

INCOME OPPORTUNITY REALTY INVESTORS INC /TX/

Form 10-K/A

November 08, 2005

UNITED STATES SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549  
FORM 10-K/A

(Mark One)

ANNUAL REPORT PURSUANT TO SECTION 13 OR 5(d) OF THE SECURITIES  
EXCHANGE ACT OF 1934

For the fiscal year ended December 31, 2003

OR

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

Commission File Number **001-14784**  
**Income Opportunity Realty Investors, Inc.**  
(Exact name of registrant as specified in its charter)

**Nevada**

**75-2615944**

(State or other jurisdiction of  
Incorporation or organization)

(IRS Employer Identification  
Number)

**1755 Wittington Place, Suite 340, Dallas, Texas**

**75234**

(Address of principal executive offices)

(Zip Code)

Registrant's Telephone Number, including area code **214-750-5800**

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

Title of Each Class  
**Common Stock, \$0.01 par value**

Name of each exchange on which registered  
**American Stock Exchange**

Securities registered pursuant to Section 12(g) of the Act: **None**

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. **Yes**  **No**

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. **Yes**  **No**

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 (§229.405 of this chapter) 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**

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

The aggregate market value of the shares of voting and non-voting common equity held by non-affiliates of the Registrant, computed by reference to the closing sales price of the Common Stock on the American Stock Exchange

as of June 30, 2004 (the last business day of the Registrant's most recently completed second fiscal quarter) was \$4,034,394 based upon a total of 298,844 shares held as of June 30, 2004 by persons believed to be non-affiliates of the Registrant. The basis of the calculation does not constitute a determination by the Registrant as defined in Rule 405 of the Securities Act of 1933, as amended, such calculation, if made as of a date within sixty days of this filing, would yield a different value. As of March 18, 2005, there were 1,389,345 shares of common stock outstanding.

DOCUMENTS INCORPORATED BY REFERENCE

None

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**AMENDMENT NO. 3 TO  
ANNUAL REPORT ON FORM 10-K FOR  
INCOME OPPORTUNITY REALTY INVESTORS, INC.**

The undersigned Registrant hereby further amends the following items, exhibits, or other portions of its Annual Report on Form 10-K for the fiscal year ended December 31, 2003 as set forth below and as reflected in the substituted pages attached hereto which replace the same numbered pages in the original filing and/or Amendment Nos. 1 and 2 (this Amendment No. 3 is necessitated by virtue of an oral request/comment of the Staff of the Securities and Exchange Commission on October 28, 2005).

Pages 25-46 Financial Statements and Supplementary Data. The Reports of Independent Registered Public Accounting Firms (pages 26-27) have been updated for a subsequent review. The consolidated balance sheets, consolidated statements of operations, consolidated statements of stockholders equity and consolidated statements of cash flows (pages 28-33) and Notes to Consolidated Financial Statements (pages 34-46) have been revised to consolidate all prior amendments to this item.

Exhibit 31.1 Certification required by Exchange Act Rules 13a-14(a) and 15d-14(a) (refiled as required by Rule 12b-15).

Exhibit 32.1 Certification pursuant to 18 U.S.C. § 1350 (refiled as required by Rule 12b-15).

**SIGNATURES**

Pursuant to the requirements of the Securities Exchange Act of 1934, as amended, the Registrant has duly caused this Amendment to be signed on its behalf by the undersigned, thereunto duly-authorized.

Date: November 7, 2005.

INCOME OPPORTUNITY REALTY  
INVESTORS, INC.

By: /s/ R. Neil Crouch, II

R. Neil Crouch, II, Executive Vice President  
and Chief Financial Officer and Acting  
Principal Executive Officer

ITEM 8. *FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA*

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| All other schedules are omitted because they are not required, are not applicable or the information required is included in the Financial Statements or the notes thereto. |             |

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

Board of Directors of  
Income Opportunity Realty Investors, Inc.

