,360

See accompanying notes to consolidated financial statements.

**LITHIA MOTORS, INC.
AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
DECEMBER 31, 2004, 2003 and 2002**

(1) Summary of Significant Accounting Policies

Organization and Business

We are a leading operator of automotive franchises and retailer of new and used vehicles and services. As of December 31, 2004, we offered 25 brands of new vehicles through 174 franchises in 86 stores in the Western United States and over the Internet. As of December 31, 2004, we operated 16 stores in Oregon, 11 in California, 11 in Washington, 9 in Texas, 7 in Idaho, 7 in Colorado, 7 in Alaska, 6 in Nevada, 6 in Montana, 2 in South Dakota, 2 in Nebraska, 1 in Oklahoma and 1 in New Mexico. We sell new and used cars and light trucks; sell replacement parts; provide vehicle maintenance, warranty, paint and repair services; and arrange related financing, service contracts, protection products and credit insurance for our automotive customers.

Principles of Consolidation

The accompanying financial statements reflect the results of operations, the financial position, and the cash flows for Lithia Motors, Inc. and its directly and indirectly wholly-owned subsidiaries. All significant intercompany accounts and transactions, consisting principally of intercompany sales, have been eliminated upon consolidation.

Cash and Cash Equivalents

Cash and cash equivalents are defined as cash on hand and cash in bank accounts.

Contracts in Transit

Contracts in transit relate to amounts due from various lenders for the financing of vehicles sold and are typically received within five days of selling a vehicle.

Trade Receivables

Trade receivables include amounts due from customers for vehicles and service and parts business, from manufacturers for factory rebates, dealer incentives and warranty reimbursement, from insurance companies, finance companies and other miscellaneous receivables. Receivables are recorded at invoice cost and do not bear interest until such time as they are 60 days past due. Reserves for uncollectible accounts are estimated based on our historical write-off experience and are reviewed on a monthly basis. Account balances are charged off against the reserve after all means of collection have been exhausted and the potential for recovery is considered remote. We do not have any off-balance sheet credit exposure related to our customers.

Inventories

Inventories are valued at the lower of market value or cost, using the specific identification method for vehicles and parts. The cost of used vehicle inventories includes the cost of any equipment added, reconditioning and transportation.

Vehicles Leased to Others and Related Leases Receivable

Vehicles leased to others are stated at cost and depreciated over their estimated useful lives (5 years) on a straight-line basis. Lease receivables result from customer, employee and fleet leases of vehicles under agreements that qualify as operating leases. Leases are cancelable at the option of the lessee after providing 30 days written notice. Vehicles leased to others are classified as current or non-current based on the remaining lease term.

Assets and Liabilities Held for Sale

Assets held for sale of \$135,000 at December 31, 2004 relate to a building held for sale. At December 31, 2003, we had \$20.4 million of assets classified as assets held for sale related to one store that was sold during 2004. The assets primarily included inventory and property, plant and equipment. Liabilities held for sale at December 31, 2003 included flooring notes payable at contract value related to the store held for sale.

Property, Plant and Equipment

Property, plant and equipment are stated at cost and are being depreciated over their estimated useful lives, principally on the straight-line basis. The range of estimated useful lives is as follows:

Buildings and improvements	40 years
Service equipment	5 to 10 years
Furniture, signs and fixtures	5 to 10 years

The cost for maintenance, repairs and minor renewals is expensed as incurred, while significant renewals and betterments are capitalized. In addition, interest on borrowings for major capital projects, significant renewals and betterments is capitalized. Capitalized interest then becomes a part of the cost of the depreciable asset and is depreciated according to the estimated useful lives as previously stated. Capitalized interest totaled \$480,000, \$260,000 and \$295,000, respectively, in 2004, 2003 and 2002.

When an asset is retired or otherwise disposed of, the related cost and accumulated depreciation are removed from the accounts, and any gain or loss is credited or charged to income.

Leased property meeting certain criteria is capitalized and the present value of the related lease payments is recorded as a liability. Amortization of capitalized leased assets is computed on a straight-line basis over the term of the lease, unless the lease transfers title or it contains a bargain purchase option, at which time, it is amortized over the useful life, and is included in depreciation expense. The payments on the lease liability are amortized over the term of the lease.

Long-Lived Asset Impairment

Long-lived assets held and used by us and intangible assets with determinable lives are reviewed for impairment whenever events or circumstances indicate that the carrying amount of assets may not be recoverable in accordance with SFAS No. 144 "Accounting for the Impairment or Disposal of Long-Lived Assets." We evaluate recoverability of assets to be held and used by comparing the carrying amount of an asset to future net undiscounted cash flows to be generated by the asset. If such assets are considered to be impaired, the impairment to be recognized is measured as the amount by which the carrying amount of the assets exceeds the fair value of the assets. Such reviews assess the fair value of the assets based upon estimates of future cash flows that the assets are expected to generate. Long-lived assets to be disposed of by sale are valued at the lower of book value or fair value less cost to sell.

Goodwill and Other Identifiable Intangible Assets

Goodwill represents the excess purchase price over fair value of net assets acquired, which is not allocable to separately identifiable intangible assets. Other identifiable intangible assets represent the franchise value of stores acquired since July 1, 2001 and non-compete agreements. Except for our non-compete agreements, all of our other identifiable intangible assets have indefinite useful lives.

We determined that our franchise agreements have indefinite useful lives based on the following:

- Certain of our franchise agreements continue indefinitely by their terms;
- Certain of our franchise agreements have limited terms, but are routinely renewed without substantial cost to us;
- In the established retail automotive franchise industry, we are not aware of manufacturers terminating franchise agreements against the wishes of the franchise owners and we have never had a franchise agreement terminated against our wishes. A manufacturer may pressure a franchise owner to sell a franchise when they are in breach of the franchise agreement over an extended period of time. The franchise owner is typically able to sell the franchise for market value.
- State dealership franchise laws typically limit the rights of the manufacturer to terminate or not renew a franchise unless there has been illegal activity on the part of the franchise owner;
- We are not aware of any legislation or other factors that would materially change the retail automotive franchise system; and
- As evidenced by our acquisition history, there is an active market for automotive dealership franchises within the United States. We attribute value to the franchise agreements acquired with the dealerships we purchase based on the understanding and industry practice that the franchise agreements will be renewed indefinitely by the manufacturer.

Accordingly, we have determined that our franchise agreements will continue to contribute to our cash flows indefinitely and, therefore, have indefinite lives.

Pursuant to SFAS No. 142, "Goodwill and Other Intangible Assets," goodwill and other identifiable intangible assets with indefinite useful lives are not amortized, but tested for impairment, at least annually, in accordance with the provisions of SFAS No. 142. The impairment test is a two step process. The first identifies potential impairments by comparing the fair value of a reporting unit with its book value, including goodwill and other identifiable intangible assets. If the fair value of the reporting unit exceeds the carrying amount, goodwill and other identifiable intangible assets are not impaired and the second step is not necessary. If the carrying value exceeds the fair value, the second step includes determining the implied fair value through further market research. The implied fair value of goodwill and other identifiable intangible assets is then compared with the carrying amount to determine if an impairment loss is recorded.

We tested our goodwill and other identifiable intangible assets for impairment utilizing the discounted cash flows method in accordance with the provisions of SFAS No. 142 as of December 31, 2004 and determined that no impairment losses were required to be recognized. Growth rates utilized in the calculation were derived from the U.S. Census Bureau on population growth and the U.S. Department of Labor, Bureau of Labor Statistics for historical consumer price index data. The discount rate applied to the future cash flows was derived from a Capital Asset Pricing Model, which factors in an equity risk premium and a risk free rate.

Incentives, Credits and Floor Plan Assistance

Manufacturers reimburse us for holdbacks, floor plan interest, and advertising credits, which are earned when each vehicle is purchased by us. The manufacturers reimburse us weekly, monthly, or quarterly depending on the manufacturer and the type of program. The manufacturers determine the amount of the reimbursements based on many factors including the value and make of the vehicles purchased. Pursuant to EITF 02-16 "Accounting by a Customer (Including a Reseller) for Certain Consideration Received from a Vendor," we recognize advertising credits, floorplan interest credits, holdbacks, cash incentives and other rebates received from manufacturers that are tied to specific vehicles as a reduction to cost of goods sold as the related vehicles are sold. When amounts are received prior to the sale of the vehicle, such amounts are netted against inventory until the vehicle is sold.

We earn certain other cash incentives and rebates from the manufacturer when the vehicles are sold to the customer. The amount of cash incentives and other rebates can vary based on the type and number of models sold.

Advertising credits that are not tied to specific vehicles are earned from the manufacturer when we submit reimbursement for qualifying advertising expenditures and are recognized as a reduction of advertising expense upon manufacturer confirmation that our submitted expenditures qualify for such credits.

Parts purchase discounts that we receive from the manufacturer are earned when certain parts or volume of parts are purchased from the manufacturer and are recognized as a reduction to cost of good sold as the related inventory is sold.

Advertising

We expense production and other costs of advertising as incurred as a component of selling, general and administrative expense. Advertising expense, net of manufacturer cooperative advertising credits of \$6.5 million, \$6.1 million and \$8.2 million, was \$18.3 million, \$20.1 million and \$16.8 million for the years ended December 31, 2004, 2003 and 2002, respectively.