We have audited the accompanying consolidated balance sheets of Income Opportunity Realty Investors, Inc. and Subsidiaries as of December 31, 2003, and the related consolidated statements of operations, stockholders' equity and cash flows for year ended December 31, 2003. We have also audited the schedules listed in the accompanying index. These financial statements and the schedules are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and schedules 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 financial statements and schedules are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements and schedules. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the financial statements and schedules. We believe 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 consolidated financial position of Income Opportunity Realty Investors, Inc. and Subsidiaries as of December 31, 2003 and the consolidated results of their operations and their cash flows for year ended December 31, 2003, in conformity with accounting principles generally accepted in the United States of America.

Also, in our opinion, the schedules referred to above presents fairly, in all material respects, the information set forth therein.

/s/ Farmer, Fuqua & Huff, P.C.

Farmer, Fuqua, & Huff, P.C.

Plano, Texas

March 12, 2004, except for the effects of the changes contained in Note 18, which is dated August 19, 2005

REPORT OF INDEPENDENT CERTIFIED PUBLIC ACCOUNTANTS

Board of Directors of  
Income Opportunity Realty Investors, Inc.

We have audited the accompanying consolidated balance sheets of Income Opportunity Realty Investors, Inc. and Subsidiaries as of December 31, 2002 and 2001, and the related consolidated statements of operations, stockholders equity and cash flows for each of the three years in the period ended December 31, 2002. We have also audited the schedules listed in the accompanying index. These financial statements and the schedules are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and schedules based on our audits.

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

As described in Note 17, Income Opportunity Realty Investors, Inc.'s management has indicated its intent to both sell income producing properties and refinance or extend debt secured by real estate, to meet its liquidity needs.

As discussed in Note 1, IORI adopted the provisions of SFAS 144, *Accounting for Impairment of Long Lived Assets*, in 2001.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of Income Opportunity Realty Investors, Inc. and Subsidiaries as of December 31, 2002 and 2001, and the consolidated results of their operations and their cash flows for each of the three years in the period ended December 31, 2002, in conformity with accounting principles generally accepted in the United States of America.

Also, in our opinion, the schedules referred to above presents fairly, in all material respects, the information set forth therein.

BDO SEIDMAN, LLP

Dallas, Texas

March 21, 2003



INCOME OPPORTUNITY REALTY INVESTORS, INC.  
CONSOLIDATED BALANCE SHEETS

|   |                                     | <b>December 31,</b>                                 |             |
|---|-------------------------------------|---|-------------|
|   |                                     | <b>2003</b>   | <b>2002</b> |
|   |                                     | <b>(dollars in thousands,<br/>except per share)</b> |             |
|   |                                     | <b>(Restated)</b>                                   |             |
|   | Assets                              |   |             |
| Real estate held for investment   |                                     | \$ 56,367   | \$ 82,252   |
| Less accumulated depreciation   |                                     | (6,002)   | (7,502)     |
|   |                                     | 50,365  | 74,750      |
| Notes and interest receivable   |                                     | 45,531  |             |
| Investment in real estate partnerships  |                                     | 607   | 609         |
| Cash and cash equivalents   |                                     | 58  | 10          |
| Receivables from affiliates   |                                     | 479   | 10,497      |
| Other assets  |                                     | 4,053   | 4,319       |
|   |                                     | \$ 101,093  | \$ 90,185   |
|   | Liabilities and Stockholders Equity |   |             |
|   | Liabilities                         |   |             |
| Notes and interest payable  |                                     | \$ 60,825   | \$ 51,432   |
| Other liabilities   |                                     | 1,615   | 1,446       |
|   |                                     | 62,440  | 52,878      |
| Commitments and contingencies   |                                     |   |             |
|   | Stockholders equity                 |   |             |
| Common Stock, \$.01 par value; authorized 10,000,000 shares; issued and outstanding 1,438,945 shares in 2003 and 2002 |                                     | 14  | 14          |
| Paid-in capital   |                                     | 62,774  | 62,774      |
| Accumulated deficit   |                                     | (24,135)  | (25,481)    |
|   |                                     | 38,653  | 37,307      |
|   |                                     | \$ 101,093  | \$ 90,185   |

The accompanying notes are an integral part of these Consolidated Financial Statements.