Environmental Liabilities and Expenditures

Accruals for environmental matters, if any, are recorded in operating expenses when it is probable that a liability has been incurred and the amount of the liability can be reasonably estimated. Accrued liabilities are exclusive of claims against third parties and are not discounted.

In general, costs related to environmental remediation are charged to expense. Environmental costs are capitalized if such costs increase the value of the property and/or mitigate or prevent contamination from future operations.

We are aware of limited contamination at certain of our current and former facilities, and are in the process of conducting investigations and/or remediation at some of these properties. Based on our current information, we do not believe that any costs or liabilities relating to such contamination, other environmental matters or compliance with environmental regulations will have a material adverse effect on our cash flows, results of operations or financial condition. There can be no assurances, however, that additional environmental matters will not arise or that new conditions or facts will not develop in the future at our current or formerly owned or operated facilities, or at sites that we may acquire in the future, that will result in a material adverse effect on our cash flows, results of operations or financial condition.

Income Taxes

Income taxes are accounted for under the asset and liability method as prescribed by SFAS No. 109 "Accounting for Income Taxes." Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases and operating loss and tax credit carryforwards. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date.

Computation of Per Share Amounts

Following is a reconciliation of the income from continuing operations and weighted average shares used for our basic earnings per share ("EPS") and diluted EPS (in thousands, except per share amounts).

Year Ended December 31,	2004			2003			2002		
	Income from Continuing Operations	Shares	Per Share Amount	Income from Continuing Operations	Shares	Per Share Amount	Income from Continuing Operations	Shares	Per Share Amount
Basic EPS									
Income from continuing operations available to common stockholders	\$42,573	18,773	\$2.27	\$35,637	18,289	\$1.95	\$32,361	17,233	\$1.88
Effect of Dilutive Securities									
2 7/8% convertible senior subordinated notes	1,231	1,485	(0.10)	-	-	-	-	-	-
Stock options	-	389	(0.05)	-	257	(0.03)	-	365	(0.04)
Diluted EPS									
Income from continuing operations available to common stockholders	<u>\$43,804</u>	<u>20,647</u>	<u>\$2.12</u>	<u>\$35,637</u>	<u>18,546</u>	<u>\$1.92</u>	<u>\$32,361</u>	<u>17,598</u>	<u>\$1.84</u>
Antidilutive Securities									
Shares issuable pursuant to stock options not included since they were antidilutive		<u>324</u>			<u>342</u>			<u>-</u>	

In October 2004, the Financial Accounting Standards Board ("FASB") ratified a consensus position of the Emerging Issues Task Force, EITF 04-8, "Accounting Issues Related to Certain Features of Contingently Convertible Debt and the Effect on Diluted Earnings Per Share," which requires the inclusion of the 2,255,314 shares issuable pursuant to our convertible debt, which was issued in the second quarter of 2004. The guidance also required that net income be increased for the related interest expense, net of taxes.

Concentrations of Credit Risk

Concentrations of credit risk with respect to trade receivables are limited due to the large number of customers comprising our customer base. Receivables from all manufacturers accounted for 22.1% and 22.4%, respectively, of total accounts receivable at December 31, 2004 and 2003. Included in the 22.1% is one manufacturer who accounted for 10.1% of the total accounts receivable balance at December 31, 2004. Included in the 22.4% is one manufacturer who accounted for 10.4% of the total accounts receivable balance at December 31, 2003.

In addition, in 2004, 2003 and 2002, 36.8%, 35.6% and 31.8%, respectively, of our total revenue was derived from vehicles from two manufacturers.

Financial instruments, which potentially subject us to concentrations of credit risk, consist principally of cash deposits. We generally are exposed to credit risk from balances on deposit in financial institutions in excess of the FDIC-insured limit.

Financial Instruments and Market Risks

The carrying amount of cash equivalents, contracts in transit, trade receivables, trade payables, accrued liabilities and short term borrowings approximates fair value because of the short-term nature of these instruments.

Fair value estimates are made at a specific point in time, based on relevant market information about the financial instrument. These estimates are subjective in nature and involve uncertainties and matters of significant judgment and therefore cannot be determined with precision. Changes in assumptions could significantly affect the estimates.

We have variable rate floor plan notes payable and other credit line borrowings that subject us to market risk exposure. At December 31, 2004 we had \$491.5 million outstanding under such facilities at interest rates ranging from 4.05% to 5.15% per annum, \$450.8 million of which was outstanding under our floorplan facilities. An increase or decrease in the interest rates would affect interest expense for the period accordingly.

The fair market value of long-term fixed interest rate debt is subject to interest rate risk. Generally, the fair market value of fixed interest rate debt will increase as interest rates fall and decrease as interest rates rise. If we refinance at current market rates, we would pay an additional \$4.2 million in interest expense over the remaining lives, which is represented in the table below as the difference between book value and fair value at December 31, 2004. The interest rate changes affect the fair market value but do not impact earnings or cash flows. We monitor our fixed rate debt regularly, refinancing debt that is at an above market rate. The book value of our fixed rate debt and the fair value, based open market trades or on discounted cash flows, was as follows at December 31, 2004 and 2003 (in thousands):

<u>December 31,</u>	<u>2004</u>	<u>2003</u>
Book value of fixed rate debt	\$ 178,282	\$ 52,978
Fair value of fixed rate debt	\$ 173,997	\$ 52,183

Lithia also subjects itself to credit risk and market risk by entering into interest rate swaps. See below and also Note 8. We minimize the credit or repayment risk on our derivative instruments by entering into transactions with high quality institutions, whose credit rating is higher than Aa.

Derivative Financial Instruments

Lithia enters into interest rate swap agreements to reduce its exposure to market risks from changing interest rates on its new vehicle floorplan lines of credit. The difference between interest paid and interest received, which may change as market interest rates change, is accrued and recognized as either additional floorplan interest expense, or a reduction thereof. If a swap is terminated prior to its maturity, the gain or loss is recognized over the remaining original life of the swap if the item hedged remains outstanding, or immediately if the item hedged does not remain outstanding. If the swap is not terminated prior to maturity, but the underlying hedged debt item is no longer outstanding, the interest rate swap is marked to market, and any unrealized gain or loss is recognized immediately.

We account for our derivative financial instruments in accordance with SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities," as amended by SFAS No. 138, "Accounting for Certain Derivative Instruments and Certain Hedging Activities-an amendment of FASB Statement No. 133" and SFAS No. 137, "Accounting for Derivative Instruments and Hedging Activities" (collectively, "the Standards"). The Standards require that all derivative instruments (including certain derivative instruments embedded in other contracts) be recorded on the balance sheet as either an asset or liability measured at its fair value, and that changes in the derivatives fair value be recognized currently in earnings unless specific hedge accounting criteria are met. See also Note 8.

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the amounts reported in the consolidated financial statements and related notes to financial statements. Changes in such estimates may affect amounts reported in future periods.

Estimates are used in the calculation of certain reserves maintained for charge backs on estimated cancellations of service contracts, life, accident and disability insurance policies, and finance fees from financial institutions. We also use estimates in the calculation of various accruals and reserves including anticipated workers compensation premium expenses related to a retrospective cost policy, estimated uncollectible accounts and notes receivable, environmental matters and warranty.

Revenue Recognition

Revenue from the sale of vehicles is recognized upon delivery, when the sales contract is signed, down payment has been received and funding has been approved from the lending agent. Fleet sales of vehicles whereby we do not take possession of the vehicles are shown on a net basis in fleet and other revenue.

Revenue from parts and service is recognized upon delivery of the parts or service to the customer.

Finance fees earned for notes placed with financial institutions in connection with customer vehicle financing are recognized, net of estimated charge-backs, as finance and insurance revenue upon acceptance of the credit by the financial institution.

Insurance income from third party insurance companies for commissions earned on credit life, accident and disability insurance policies sold in connection with the sale of a vehicle are recognized, net of anticipated cancellations, as finance and insurance revenue upon execution of the insurance contract.

Commissions from third party service contracts are recognized, net of anticipated cancellations, as finance and insurance revenue upon sale of the contracts.

We may also participate in future underwriting profit, pursuant to retrospective commission arrangements, that would be recognized as income upon receipt.

Sales Returns

As is typical in the automotive retailing industry, we do not allow for sales returns for our vehicle sales, and have therefore not provided for an allowance for sales returns. Historically, we have not experienced sales returns. We do allow for customer returns on sales of our parts inventory up to 30 days after the sale. Most parts returns generally occur within one to two weeks from the time of sale, and are not significant. We, therefore, have not provided for an allowance for parts sales returns.

Debt Issuance Costs and Loan Origination Fees

Debt issuance costs and loan origination fees paid, including incremental direct costs of completed loan agreements, are deferred and amortized over the life of the debt to which it relates and are shown as an increase to the related interest expense.

Warranty

We offer a 60-day limited warranty on the sale of retail used vehicles. We estimate our warranty liability based on the number of vehicles sold and an estimated claim cost per vehicle based on past experience. Each year, we analyze the warranty charges related to our used vehicle sales and update our per used vehicle warranty estimate. The estimated warranty is added to cost of sales upon sale of the related vehicle. At December 31, 2004 and 2003, accrued warranty totaled \$198,000 and \$220,000, respectively, and is included in other current liabilities on the consolidated balance sheet. A roll-forward of our warranty liability for the years ended December 31, 2004, 2003 and 2002 is as follows (in thousands):

Year Ended December 31,	2004	2003	2002
Balance, beginning of period	\$ 220	\$ 525	\$ 456
Warranties issued	2,574	2,935	2,827
Reductions for warranty payments made	(2,562)	(2,918)	(2,758)
Adjustments and changes in estimates	(34)	(322)	-
Balance, end of period	\$ 198	\$ 220	\$ 525

Comprehensive Income

Comprehensive income includes the unrealized gain or loss on investments and the fair value of cash flow hedging instruments that are reflected in stockholders' equity, net of tax, instead of net income.

Major Supplier and Franchise Agreements

We purchase substantially all of our new vehicles and inventory from various manufacturers at the prevailing prices charged by auto makers to all franchised dealers. Our overall sales could be impacted by the auto makers' inability or unwillingness to supply the dealership with an adequate supply of popular models.

We enter into agreements (Franchise Agreements) with the manufacturers. The Franchise Agreements generally limit the location of the dealership and provide the auto maker approval rights over changes in dealership management and ownership. The automakers are also entitled to terminate the Franchise Agreements if the dealership is in material breach of the terms. Our ability to expand operations depends, in part, on obtaining consents of the manufacturers for the acquisition of additional dealerships. See also "Goodwill and Other Identifiable Intangible Assets" above.

Stock-Based Compensation

We account for stock options using the intrinsic value method as prescribed by Accounting Principles Board (APB) Opinion No. 25, "Accounting for Stock Issued to Employees." Pursuant to SFAS No. 148 "Accounting for Stock-Based Compensation - Transition and Disclosure," we have computed, for pro forma disclosure purposes, the impact on net income and net income per share as if we had accounted for our stock-based compensation plans in accordance with the fair value method prescribed by SFAS No. 123 "Accounting for Stock-Based Compensation" as follows (in thousands):

Year Ended December 31,	2004	2003⁽¹⁾	2002⁽¹⁾
Net income, as reported	\$ 42,671	\$ 35,547	\$ 32,316
Add – Stock-based employee compensation expense included in reported net income, net of related tax effects	101	99	103
Deduct - total stock-based employee compensation expense determined under the fair value based method for all awards, net of related tax effects	(3,266)	(3,128)	(2,318)
Net income, pro forma	\$ 39,506	\$ 32,518	\$ 30,101
Basic net income per share:			
As reported	\$ 2.27	\$ 1.94	\$ 1.88
Pro forma	\$ 2.10	\$ 1.78	\$ 1.75
Diluted net income per share:			
As reported	\$ 2.13	\$ 1.92	\$ 1.84
Pro forma	\$ 1.99	\$ 1.77	\$ 1.74

⁽¹⁾ 2003 and 2002 have been restated to reflect adjustments made pursuant to EITF 97-1 "Accounting under Statement 123 for Certain Employee Stock Purchase Plans with a Look-Back Option," for updated forfeiture estimates and the appropriate tax effect on the option expense. The impact on pro forma diluted EPS was a decrease of \$0.04 and \$0.02 in 2003 and 2002, respectively.

See Note 19 for a discussion of SFAS No. 123R, "Share-Based Payment: an amendment of FASB Statements No. 123 and 95," which requires companies to recognize in their income statement the grant-date fair value of stock options and other equity-based compensation issued to employees.

We used the Black-Scholes option pricing model and the following weighted average assumptions in calculating the value of all options granted during the periods presented:

Year Ended December 31,	2004	2003	2002
Employee Stock Purchase Plan			
Risk-free interest rates	0.93% - 1.71%	0.89% - 1.22%	1.59% - 1.76%
Dividend yield	0.99% - 1.45%	0.00% - 1.27%	n/a
Expected lives	3 months	3 months	3 months
Volatility	28.11% - 47.31%	42.59% - 50.14%	42.59% - 51.80%
Option Plans			
Risk-free interest rates	2.80%	2.50% - 3.00%	4.00%
Dividend yield	1.04%	n/a	n/a
Expected lives	5.4 years	7.7 - 8.0 years	8.0 years
Volatility	43.32%	46.24% - 46.79%	46.80%

Using the Black-Scholes methodology, the weighted average fair value of options granted during 2004, 2003 and 2002, before estimated forfeitures, was \$8.55, \$3.84 and \$7.54 per share, respectively. The fair value would be amortized on a pro forma basis over the vesting period of the options, typically four to five years for options granted from the 2001 Plan and three months for options granted from the Purchase Plan.

Segment Reporting

Based upon definitions contained within SFAS No. 131 "Disclosures about Segments of an Enterprise and Related Information," we have determined that we operate in one segment, automotive retailing.

Reclassifications

Certain amounts in the prior year financial statements have been reclassified to conform with the current year presentation. In prior years, we included cash flows from notes receivable issued and principal payments received on notes receivable as investing activities. Based on recent guidance regarding the sale of goods and services to customers, we now show such cash flows as a component of the change in trade and installment contracts receivable, net and other non-current assets in the operating activities section of our cash flow statement.

(2) Discontinued Operations

During 2003, we decided to sell certain stores and related franchises. We recognized a net gain on the sale of one of our stores classified as discontinued operations totaling \$374,000, net of tax, in 2003, which is netted with loss from discontinued operations on our consolidated statement of operations. During the third quarter of 2004, we disposed of one of the franchises included with the store we had held for sale, which resulted in a gain of \$212,000, net of tax. In the fourth quarter of 2004, we disposed of the remaining franchise, which resulted in a loss of \$20,000, net of tax. In addition, in 2004, we recognized losses from operations of the discontinued operations of \$88,000 and a \$6,000 loss from discontinued operations that were disposed of in 2003. At December 31, 2004, we did not have any assets held for sale related to discontinued operations.

We continually monitor the performance of each of our stores and make determinations to sell based on return on capital criteria.

Interest expense is allocated to stores classified in discontinued operations for actual flooring interest expense directly related to the new vehicles in the store. Interest expense related to the used vehicle line of credit is allocated based on total used vehicle inventory of the store, and interest expense related to the equipment line of credit is allocated based on the amount of fixed assets.

(3) Trade Receivables

Trade receivables consisted of the following (in thousands):

December 31,	2004	2003
Trade receivables	\$ 12,197	\$ 12,052
Vehicle receivables	9,971	9,999
Manufacturer receivables	18,694	19,520
Other	1,150	1,298
	42,012	42,869
Less: Allowances	(436)	(462)
Total receivables, net	\$ 41,576	\$ 42,407

Vehicle receivables represent receivables from financial institutions for the portion of the vehicle sales price financed by the customer.

(4) Inventories and Related Notes Payable

The new and used vehicle inventory, collateralizing related notes payable, and other inventory were as follows (in thousands):

December 31,	2004		2003	
	Inventory Cost	Notes Payable	Inventory Cost	Notes Payable
New and program vehicles	\$ 427,134	\$ 450,859	\$ 355,937	\$ 378,961
Used vehicles	84,739	-	68,747	56,267
Parts and accessories	24,780	-	20,597	-
Total inventories	\$ 536,653	\$ 450,859	\$ 445,281	\$ 435,228

The inventory balance is generally reduced by manufacturer holdbacks and incentives, while the related floor plan liability is reflective of the gross cost of the vehicle. The floor plan liability, as shown in Notes Payable in the above table, will generally also be higher than the inventory cost due to the timing of the sale of a vehicle and payment of the related liability.

All new vehicles are pledged to collateralize floor plan notes payable to financial institutions. The floor plan notes payable bear interest, payable monthly on the outstanding balance, at a rate of interest determined by the lender, subject to incentives. The new vehicle floor plan notes are due when the related vehicle is sold. As such, these floor plan notes payable are shown as current liabilities in the accompanying consolidated balance sheets.

At December 31, 2004 and 2003, used vehicles and parts and accessories inventory were pledged to collateralize our used vehicle and working capital credit facility.