INCOME OPPORTUNITY REALTY INVESTORS, INC.  
CONSOLIDATED STATEMENTS OF OPERATIONS

**For the Years Ended December 31,**  
**2003**                      **2002**                      **2001**  
**(Restated)**  
**(dollars in thousands, except per share)**

|   |           |           |            |
|---|-----------|-----------|------------|
| Property revenue  |           |           |            |
| Rents   | \$ 7,814  | \$ 7,739  | \$ 7,322   |
| Property expense  |           |           |            |
| Property operations   | 4,560     | 3,819     | 3,701      |
| Operating income  | 3,254     | 3,920     | 3,621      |
| Other income  |           |           |            |
| Interest  | 626       | 270       | 194        |
| Equity in income (loss) of equity partnerships              | (7)       | 862       | (9)        |
| Recovery of loss provision on receivable from related party | 1,569     |           |            |
|   | 2,188     | 1,132     | 185        |
| Other expense   |           |           |            |
| Interest  | 2,563     | 2,279     | 2,149      |
| Depreciation  | 1,199     | 1,216     | 1,568      |
| Advisory fee to affiliate                                   | 424       | 714       | 817        |
| Net income fee to affiliate                                 | 109       | 169       |            |
| Provision for loss on receivable from related party         |           | 1,568     |            |
| Provision for Asset Impairment                              | 848       |           |            |
| General and administrative                                  | 779       | 1,037     | 739        |
|   | 5,922     | 6,983     | 5,273      |
| Net income (loss) from continuing operations                | (480)     | (1,931)   | (1,467)    |
| Discontinued operations:                                    |           |           |            |
| Income (loss) from operations                               | (1,998)   | (3,136)   | (1,995)    |
| Gain on sale of real estate by equity investees             |           | 383       |            |
| Gain on sale of operations                                  | 3,824     | 6,769     |            |
| Net income (loss) from discontinued operations              | 1,826     | 4,016     | (1,995)    |
| Net income (loss)   | \$ 1,346  | \$ 2,085  | \$ (3,462) |
| Earnings per share  |           |           |            |
| Net income (loss) from continuing operations                | \$ (0.33) | \$ (1.34) | \$ (0.98)  |
| Discontinued operations                                     | 1.27      | 2.79      | (1.34)     |
| Net income (loss)   | \$ 0.94   | \$ 1.45   | \$ (2.32)  |
|   | 1,438,945 | 1,438,945 | 1,493,675  |

Weighted average shares of Common Stock used in  
computing earnings per share

The accompanying notes are an integral part of these Consolidated Financial Statements.

INCOME OPPORTUNITY REALTY INVESTORS, INC.  
CONSOLIDATED STATEMENTS OF STOCKHOLDERS EQUITY

|  | Common Stock<br>Shares                | Amount | Paid-in<br>Capital | Accumulated<br>Deficit | Stockholders<br>Equity |
|--|---------------------------------------|--------|--------------------|------------------------|------------------------|
|  | (dollars in thousands, except shares) |        |                    |                        |                        |
| <b>Balance, January 1, 2001</b>                    | 1,514,045                             | 15     | 64,087             | (24,104)               | 39,998                 |
| Repurchase of Common Stock                         | (75,100)                              | (1)    | (1,313)            |                        | (1,314)                |
| Net (loss)   |                                       |        |                    | (3,462)                | (3,462)                |
| <b>Balance, December 31, 2001</b>                  | 1,438,945                             | 14     | 62,774             | (27,566)               | 35,222                 |
| Net income   |                                       |        |                    | 2,085                  | 2,085                  |
| <b>Balance, December 31, 2002</b>                  | 1,438,945                             | 14     | 62,774             | (25,481)               | 37,307                 |
| Net income (as Restated)                           |                                       |        |                    | 1,346                  | 1,346                  |
| <b>Balance, December 31, 2003</b><br>(as Restated) | 1,438,945                             | \$ 14  | \$ 62,774          | \$ (24,135)            | \$ 38,653              |

The accompanying notes are an integral part of these Consolidated Financial Statements.

INCOME OPPORTUNITY REALTY INVESTORS, INC.  
CONSOLIDATED STATEMENTS OF CASH FLOWS

|   | <b>For the Years Ended December 31,</b> |                |                |
|---|---|----------------|----------------|
|   | <b>2003</b>                             | <b>2002</b>    | <b>2001</b>    |
|   | <b>(dollars in thousands)</b>           |                |                |
|   | <b>(Restated)</b>                       |                |                |
| <b>Cash Flows from Operating Activities</b>   |   |                |                |
| Rents collected   | \$ 10,671                               | \$ 10,554      | \$ 12,966      |
| Payments for property operations  | (5,903)                                 | (7,131)        | (6,981)        |
| Interest collected  | 262                                     | 291            | 148            |
| Interest paid   | (3,702)                                 | (4,339)        | (5,528)        |
| Advisory and net income fee paid to affiliate                                       | (451)                                   | (868)          | (1,054)        |
| General and administrative expenses paid  | (785)                                   | (1,029)        | (1,618)        |
| Distributions from equity partnerships operating cash flow                          |   | 25             | 18             |
| Other   |   |                | 20             |
| <b>Net cash provided by (used in) operating activities</b>                          | <b>92</b>                               | <b>(2,497)</b> | <b>(2,029)</b> |
| <b>Cash Flows from Investing Activities</b>   |   |                |                |
| Funding of equity partnerships  |   |                | (28)           |
| Real estate improvements  |   | (365)          | (3,466)        |
| Deposits on pending purchases and financings  |   |                | (25)           |
| Proceeds from sale of real estate   | 9,582                                   | 19,230         |                |
| Distributions from equity partnership s investing cash flow                         |   | 752            |                |
| Funding of note receivable (including \$5,109 in 2002 to related party)             | (1,567)                                 | (7,109)        |                |
| Collection of note receivable   |   | 500            | 1,000          |
| Payments from (to) advisor and affiliates   | (7,955)                                 | (6,244)        | 4,635          |
| <b>Net cash provided by investing activities</b>                                    | <b>60</b>                               | <b>6,764</b>   | <b>2,116</b>   |
| <b>Cash Flows from Financing Activities</b>   |   |                |                |
| Proceeds from notes payable   | 917                                     | 23,152         | 14,900         |
| Payments on notes payable   | (603)                                   | (26,308)       | (14,783)       |
| Deferred financing costs  | (418)                                   | (1,167)        | (911)          |
| Repurchase of Common Stock  |   |                | (1,314)        |
| <b>Net cash used in financing activities</b>  | <b>(104)</b>                            | <b>(4,323)</b> | <b>(2,108)</b> |
| <b>Net increase (decrease) in cash and cash equivalents</b>                         | <b>48</b>                               | <b>(56)</b>    | <b>(2,021)</b> |
| Cash and cash equivalents, beginning of year  | 10                                      | 66             | 2,087          |
| <b>Cash and cash equivalents, end of year</b>                                       | <b>\$ 58</b>                            | <b>\$ 10</b>   | <b>\$ 66</b>   |
| <b>Reconciliation of net income (loss) to net cash used in operating activities</b> |   |                |                |
| Net income (loss)   | \$ 1,346                                | \$ 2,085       | \$ (3,462)     |
| Adjustments to reconcile net income (loss) to net cash used in operating activities |   |                |                |
| Depreciation and amortization   | 2,165                                   | 1,867          | 2,930          |