(5) Property, Plant and Equipment

Property, plant and equipment consisted of the following (in thousands):

December 31,	2004	2003
Buildings and improvements	\$ 129,687	\$ 93,455
Service equipment	25,373	19,856
Furniture, signs and fixtures	70,804	56,742
	225,864	170,053
Less accumulated depreciation – buildings	(8,110)	(5,683)
Less accumulated depreciation – equipment and other	(25,922)	(18,315)
	191,832	146,055
Land	95,583	71,592
Construction in progress, buildings	9,196	5,312
Construction in progress, other	3,020	4,354
	\$ 299,631	\$ 227,313

(6) Goodwill and Other Intangible Assets

The roll forward of goodwill is as follows (in thousands):

Year Ended December 31,	2004	2003
Balance, beginning of year	\$ 207,027	\$ 185,212
Goodwill acquired and post acquisition adjustments	37,505	25,156
Goodwill included in gain or loss on disposal of franchises and discontinued operations	-	(3,341)
Balance, end of year	\$ 244,532	\$ 207,027

At December 31, 2004 and 2003, other intangible assets included the value of franchise agreements and non-compete agreements. The value attributed to franchise agreements has an indefinite useful life and non-compete agreements are amortized over the life of the agreements, typically 3 to 5 years. The gross amount of other intangible assets and the related accumulated amortization for non-compete agreements were as follows (in thousands):

December 31,	2004	2003
Franchise value	\$ 44,602	\$ 28,875
Non-compete agreements	110	110
Accumulated amortization	<u>(63)</u>	<u>(39)</u>
Net non-compete agreements	47	71
Total other intangible assets, net	<u>\$ 44,649</u>	<u>\$ 28,946</u>

Amortization expense related to the non-compete agreements totaled \$24,000, \$21,000 and \$18,000, respectively, for the years ended December 31, 2004, 2003 and 2002. Amortization of non-compete agreements is as follows over the next five years (in thousands):

2005	\$ 23
2006	22
2007	2
2008	-
2009	-

(7) Trade Payables

Trade payables consisted of the following (in thousands):

December 31,	2004	2003
Trade payables	\$ 10,001	\$ 10,200
Lein payables	8,192	8,378
Manufacturer payables	4,651	3,312
Other	<u>3,977</u>	<u>2,512</u>
Total trade payables	<u>\$ 26,821</u>	<u>\$ 24,402</u>

Lein payables represent amounts owed to financial institutions for customer vehicle trade-ins.

(8) Derivative Financial Instruments

We have entered into interest rate swaps to manage the variability of our interest rate exposure, thus leveling a portion of our interest expense in a rising or falling rate environment.

We have effectively changed the variable-rate cash flow exposure on a portion of our flooring debt to fixed-rate cash flows by entering into receive-variable, pay-fixed interest rate swaps. Under the interest rate swaps, we receive variable interest rate payments and make fixed interest rate payments, thereby creating fixed rate flooring debt.

We do not enter into derivative instruments for any purpose other than to manage interest rate exposure. That is, we do not speculate using derivative instruments.

As of December 31, 2004, we have outstanding the following interest rate swaps with U.S. Bank Dealer Commercial Services:

- effective September 1, 2000 – a five year, \$25 million interest rate swap at a fixed rate of 6.88% per annum, variable rate adjusted on the 1st and 16th of each month
- effective January 26, 2003 – a five year, \$25 million interest rate swap at a fixed rate of 3.265% per annum, variable rate adjusted on the 26th of each month
- effective February 18, 2003 – a five year, \$25 million interest rate swap at a fixed rate of 3.30% per annum, variable rate adjusted on the 1st and 16th of each month

- effective November 18, 2003 – a five year, \$25 million interest rate swap at a fixed rate of 3.65% per annum, variable rate adjusted on the 1st and 16th of each month
- effective November 26, 2003 – a five year, \$25 million interest rate swap at a fixed rate of 3.63% per annum, variable rate adjusted on the 26th of each month
- effective March 9, 2004 – a five year, \$25 million interest rate swap at a fixed rate of 3.25% per annum, variable rate adjusted on the 1st and 16th of each month;
- effective March 18, 2004 – a five year, \$25 million interest rate swap at a fixed rate of 3.10% per annum, variable rate adjusted on the 1st and 16th of each month.

We earn interest on all of the interest rate swaps at the one-month LIBOR rate. The one-month LIBOR rate at December 31, 2004 was 2.4% per annum.

The fair value of our interest rate swap agreements represents the estimated receipts or payments that would be made to terminate the agreements. These amounts are recorded as deferred gains or losses in our consolidated balance sheet with the offset recorded in accumulated other comprehensive income, net of tax. The amount of deferred gains and (losses) at December 31, 2004 were \$1.9 million and \$(644,000), respectively. The difference between interest earned and the interest obligation results in a monthly settlement, which is reclassified from accumulated other comprehensive income to the statement of operations as incremental flooring interest expense. The resulting cash settlement reduces the amount of deferred gains and losses. Because the critical terms of the interest rate swaps and the underlying debt obligations are the same, there was no ineffectiveness recorded in interest expense.

If, in the future, the interest rate swap agreements were determined to be ineffective or were terminated before the contractual termination date, or if it became probable that the hedged variable cash flows associated with the variable rate borrowings would stop, we would be required to reclassify into earnings all or a portion of the deferred gains or losses on cash flow hedges included in accumulated other comprehensive income.

At current interest rates, we estimate that we will incur additional interest expense, net of tax, of approximately \$1.6 million related to our interest rate swaps during 2005.

(9) Lines of Credit and Long-Term Debt

Lines of Credit

We have a working capital and used vehicle flooring credit facility with DaimlerChrysler Services North America LLC and Toyota Motor Credit Corporation totaling up to \$150 million, which expires May 1, 2007 with an option for the lenders to extend to May 1, 2008, with interest due monthly. This credit facility is cross-collateralized and secured by cash and cash equivalents, new and used vehicles on a subordinated basis to the extent not specifically financed by other lenders, parts inventories, accounts receivable, intangible assets and equipment. We pledged to DaimlerChrysler Services and Toyota Motor Credit the stock of all of our dealership subsidiaries except entities operating BMW, Honda, Nissan or Toyota stores.

The financial covenants in our agreement with DaimlerChrysler Services and Toyota Motor Credit require us to maintain compliance with, among other things, (i) a specified current ratio; (ii) a specified fixed charge coverage ratio; (iii) a specified interest coverage ratio; (iv) a specified adjusted leverage ratio; and (v) certain working capital levels. At December 31, 2004, we were in compliance with all of the covenants of this agreement.

Ford Motor Credit, General Motors Acceptance Corporation and Volkswagen Credit have agreed to floor all of our new vehicles for their respective brands with DaimlerChrysler Services North America LLC and Toyota Motor Credit Corporation serving as the primary lenders for substantially all other brands. These new vehicle lines are secured by new vehicle inventory of the relevant brands.

We also have a revolving credit real estate line with Toyota Motor Credit totaling \$40 million, which expires in May 2005. The advances are secured by the real estate financed under this line of credit.

We have a credit facility with U.S. Bank N.A., which provides for a \$50.0 million revolving line of credit for leased vehicles and equipment purchases and expires April 30, 2006. The financial covenants in our agreement with U.S. Bank N.A. require us to maintain compliance with, among other things, (i) a specified current ratio; (ii) a specified fixed charge coverage ratio; (iii) a minimum total net worth; and (iv) a minimum tangible net worth. At December 31, 2004, we were in compliance with all of the covenants of this agreement.

Interest rates on all of the above facilities ranged from 4.05% to 5.15% at December 31, 2004. Amounts outstanding on the lines at December 31, 2004 together with amounts remaining available under such lines were as follows (in thousands):

	<u>Outstanding at December 31, 2004</u>	<u>Remaining Availability as of December 31, 2004</u>
New and program vehicle lines	\$450,859	\$ *
Working capital and used vehicle line	-	150,000
Real estate line	-	40,000
Equipment/leased vehicle line	40,686	9,314
	<u>\$491,545</u>	<u>\$199,314*</u>

* There are no formal limits on the new and program vehicle lines with certain lenders.

Senior Subordinated Convertible Notes

In May 2004, we sold \$85.0 million of 2.875% senior subordinated convertible notes (the "Notes") due 2014 through a Rule 144A offering to qualified institutional buyers. We will also pay contingent interest on the notes during any six-month interest period beginning May 1, 2009, in which the trading price of the Notes for a specified period of time equals or exceeds 120% of the principal amount of the Notes. Net proceeds from this offering were approximately \$82.5 million. The Notes are convertible into shares of our Class A common stock at a price of \$37.69 per share (or 26.53 shares per \$1,000 of Notes) upon the satisfaction of certain conditions and upon the occurrence of certain events as follows:

- if, prior to May 1, 2009, and during any calendar quarter, the closing sale price of our common stock exceeds 120% of the conversion price for at least 20 trading days in the 30 consecutive trading days ending on the last trading day of the preceding calendar quarter;
- if, after May 1, 2009, the closing sale price of our common stock exceeds 120% of the conversion price;
- if, during the five business day period after any five consecutive trading day period in which the trading price per \$1,000 principal amount of Notes for each day of such period was less than 98% of the product of the closing sale price of our common stock and the number of shares issuable upon conversion of \$1,000 principal amount of the Notes;
- if the Notes have been called for redemption; or
- upon certain specified corporate events.

Any declaration and payment of a dividend in excess of \$0.08 per share per quarter will result in an adjustment in the conversion rate for the Notes.

The Notes are redeemable at our option beginning May 6, 2009 at the redemption price of 100% of the principal amount plus any accrued interest. The holders of the Notes can require us to repurchase all or some of the notes on May 1, 2009 and upon certain events constituting a fundamental change or a termination of trading. A fundamental change is any transaction or event in which all or substantially all of our common stock is exchanged for, converted into, acquired for, or constitutes solely the right to receive, consideration that is not all, or substantially all, common stock that is listed on, or immediately after the transaction or event, will be listed on, a United States national securities exchange. A termination of trading will have occurred if our common stock is not listed for trading on a national exchange or the NASDAQ stock market.