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|   |           |            |            |
|---|-----------|------------|------------|
| Gain on sale of real estate   | (3,824)   | (7,152)    |            |
| Impairment of asset   | 848       |            |            |
| Equity in (income) loss of partnerships   | 2         | (862)      | 9          |
| Distributions from equity partnerships  |           | 25         | 18         |
| operating cash flow   |           |            |            |
| Provision for loss  |           | 1,568      |            |
| Decrease in interest receivable   | (368)     | 5          |            |
| (Increase) decrease in other assets   | 1         | 774        | (1,554)    |
| Decrease in interest payable  | 29        | (9)        | (103)      |
| Increase (decrease) in other liabilities  | (107)     | (798)      | 133        |
| Net cash provided by operating activities   | \$ 92     | \$ (2,497) | \$ (2,029) |
| Schedule of noncash investing and financing activities                                  |           |            |            |
| Notes payable from purchase of real estate  | \$ 18,687 | \$         | \$         |
| Notes payable assumed by buyer on sale of real estate                                   | 9,637     |            |            |
| Notes receivable collected by affiliates  | 8,760     | 5,541      |            |
| The accompanying notes are an integral part of these Consolidated Financial Statements. |           |            |            |

INCOME OPPORTUNITY REALTY INVESTORS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS Continued

The accompanying Consolidated Financial Statements of Income Opportunity Realty Investors, Inc. and consolidated entities were prepared in conformity with accounting principles generally accepted in the United States of America, the most significant of which are described in NOTE 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES. The Notes to Consolidated Financial Statements are an integral part of these Consolidated Financial Statements. The data presented in the Notes to Consolidated Financial Statements are as of December 31 of each year and for the year then ended, unless otherwise indicated. Dollar amounts in tables are in thousands, except per share amounts. Certain balances for 2002 and 2001 have been reclassified to conform to the 2003 presentation.

NOTE 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

*Organization and business.* Income Opportunity Realty Investors, Inc. ( IORI ) is the successor to a California business trust organized on December 14, 1984, which commenced operations on April 10, 1985. IORI invests in real estate through direct ownership, leases and partnerships and it also may invest in mortgage loans on real estate.

In October 2001, IORI announced a preliminary agreement for the acquisition of IORI by American Realty Investors, Inc. ( ARI ), a related party. See NOTE 17. COMMITMENTS AND CONTINGENCIES AND LIQUIDITY.

*Basis of consolidation.* The Consolidated Financial Statements include the accounts of IORI and controlled subsidiaries and partnerships. All significant intercompany transactions and balances have been eliminated.

*Accounting estimates.* In the preparation of the Consolidated Financial Statements in conformity with accounting principles generally accepted in the United States of America, it is necessary for management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the Consolidated Financial Statements and the reported amounts of revenues and expenses for the year then ended. Actual results could differ from those estimates.

*Recent accounting pronouncements.* In April 2002, the FASB issued Statement 145, Rescission of FASB Statements No. 4, 44 and 64, Amendment of FASB Statement No. 13, and Technical Correction ( SFAS No. 145 ). Statement 4,

Reporting Gains and Losses from Extinguishment of Debt ( SFAS No. 4 ), required that gains and losses from the extinguishment of debt that were included in the determination of net income be aggregated and, if material, classified as an extraordinary items. The provisions of SFAS No. 145 related to the rescission of SFAS No. 4 will require IORI to reclassify prior period items that do not meet the extraordinary classification. The provisions of SFAS No. 145 that relates to the rescission of SFAS No. 4 become effective in fiscal years beginning after May 15, 2002. The adoption of SFAS No. 145 is not expected to have a material impact on the consolidated financial position or results of operations of IORI.

In June 2002, the FASB issued SFAS No. 146, Accounting for Costs Associated with Exit or Disposal Activities, which addresses accounting for restructuring and similar costs. SFAS No. 146 supersedes previous accounting guidance, principally Emerging Issues Task Force ( EITF ) Issue No. 94-3. IORI will adopt the provisions of SFAS No. 146 for restructuring activities initiated after December 31, 2002. SFAS No. 146 requires that the liability for costs associated with an exit or disposal activity be recognized when the liability is incurred. Under EITF No. 94-3, a liability for an exit cost was recognized at the date of a company's commitment to an exit plan. SFAS No. 146 also establishes that the liability should initially be measured and recorded at fair value. Accordingly, SFAS No. 146 may affect the timing of recognizing future restructuring costs as well as the amount recognized.