We filed a registration statement on Form S-3 with the Securities and Exchange Commission on July 26, 2004 covering the resale of the Notes and the common stock issuable upon conversion of the Notes. The registration statement was declared effective by the Securities and Exchange Commission in October 2004.

Summary

Long-term debt consisted of the following (in thousands):

<u>December 31,</u>	<u>2004</u>	<u>2003</u>
Variable Rate Debt:		
Equipment and leased vehicle line of credit, expiring April 2006	\$ 40,686	\$ 35,000
Real estate line of credit payable with monthly payments of interest only, expiring May 2005; secured by land and buildings	-	9,018
Working capital and used vehicle flooring line of credit payable with monthly payments of interest only, expiring May 2007	-	117,000
Mortgages payable in monthly installments of \$386, including interest between 4.20% and 6.44%, maturing through April 2024; secured by land and buildings	52,382	32,949
Notes payable in monthly installments of \$21, including interest between 0.0% and 4.7%, maturing at various dates through 2005; secured by vehicles leased to others	2,194	1,607
Notes payable related to acquisitions, with interest rate of 5.25%, maturing February 2008	331	481
Total Variable Rate Debt	<u>95,593</u>	<u>196,055</u>
Fixed Rate Debt:		
2.875% senior subordinated convertible notes, due May 2014 with interest due semi-annually in May and November of each year	85,000	-
Mortgages payable in monthly installments of \$622, including interest between 4.00% and 6.96%, maturing fully May 2022; secured by land and buildings	91,298	49,837
Notes payable related to acquisitions, with interest rates between 4.00% and 7.25%, maturing at various dates through May 2009	1,454	3,141
Capital lease obligations, net of interest of \$174, with monthly lease payments of \$5	530	-
Total Fixed Rate Debt	<u>178,282</u>	<u>52,978</u>
Total Long-Term Debt	273,875	249,033
Less current maturities	(6,565)	(14,299)
	<u>\$ 267,310</u>	<u>\$ 234,734</u>

The schedule of future principal payments on long-term debt after December 31, 2004 is as follows (in thousands):

<u>Year Ending December 31,</u>	
2005	\$ 6,565
2006	45,354
2007	12,868
2008	37,363
2009	22,398
Thereafter	149,327
Total principal payments	<u>\$ 273,875</u>

(10) Stockholders' Equity

Class A and Class B Common Stock

The shares of Class A common stock are not convertible into any other series or class of our securities. Each share of Class B common stock, however, is freely convertible into one share of Class A common stock at the option of the holder of the Class B common stock. All shares of Class B common stock shall automatically convert to shares of Class A common stock (on a share-for-share basis, subject to the adjustments) on the earliest record date for an annual meeting of our stockholders on which the number of shares of Class B common stock outstanding is less than 1% of the total number of shares of common stock outstanding. Shares of Class B common stock may not be transferred to third parties, except for transfers to certain family members and in other limited circumstances.

Holders of Class A common stock are entitled to one vote for each share held of record and holders of Class B common stock are entitled to ten votes for each share held of record. The Class A common stock and Class B common stock vote together as a single class on all matters submitted to a vote of stockholders.

In March 2002, we registered and sold 4.5 million newly issued shares of Class A common stock. Proceeds, net of offering expenses, totaled approximately \$77.2 million. In connection with the sale, existing stockholders sold 1.25 million shares of Class A common stock and 121,488 shares of Class B common stock were converted into a like number of shares of Class A common stock.

In September 2002, 156,000 Class B shares were converted into Class A shares.

Series M Redeemable, Convertible Preferred Stock

In 1999, the Company authorized 15,000 shares of Series M Redeemable, Convertible preferred stock ("Series M Preferred Stock"). In May 1999, in connection with the acquisition of Moreland Automotive Group, the Company issued 10,360 shares of Series M Preferred Stock. The Series M Preferred Stock was convertible into Class A Common Stock at the option of the Company at any time and at the option of the holder under limited circumstances. The Series M Preferred Stock was redeemable at the option of the Company. The Series M Preferred Stock converted into Class A common stock based on a formula that divided the average Class A common stock price for a certain 15-day period into \$1,000 and then multiplied by the number of Series M Preferred Stock being converted. The Series M Preferred Stock had a \$1,000 per share liquidation preference.

In the first quarter of 2000, the Company issued 303,542 shares of Class A common stock and 4,499 shares of Series M Preferred Stock in order to satisfy contingent payout requirements related to the Moreland acquisition.

All shares of Series M Preferred Stock have been converted or redeemed and, as of December 31, 2002, no shares of Series M Preferred Stock remained outstanding.

(11) Cost of Sales

Cost of sales categorized by revenue category from continuing operations is as follows (in thousands):

<u>Year Ended December 31,</u>	<u>2004</u>	<u>2003</u>	<u>2002</u>
New vehicle sales	\$ 1,465,252	\$ 1,330,446	\$ 1,114,885
Used vehicle sales	662,221	642,443	643,713
Finance and insurance	376	276	459
Service, body and parts	150,609	132,653	112,433
Fleet and other	7,393	4,575	42,214
	<u>\$ 2,285,851</u>	<u>\$ 2,110,393</u>	<u>\$ 1,913,704</u>

(12) Income Taxes

Income tax expense from continuing operations for 2004, 2003 and 2002 was as follows (in thousands):

<u>Year Ended December 31,</u>	<u>2004</u>	<u>2003</u>	<u>2002</u>
Current:			
Federal	\$ 13,163	\$ 11,413	\$ 14,033
State	1,990	1,692	1,917
	<u>15,153</u>	<u>13,105</u>	<u>15,950</u>
Deferred:			
Federal	10,423	9,406	4,008
State	1,302	1,050	522
	<u>11,725</u>	<u>10,456</u>	<u>4,530</u>
Total	<u>\$ 26,878</u>	<u>\$ 23,561</u>	<u>\$ 20,480</u>

At December 31, 2004, we had prepaid income taxes totaling \$2.2 million and at December 31, 2003, we had income taxes payable totaling \$1.8 million.

Individually significant components of the deferred tax assets and liabilities are presented below (in thousands):

December 31,	2004	2003
Deferred tax assets:		
Allowance and accruals	\$ 3,638	\$ 4,189
Deferred revenue and cancellation reserves	4,801	4,398
Total deferred tax assets	8,439	8,587
Deferred tax liabilities:		
Inventories	(5,766)	(5,177)
Interest expense	(1,856)	-
Goodwill	(22,896)	(15,921)
Property and equipment, principally due to differences in depreciation	(14,670)	(11,045)
Total deferred tax liabilities	(45,188)	(32,143)
Total	\$ (36,749)	\$ (23,556)

In 2004, 2003 and 2002, income tax benefits attributable to employee stock option transactions of \$415,000, \$138,000 and \$264,000, respectively, were allocated to stockholders' equity.

The reconciliation between amounts computed using the federal income tax rate of 35% and our income tax expense from continuing operations for 2004, 2003 and 2002 is shown in the following tabulation (in thousands):

Year Ended December 31,	2004	2003	2002
Computed "expected" tax expense	\$ 24,364	\$ 20,719	\$ 18,494
State taxes, net of federal income tax benefit	2,138	1,769	1,580
Other	376	1,073	406
Income tax expense	\$ 26,878	\$ 23,561	\$ 20,480

(13) 401(k) Profit Sharing Plan

We have a defined contribution 401(k) plan and trust covering substantially all full-time employees. The annual contribution to the plan is at the discretion of our Board of Directors. Contributions of \$1.3 million, \$0.6 million and \$0.9 million were recognized for the years ended December 31, 2004, 2003 and 2002, respectively. Employees may contribute to the plan as they meet certain eligibility requirements.

(14) Stock Incentive Plans

At our annual shareholders meeting in May 2003, our shareholders approved an amendment to, and restatement of, our 2001 Stock Option Plan in the form of the 2003 Stock Incentive Plan (the "2003 Plan"). As amended in May 2004, the 2003 Plan allows for the granting of up to a total of 2.2 million incentive and nonqualified stock options and shares of restricted stock to our officers, key employees and consultants. We also have options outstanding and exercisable pursuant to their original terms pursuant to prior plans. Options canceled under prior plans do not return to the pool of options to be granted again in the future. All of the option plans are administered by the Compensation Committee of the Board and permit accelerated vesting of outstanding options upon the occurrence of certain changes in control. Options become exercisable over a period of up to ten years from the date of grant and at exercise prices as determined by the Board. Beginning in 2004, the term of options granted has been reduced to six years. At December 31, 2004, 2,807,801 shares of Class A common stock were reserved for issuance under the plans, of which 1,379,171 were available for future grant.