In December 2002, the FASB issued SFAS No. 148, Accounting for Stock-Based Compensation, Transition and Disclosure, an amendment of FASB Statement No. 123. SFAS No. 148 provides alternative methods of transition for an entity that voluntarily changes to the fair value method of accounting for stock-based employee compensation. It also amends the disclosure provisions of SFAS No. 123 to require prominent disclosure about the effects on reported net income of an entity's accounting policy decisions with respect to stock-based employee compensation. Finally, this Statement amends APB Opinion No. 28, Interim Financial Reporting, to require disclosure about those effects in interim financial information. Management currently believes that the adoption of SFAS No. 148 will not have a material impact on the financial statements.

In November 2002, the FASB issued Interpretation No. 45, Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others, which disclosures are effective for financial statements issued after December 15, 2002. While IORI has various guarantees included in contracts in the normal course of business, these guarantees do not represent significant commitments or contingent liabilities of the indebtedness of entities outside of the consolidated company.

In January 2003, the FASB issued Interpretation No. 46, Consolidation of Variable Interest Entities (FIN 46) which requires the consolidation of variable interest entities, as defined. FIN 46 is applicable to financial statements to be issued by IORI after 2002, however, disclosures are required currently if IORI expects to consolidate any variable interest entities. IORI does not currently believe that any entities will be consolidated as a result of FIN 46.

*Real estate held for investment and depreciation.* Real estate held for investment is carried at cost. Statement of Financial Accounting Standards No. 144 (SFAS No. 144) requires that a property be considered impaired, if the sum of the expected future cash flows (undiscounted and without interest charges) is less than the carrying amount of the property. If impairment exists, an impairment loss is recognized by a charge against earnings equal to the amount by which the carrying amount of the property exceeds the fair value of the property. If impairment of a property is recognized, the carrying amount of the property is reduced by the amount of the impairment and a new cost for the property is established. Such new cost is depreciated over the property's remaining useful life. Depreciation is provided by the straight-line method over estimated useful lives, which range from 2 to 40 years.

*Revenue recognition on the sale of real estate.* Sales of real estate are recognized when and to the extent permitted by Statement of Financial Accounting Standards No. 66, Accounting for Sales of Real Estate (SFAS No. 66). Until the requirements of SFAS No. 66 for full profit recognition have been met, transactions are accounted for using either the deposit, the installment sale, the cost recovery or the financing method, whichever is appropriate. See NOTE 2. REAL ESTATE.

*Investment in noncontrolled partnerships.* The equity method is used to account for investments in partnerships which IORI does not control. Under the equity method, an initial investment, recorded at cost, is increased by a proportionate share of the partnership's operating income and any additional advances and decreased by a proportionate share of the partnership's operating losses and distributions received.

*Operating segments.* Management has determined reportable operating segments to be those that are used for internal reporting purposes which disaggregates operations by type of real estate.

*Fair value of financial instruments.* The following assumptions were used in estimating the fair value of notes receivable and payable. For notes receivable the fair value was estimated by discounting future cash flows using current interest rates for similar loans. For notes payable the fair value was estimated using year end interest rates for mortgages with similar terms and maturities.

*Cash equivalents.* For purposes of the Consolidated Statements of Cash Flows, all highly liquid investments purchased with an original maturity of three months or less are considered cash equivalents.

*Earnings per share.* Income (loss) per share is presented in accordance with Statement of Financial Accounting Standards No. 128 Earnings Per Share. Income (loss) per share is computed based upon the weighted average number of shares of Common Stock outstanding during each year.