Activity under the above plans is as follows (in thousands):

	Shares Available for Grant	Shares Subject to Options	Weighted Average Exercise Price
Balances, December 31, 2001	325	1,373	\$14.02
Additional shares reserved	600	-	-
Options granted	(433)	433	15.80
Options canceled	52	(173)	17.00
Options exercised	-	(136)	12.00
Balances, December 31, 2002	544	1,497	14.25
Options granted	(16)	16	14.09
Options canceled	133	(151)	16.54
Options exercised	-	(38)	10.09
Balances, December 31, 2003	661	1,324	14.10
Additional shares reserved	1,000	-	-
Options granted	(337)	337	29.14
Options canceled	55	(64)	18.41
Options exercised	-	(168)	9.14
Balances, December 31, 2004	1,379	1,429	\$18.04

The following table summarizes stock options outstanding at December 31, 2004:

Options Outstanding			Options Exercisable		
Range of Exercise Prices	Number of Shares Outstanding	Weighted Average Remaining Contractual Life (years)	Weighted Average Exercise Price	Number of Shares Exercisable	Weighted Average Exercise Price
\$1.00	87,298	5.3	\$ 1.00	16,298	\$ 1.00
10.75	14,000	0.2	10.75	14,000	10.75
10.87 – 12.99	169,064	5.4	11.92	115,664	11.96
14.31 – 16.18	323,616	6.6	15.09	98,601	14.94
16.50 – 18.43	303,723	4.5	16.83	212,886	16.86
19.24 – 20.52	206,600	7.0	19.32	47,600	19.34
29.42	324,329	5.2	29.42	8,000	29.42
\$1.00 - \$29.42	1,428,630	5.6	\$18.04	513,049	\$15.14

At December 31, 2003 and 2002, 527,250 and 399,810 shares were exercisable at weighted average exercise prices of \$12.99 and \$11.88, respectively.

In 1998, the Board of Directors and the stockholders approved the implementation of an Employee Stock Purchase Plan (the "Purchase Plan"), and, as amended in May 2000, 2002, 2003 and 2004, have reserved a total of 1.75 million shares of Class A common stock for issuance thereunder. The Purchase Plan is intended to qualify as an "Employee Stock Purchase Plan" under Section 423 of the Internal Revenue Code of 1986, as amended, and is administered by the Compensation Committee of the Board. Eligible employees are entitled to invest up to 10% of their base pay for the purchase of stock up to \$25,000 of fair market value of our Class A common stock annually. The purchase price for shares purchased under the Purchase Plan is 85% of the lesser of the fair market value at the beginning or end of the purchase period. A total of 281,357, 375,988 and 217,230 shares of our Class A common stock were issued under the Purchase Plan during 2004, 2003 and 2002, respectively, and 540,496 remained available for issuance at December 31, 2004.

(15) Dividend Payments

We declared and paid a dividend of \$0.07 per share of Class A and Class B common stock for each of the second, third and fourth quarters of 2003 and the first quarter of 2004, totaling approximately \$1.3 million each quarter. In addition, we declared and paid a dividend of \$0.08 per share of Class A and Class B common stock for each of the second and third quarters of 2004, totaling approximately \$1.5 million per quarter. See also Note 19 for information regarding the declaration of a dividend related to the fourth quarter of 2004.

(16) Commitments and Contingencies

Leases

We lease certain of our facilities under non-cancelable operating leases. These leases expire at various dates through 2030. Certain lease commitments contain fixed payment increases at predetermined intervals over the life of the lease, while other lease commitments are subject to escalation clauses of an amount equal to the cost of living based on the "Consumer Price Index - U.S. Cities Average - All Items for all Urban Consumers" published by the U.S. Department of Labor.

The minimum lease payments under the operating leases after December 31, 2004 are as follows (in thousands):

<u>Year Ending December 31,</u>	
2005	\$ 19,809
2006	18,457
2007	17,360
2008	16,512
2009	13,251
Thereafter	<u>39,404</u>
Total minimum lease payments	124,793
Less: sublease rentals	<u>(4,434)</u>
	<u>\$ 120,359</u>

Rental expense for all operating leases was \$20.4 million, \$19.3 million and \$17.8 million for the years ended December 31, 2004, 2003 and 2002, respectively.

Primarily in connection with dispositions of dealerships, we occasionally assign or sublet our interests in any real property leases associated with such dealerships to the purchaser. We often retain responsibility for the performance of certain obligations under such leases to the extent that the assignee or sublessee does not perform, whether such performance is required prior to or following the assignment of subletting of the lease. Additionally, we generally remain subject to the terms of any guarantees made by us in connection with such leases. However, we generally have indemnification rights against the assignee or sublessee in the event of non-performance, as well as certain other defenses. We presently have no reason to believe that we will be called upon to perform under any such assigned leases or subleases. Lease rental payments under assigned or sublet leases for their remaining terms totaled approximately \$4.4 million at December 31, 2004. We may also be called upon to perform other obligations under these leases, such as environmental remediation of the premises or repairs upon termination of the lease. Although we currently have no reason to believe that we will be called upon to perform any such services, there can be no assurance that any future performance required by us under these leases will not have a material adverse effect on our financial condition or results of operations.

Capital Commitments

We had capital commitments of \$14.7 million at December 31, 2004 for the construction of five new facilities, additions to three existing facilities and the remodel of one facility. The new facilities will be for our Chevrolet dealership in Fairbanks, Alaska, our Toyota dealership in Springfield, Oregon, our Chevrolet and Hyundai dealerships in Odessa, Texas and a body shop also in Odessa, Texas. We have already incurred \$11.5 million for these projects and anticipate incurring the remaining \$14.7 million in 2005. We expect to pay for the construction out of existing cash balances until completion of the projects, at which time we anticipate securing long-term financing and general borrowings from third party lenders for 70% to 90% of the amounts expended.

Charge-Backs for Various Contracts

We have recorded a reserve for our estimated contractual obligations related to potential charge-backs for vehicle service contracts, lifetime oil change contracts and other various insurance contracts that are terminated early by the customer. At December 31, 2004, this reserve totaled \$11.8 million. Based on past experience, we estimate that the \$11.8 million will be paid out as follows: \$6.9 million in 2005; \$3.2 million in 2006; \$1.2 million in 2007; \$0.4 million in 2008; and \$0.1 million thereafter.

Litigation

We are party to numerous legal proceedings arising in the normal course of our business. While we cannot predict with certainty the outcomes of these matters, we do not anticipate that the resolution of these proceedings will have a material adverse effect on our business, results of operations, financial condition, or cash flows.

On April 28, 2004, a lawsuit was filed against us in the United States District Court for the District of Oregon: Robert Allen, et al., vs. Lithia Motors, Inc., et al., Civil Case No. 04-03032-CO. The complaint seeks money damages from us for alleged federal and state RICO violations, violation of Oregon's Unlawful Trade Practices Act and fraud, with respect to arranging the financing of vehicles. Each of the 23 Allen plaintiffs seeks stated actual damages ranging from \$733 to \$20,859, damages for mental distress ranging from \$10,000 to \$250,000, and punitive damages of \$1,500,000. With statutory penalties, the Allen plaintiffs seek actual damages that total less than \$250,000, trebled, approximately \$3.0 million in mental distress claims and punitive damages of \$34.5 million. Management believes that if damages were assessed, most would be covered by insurance. The case is still in its pleading stage and no depositions or document production has yet occurred. We intend to vigorously defend this matter and management believes that the likelihood of a judgment for the amount of damages sought is remote.

(17) Related Party Transactions

Mark DeBoer Construction

During 2004, 2003 and 2002, Lithia Real Estate, Inc. paid Mark DeBoer Construction, Inc. \$1.6 million, \$1.6 million, and \$4.3 million, respectively, for remodeling certain of our facilities. Mark DeBoer is the son of Sidney B. DeBoer, our Chairman and Chief Executive Officer. These amounts included \$0.7 million, \$0.9 million, and \$3.5 million, respectively, paid for subcontractors and materials, \$42,000, \$102,000 and \$183,000, respectively for permits, licenses, travel and various miscellaneous fees, and \$880,000, \$638,000, and \$558,000, respectively, for contractor fees. In 2004 and 2003, we paid more of the subcontractors directly, which reduced the overall payments to Mark DeBoer Construction, Inc. We believe the amounts paid are fair in comparison with fees negotiated with independent third parties and all significant transactions are reviewed and approved by our independent audit committee.

W. Douglas Moreland

In May 1999, we purchased certain dealerships owned by W. Douglas Moreland for total consideration of approximately \$66.0 million, at which time, Mr. Moreland became a member of our Board of Directors. During the normal course of business, these dealerships paid \$1.1 million in 2002 to other companies owned by Mr. Moreland for vehicle purchases, recourse paid to a financial lender and management fees. We also paid rental expense of \$2.6 million in 2002 to other companies owned by Mr. Moreland. As of October 31, 2002, Mr. Moreland was no longer a member of our Board of Directors.

(18) Acquisitions

The following acquisitions were made in 2004:

- In January 2004, we acquired one Chrysler and Jeep store in Reno, Nevada, which had anticipated annual revenues of approximately \$55.0 million. The store has been renamed Lithia Chrysler Jeep of Reno.
- In March 2004, we acquired one Chevrolet store in Helena, Montana, which had anticipated annual revenues of approximately \$40.0 million. The store has been renamed Chevrolet of Helena.
- In April 2004, we acquired Tony Chevrolet of Anchorage and Tony Chevrolet of Wasilla, Alaska, which had anticipated combined annual revenues of approximately \$125 million. The stores have been renamed Chevrolet of South Anchorage and Chevrolet of Wasilla, respectively.

- In June 2004, we acquired the Saab dealership assets of Pacific Motors Group, Inc. The Saab franchise purchased with this acquisition was combined with Chevrolet of South Anchorage.
- In July 2004, we acquired one Toyota store in Odessa, Texas, which had anticipated annual revenues of approximately \$20.0 million. The store has been renamed Lithia Toyota of Odessa.
- In September 2004, we acquired a Chrysler Dodge Jeep and a Honda store in Great Falls, Montana, which had anticipated combined annual revenue of approximately \$40 million. The stores have been renamed Lithia Chrysler Dodge Jeep of Great Falls and Honda of Great Falls, respectively.
- In October 2004, we acquired a Chrysler and a Jeep franchise in Santa Rosa, California, which had anticipated annual revenue of approximately \$10 million. These franchises have been combined with our existing Dodge store in Santa Rosa. The store is now named Lithia Chrysler Dodge Jeep of Santa Rosa.
- In October 2004, we acquired a BMW store in Anchorage, Alaska, which had anticipated annual revenue of approximately \$15 million. The store is now named BMW of Anchorage.
- In November 2004, we acquired a Chrysler Jeep Dodge franchise in Santa Fe, New Mexico, which had anticipated annual revenue of approximately \$20 million. The store is now named Lithia Chrysler Jeep Dodge of Santa Fe.
- In November 2004, we acquired a Dodge store in Helena, Montana, which had anticipated annual revenue of approximately \$18 million. The store is now named Lithia Dodge of Helena.

The following acquisitions were made in 2003:

- In February 2003, we acquired Richardson Chevrolet in Salinas, California, which had anticipated 2003 annual revenues of approximately \$35.0 million. This store has been renamed Chevrolet of Salinas.
- In March 2003, we acquired Pacific Hyundai of Anchorage, Alaska, which had anticipated 2003 revenues of approximately \$10.0 million. The store has been renamed Lithia Hyundai of Anchorage.
- In March 2003, we acquired Randy Hansen Chevrolet of Twin Falls, Idaho, which had anticipated 2003 annual revenues of approximately \$30.0 million. The store has been renamed Chevrolet Cadillac of Twin Falls.
- In April 2003, we acquired Grizzly Chrysler Dodge of Missoula, Montana, which had anticipated 2003 revenues of approximately \$25.0 million. The store has been renamed Lithia Auto Center of Missoula.
- In May 2003, we acquired Expressway Dodge of Broken Arrow, Oklahoma, which had anticipated 2003 revenues of approximately \$40.0 million. The store has been renamed Lithia Dodge of Broken Arrow.
- In June 2003, we acquired Midland Dodge of Billings, Montana, which had anticipated 2003 revenues of approximately \$35.0 million. The store has been renamed Lithia Dodge of Billings.
- In August 2003, we acquired Mercedes Benz of Spokane, Washington, which had anticipated 2003 revenues of approximately \$20.0 million. The store has been renamed Mercedes-Benz of Spokane.
- In August 2003, we acquired Santa Rosa Dodge in California, which had anticipated 2003 revenues of approximately \$30.0 million. The store has been renamed Lithia Dodge of Santa Rosa.
- In October 2003, we acquired Chevrolet Cadillac of Fairbanks, Alaska, which had anticipated 2003 revenues of approximately \$15.0 million. The store name will remain the same.
- In October 2003, we acquired Grapevine Dodge in Grapevine, Texas, which had anticipated 2003 revenues of approximately \$70.0 million. The store has been renamed Lithia Dodge of Grapevine.

- In November 2003, we acquired Fairfield Dodge in Fairfield, California, which had anticipated 2003 revenues of approximately \$20.0 million. The store has been renamed Lithia Dodge of Fairfield.

The above acquisitions were all accounted for under the purchase method of accounting. Pro forma results of operations assuming all of the above acquisitions occurred as of January 1, 2003 are as follows (in thousands, except per share amounts).

Year Ended December 31,	2004	2003
Total revenues	\$ 2,867,586	\$ 2,996,994
Net income	44,930	42,719
Basic earnings per share	2.39	2.34
Diluted earnings per share	2.24	2.30

There are no future contingent payouts related to any of the above acquisitions and no portion of the purchase price was paid with our equity securities. During 2004, we acquired 12 stores for \$91.6 million, which included \$38.0 million of goodwill and \$15.6 million of other intangible assets. During 2003, we acquired 11 stores for \$63.4 million, which included \$24.7 million of goodwill and \$8.0 million of other intangible assets.

Within one year from the purchase date, we may update the value allocated to purchased assets and the resulting goodwill balances for information received regarding the valuation of such assets as of the date of acquisition.

(19) Recent Accounting Pronouncements

In December 2004, the Financial Accounting Standards Board (“FASB”) issued SFAS No. 123R, “Share-Based Payment: an amendment of FASB Statements No. 123 and 95,” which requires companies to recognize in their income statement the grant-date fair value of stock options and other equity-based compensation issued to employees. SFAS No. 123R is effective for interim or annual periods beginning after June 15, 2005. Accordingly, we will adopt SFAS No. 123R in our third quarter of 2005. See Note 1 *Summary of Significant Accounting Policies – Stock-Based Compensation* above for the pro forma effects of how SFAS No. 123 would have affected results of operations in 2004, 2003 and 2002. We do not expect the results of SFAS No. 123R to be significantly different than those of applying SFAS No. 123. SFAS No. 123R will not have any effect on our cash flows.

In December 2004, the FASB issued SFAS No. 153, “Exchanges of Nonmonetary Assets.” SFAS No. 153 amends APB Opinion No. 29, “Accounting for Nonmonetary Transactions,” by replacing the exception for exchanges of similar productive assets with an exception for exchanges that do not have commercial substance. A transaction has commercial substance if the future cash flows of the entity are expected to change significantly as a result of the exchange. SFAS No. 153 is effective for fiscal periods beginning after June 15, 2005. We do not expect the adoption of SFAS No. 153 to have any effect on our financial position, results of operations or cash flow.

In October 2004, the FASB ratified Emerging Issues Task Force (“EITF”) 04-8, “Accounting Issues Related to Certain Features of Contingently Convertible Debt and the Effect on Diluted Earnings Per Share.” Pursuant to EITF 04-8, we are required to include 2,255,314 shares of common stock issuable upon conversion of our outstanding convertible debt in our diluted earnings per share calculations. Diluted EPS in prior periods in which the convertible debt was outstanding have been restated. Adoption of this accounting statement change did not affect our net income, cash flows or basic earnings per share.

In December 2003, the FASB issued Interpretation No. 46R (FIN 46R), “Consolidation of Variable Interest Entities,” which replaces FIN 46. FIN 46R clarifies the application of Accounting Research Bulletin No. 51, “Consolidated Financial Statements,” to certain entities in which equity investors do not have the characteristics of a controlling financial interest or do not have sufficient equity at risk for the entity to finance its activities without additional subordinated financial support from other parties. FIN 46R applies to variable interest entities (VIE’s) created after December 31, 2003, and to VIE’s in which an enterprise obtains an interest after that date. It applies in the first fiscal year or interim period ending after December 15, 2004 to VIE’s in which an enterprise holds a

variable interest that it acquired before January 1, 2004. We do not have any VIEs and, therefore, the adoption of FIN 46R in December 2004 did not have any effect on our financial position, results of operations or cash flows.

In May 2003, the FASB issued SFAS No. 149, "Amendment of Statement 133 on Derivative Instruments and Hedging Activities." SFAS No. 149 addresses certain accounting issues related to hedging activity and derivative instruments embedded in other contracts. In general, the amendments require contracts with comparable characteristics to be accounted for similarly. In addition, SFAS No. 149 provides guidance as to when a financing component of a derivative must be given special reporting treatment in the statement of cash flows. SFAS No. 149 is effective for contracts entered into or modified after June 30, 2003. The adoption of SFAS No. 149 did not have any effect on our financial position, results of operations or cash flows.

(20) Subsequent Events

Dividend

In January 2005, our Board of Directors approved a dividend on our Class A and Class B common stock of \$0.08 per share for the fourth quarter of 2004. The dividend, which will total approximately \$1.5 million, will be paid on March 14, 2005 to shareholders of record on February 28, 2005.

Acquisitions

In January 2005, we acquired a Chrysler and Jeep franchise in Concord, California. The franchises were added to our Dodge store in that market. The store is now named Lithia Chrysler Dodge Jeep of Concord.

In January 2005, we acquired a Chrysler franchise in Eugene, Oregon. The franchise was added to our Dodge store in that market. The store's name is now Lithia Chrysler Dodge of Eugene.

In February 2005, we acquired a Chrysler, Dodge and Jeep store in Omaha, Nebraska. The store has anticipated annualized revenues of \$110 million. The store was renamed Lithia Chrysler Dodge Jeep of Omaha.

CORPORATE INFORMATION

Annual Meeting

The Company's Annual Meeting of Shareholders will be held at 4:00 P.M., Thursday, May 5, Rogue Valley Country Club, 2660 Hillcrest Road, Medford, Oregon, 97504. Notice of the meeting and proxy statement materials are being sent to all shareholders. The Company's Annual Report on Form 10-K for the year ended December 31, 2004 includes all information as filed with the Securities and Exchange Commission, except exhibits.