#### NOTE 2. REAL ESTATE

In 2003, IORI sold the following properties:

| Property           | Location           | Sq.Ft.        | Sales Price | Net Cash Received | Debt Discharged | Gain/(Loss) on Sale |
|--------------------|--------------------|---------------|-------------|-------------------|-----------------|---------------------|
| Office Building    |                    |               |             |                   |                 |                     |
| Mowry Building     | Newark, CA         | 58,758 Sq.Ft. | \$ 5,000    | \$1,113           | \$4,057         |                     |
| La Mesa Building   | La Mesa, CA        | 90,105 Sq.Ft. | \$13,500    | \$6,521           | \$5,468         | \$3,824             |
| One Hickory Centre | Farmers Branch, TX | 97,361 Sq.Ft. | \$12,200    | \$ 227            |                 |                     |
| Land               |                    |               |             |                   |                 |                     |
| Travelers Land     | Farmers Branch, TX | 1.01 Acres    | \$25,000    | \$2,198           |                 |                     |





The Mowry building, located at 5600 Mowry School Road, Newark, California, was sold on July 1, 2003 at the sales price of \$5.0 million. Prior to the sale, IORI wrote down the carrying value of the property to its fair value, and an impairment loss of \$848,000 was recognized.

*Concentration of investment risk.* IORI has a high concentration of investment risk on properties in the Southwest region of the United States. This risk includes, but is not limited to changes in local economic conditions, changes in real estate and zoning laws, increases in real estate taxes, floods, tornados and other acts of God and other factors beyond the control of management.

*Concentration of investment risk (continued).* In the opinion of management, this investment risk is partially mitigated by the diversification of property types in other geographical regions of the United States, management's review of additional investments, acquisitions in other areas and by insurance.

**NOTE 3. NOTES AND INTEREST RECEIVABLE**

*Junior Mortgage Loans.* Junior mortgage loans are loans secured by mortgages that are subordinate to one or more prior liens either on the fee or a leasehold interest in real estate. Recourse on the loans ordinarily includes the real estate which secures the loan, other collateral and personal guarantees of the borrower.

In January 2002, IORI purchased 100% of the outstanding common shares of Rosedale Corporation ( Rosedale ), a wholly-owned subsidiary of American Realty Investors, Inc. ( ARI ), a related party, for \$5.1 million cash. Rosedale owned the 83,331 sq. ft. Rosedale Towers Office Building in Roseville, Minnesota. ARI guaranteed that the asset would produce at least a 12% return annually of the purchase price for a period of three years from the purchase date.

If the asset failed to produce the 12% return, ARI agreed to pay IORI any shortfall. Management recorded this related party transaction as a note receivable from ARI. In the first quarter of 2002, after reviewing the property's fair value after costs to sell, even though ARI has guaranteed the 12% return, IORI recognized a provision for loss on the note receivable of \$767,000. In December 2002, the Rosedale Towers Office Building was sold for \$7.2 million. ARI received \$3.5 million of the proceeds after the payment of the first lien debt and various closing costs, and IORI recognized an additional loss of \$801,000 on this note. The \$3.5 million received by ARI is included within other assets in the accompanying Consolidated Balance Sheet. In the second quarter of 2003, IORI received a \$2.0 million paydown from ARI on the receivable. In the third quarter of 2003, the remaining \$1.5 million was collected.

In February 2002, IORI funded a \$2.0 million mortgage loan as a participation agreement with Transcontinental Realty Investors, Inc. ( TCI ), a related party. The loan was secured by a second lien on a retail center in Montgomery County, Texas. The note receivable bore interest at 16.0% per annum, required monthly interest only payments of \$47,000 and matured in February 2002. In February 2002, the loan was extended until April 2002. In April 2002, IORI extended the loan until July 2002, receiving \$8,500 as an extension fee. In July 2002, the loan was extended until September 2002, with IORI receiving \$8,500 as an extension fee. Of the \$2.0 million in principal payments, \$1.5 million was received by TCI and \$500,000 was received by Basic Capital Management, Inc. ( BCM ), an affiliate and the advisor to IORI, until July 1, 2003. These amounts are included within receivables from affiliates in the accompanying Consolidated Balance Sheet.