Shareholder Communications

The Company welcomes your comments about its operations or any aspect of its business. Please contact our Investor Relations Group at 1-541-776-6591.

Description of Business:

Automobile sales and service

Corporate Headquarters:

360 East Jackson Street, Medford, Oregon 97501

Trading Information

(As of March 8, 2005):

(NYSE - LAD)

19,114,333 shares issued and outstanding

Class A 15,352,102

Class B 3,762,231

Auditors:

KPMG LLP, Portland, Oregon

Legal Counsel:

Foster, Pepper and Tooze, Portland, Oregon

Transfer Agent:

Computershare Trust Company
350 Indian St., Suite 800
Golden, Colorado 80401

Executive Officers:

Sidney B. DeBoer, Chairman and Chief Executive Officer
M.L. Dick Heimann, President and Chief Operating Officer
R. Bradford Gray, Executive Vice President
Bryan DeBoer, Executive Vice President
Don Jones, Jr., Senior Vice President, Retail Operations
Jeffrey B. DeBoer, Senior Vice President and Chief
Financial Officer

Lithia Board of Directors:

Sidney B. DeBoer
M.L. Dick Heimann
R. Bradford Gray
Thomas R. Becker
William J. Young
Gerald F. Taylor
Philip J. Romero

LITHIA MOTORS LOCATIONS

87 Stores - 26 Brands

ALASKA

Chevrolet Cadillac of Fairbanks
 Chevrolet of Wasilla
 Chevrolet Saab of South Anchorage
 Lithia Chrysler Jeep of Anchorage
 Lithia Dodge of South Anchorage
 Lithia Hyundai of Anchorage
 BMW of Anchorage

WASHINGTON

BMW Seattle
 Chevrolet Hummer of Bellevue
 Chevrolet of Issaquah
 Lithia Chrysler Jeep Dodge of Renton
 Lithia Hyundai of Renton
 Camp Chevrolet Cadillac
 Camp Imports
 Mercedes-Benz of Spokane
 Lithia Dodge of Tri-Cities
 Lithia Ford
 Honda of Tri-Cities

OREGON

Lithia Subaru of Oregon City
 Lithia Toyota of Springfield
 Lithia Chrysler Dodge of Eugene
 Lithia Nissan of Eugene
 Saturn of Eugene
 Lithia Chrysler Jeep Dodge of Roseburg
 Lithia Ford Lincoln Mercury of Roseburg
 Lithia Klamath Falls Auto Center
 Lithia Grants Pass Auto Center
 Lithia Chrysler Jeep Dodge
 Lithia Honda
 Lithia Nissan
 Medford BMW
 Saturn of Southwest Oregon
 Lithia Toyota
 Lithia Volkswagen

CALIFORNIA

Lithia Chevrolet of Redding
 Lithia Toyota/Scion of Redding
 Lithia Dodge Chrysler Jeep of Santa Rosa
 Lithia Toyota/Scion of Vacaville
 Lithia Dodge of Fairfield
 Lithia Chrysler Jeep Dodge of Concord
 Lithia Chrysler Jeep Dodge of Burlingame
 Chevrolet of Salinas
 Lithia Ford of Fresno
 Lithia Mazda Suzuki of Fresno
 Lithia Nissan Hyundai of Fresno

NEVADA

Lithia Reno Hyundai
 Lithia Lincoln Mercury Audi Isuzu of Reno
 Lithia Reno Subaru
 Lithia Volkswagen of Reno
 Lithia Chrysler Jeep of Reno
 Lithia Sparks Suzuki

IDAHO

Chevrolet of Caldwell
 Chevrolet of Boise
 Lithia Ford of Boise
 Lithia Lincoln Mercury of Boise
 Lithia Chrysler Dodge Hyundai of Pocatello
 Honda of Pocatello
 Chevrolet Cadillac of Twin Falls

MONTANA

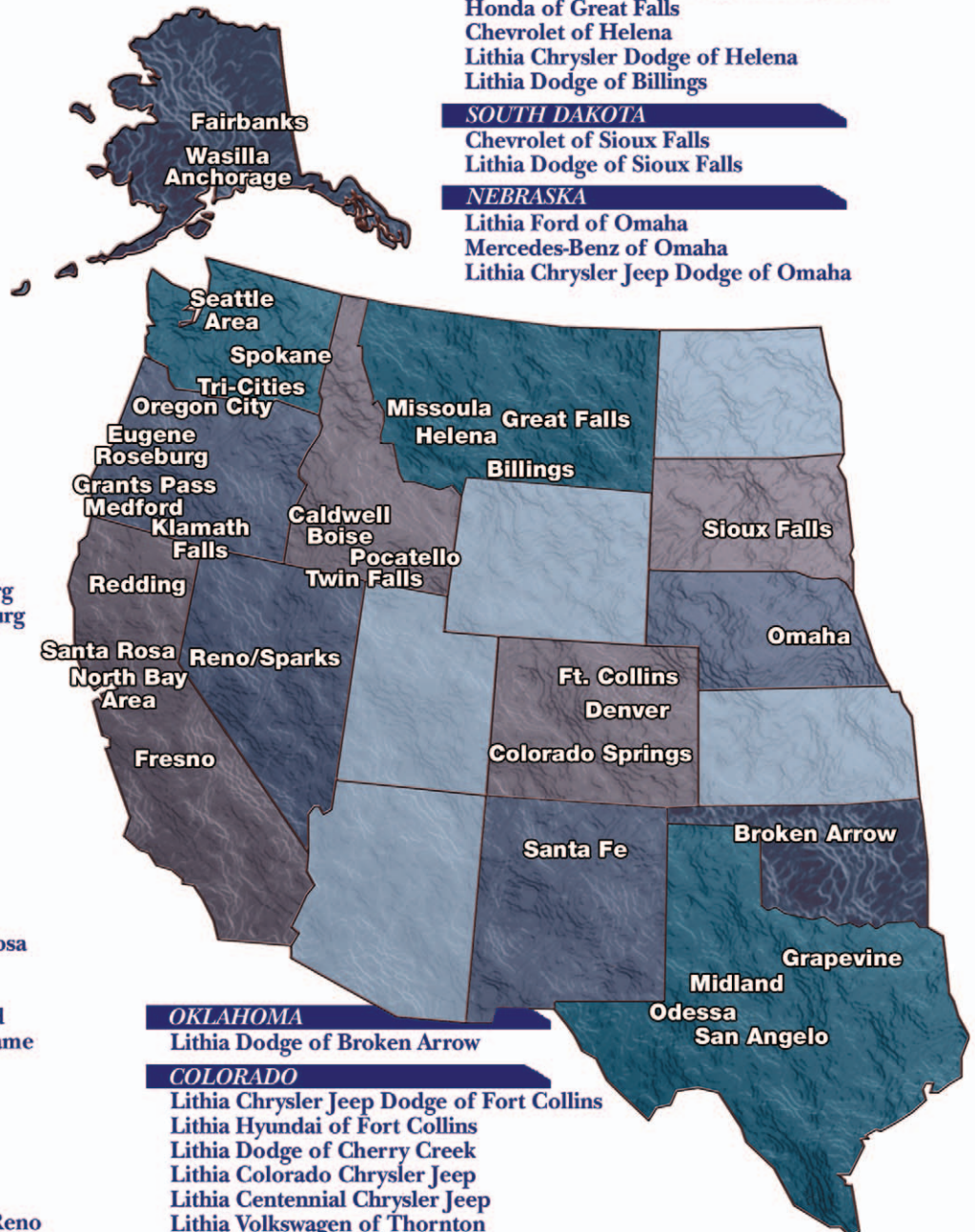
Lithia Chrysler Dodge of Missoula
 Lithia Chrysler Jeep Dodge of Great Falls
 Honda of Great Falls
 Chevrolet of Helena
 Lithia Chrysler Dodge of Helena
 Lithia Dodge of Billings

SOUTH DAKOTA

Chevrolet of Sioux Falls
 Lithia Dodge of Sioux Falls

NEBRASKA

Lithia Ford of Omaha
 Mercedes-Benz of Omaha
 Lithia Chrysler Jeep Dodge of Omaha



OKLAHOMA

Lithia Dodge of Broken Arrow

COLORADO

Lithia Chrysler Jeep Dodge of Fort Collins
 Lithia Hyundai of Fort Collins
 Lithia Dodge of Cherry Creek
 Lithia Colorado Chrysler Jeep
 Lithia Centennial Chrysler Jeep
 Lithia Volkswagen of Thornton
 Lithia Colorado Springs Jeep Chrysler

TEXAS

Lithia Dodge of Grapevine
 All American Chevrolet of Midland
 All American Dodge Hyundai of Midland
 All American Chevrolet of Odessa
 All American Chrysler Jeep Dodge of Odessa
 Lithia Toyota of Odessa
 All American Chevrolet of San Angelo
 All American Chrysler Jeep Dodge of San Angelo
 Honda of San Angelo

NEW MEXICO

Lithia Chrysler Jeep Dodge of Santa Fe

REVISED 1/11/05

LITHIA MOTORS, INC.

www.lithia.com