On October 14, 2003, IORI sold and conveyed the office building known as One Hickory Centre and 202 acres of unimproved real property known as the Travelers Land in Dallas County, Texas to Encino Executive Plaza, Ltd. The sale price for One Hickory Centre was \$12,200,000 and Encino Executive Plaza, Ltd. executed a wrap-around promissory note in the amount of \$11,973,025 payable to the order of IORI secured by a Deed of Trust encumbering One Hickory Centre. The note bore interest at 6.7% per annum. As with the prior transaction, the difference between the purchase price and the promissory note represented adjustments for various prorations. The sale price for the Travelers Land was \$25,000,000. At closing, Encino Executive Plaza, Ltd. executed an all inclusive wrap-around promissory note payable to the order of IORI in the principal amount of \$22,801,987 secured by a Deed of Trust covering the Travelers Land sold and delivered cash to IORI in the amount of \$1,946,715, the remaining difference of which was as a result of prorations and various expenses paid by IORI in connection with the closing of the transaction. The note bore interest at 6.7% per annum. Subsequently, IORI made a loan to Encino Executive Plaza, Ltd. in the amount of \$1,567,232 payable upon demand or if no demand is made prior thereto on June 30, 2006 with a market rate of interest. Encino Executive Plaza, Ltd. executed and delivered a promissory note payable to the order of IORI in the stated principal amount of \$1,567,232. The note bore interest at 6.7% per annum.



On December 30, 2003, a Promissory Note in the amount of \$2,000,000 given by Housing for Seniors of Humble ( Housing ), LLC to NLP Lakeshore Villas, LLC ( NLP ) was assigned from ARI to IORI as additional paydown of certain intercompany receivables.

**NOTE 4. INVESTMENT IN EQUITY METHOD PARTNERSHIPS**

Investments in equity method partnerships consisted of the following:

|                                       | <b>2003</b> | <b>2002</b> |
|---------------------------------------|-------------|-------------|
| Nakash Income Associates ( NIA )      | 341         | 275         |
| TCI Eton Square, L.P. ( Eton Square ) | 266         | 334         |
|                                       | \$ 607      | \$ 609      |

IORI owned a 36.3% general partner interest in Tri-City, which in turn owned a shopping center in Houston, Texas. TCI owned a 63.7% limited partner interest in Tri-City. In November 2002, the shopping center was sold for \$4.2 million. Tri-City received net cash of \$1.9 million after the payment of various closing costs. IORI received a distribution of \$704,000 of the net proceeds and recognized a gain of \$1.3 million on its investment in Tri-City. IORI also owns a 40% general partner interest in NIA. NIA's only asset is a wraparound mortgage note receivable secured by a shopping center in Maulden, Missouri. TCI owns the remaining 60% general partner interest in NIA. IORI further owns a 10% limited partner interest in Eton Square, which at December 31, 2003, owned the Eton Square Building in Tulsa, Oklahoma. TCI owns a 90% general partner interest in Eton Square.

Set forth below are summarized financial data for the partnerships accounted for using the equity method:

|  | <b>2003</b> | <b>2002</b> |
|--|-------------|-------------|
| Notes receivable   | \$ 902      | \$ 902      |
| Real estate, net of accumulated depreciation (\$1,631 in 2003 and \$1,230 in 2002) | 13,753      | 14,152      |
| Other assets   | (262)       |             |
| Notes payable  | (10,206)    | (10,362)    |
| Other liabilities  | (677)       | (559)       |
| Partners' capital  | \$ 3,510    | \$ 4,133    |

|  | <b>2003</b> | <b>2002</b> | <b>2001</b> |
|--|-------------|-------------|-------------|
| Rents                                    | \$ 1,233    | \$ 2,981    | \$ 2,579    |
| Interest income                          | 156         | 156         | 80          |
| Interest expense                         | (685)       | (1,119)     | (1,131)     |
| Property operations expense              | (802)       | (1,453)     | (1,230)     |
| Depreciation                             | (400)       | (628)       | (586)       |
| Loss before gains on sale of real estate | (498)       | (63)        | (288)       |
| Gain on sale                             |             | 1,054       |             |
| Net income (loss)                        | \$ (498)    | \$ 991      | \$ (288)    |

IORI's equity share of:

|   | <b>2003</b> | <b>2002</b> | <b>2001</b> |
|---|-------------|-------------|-------------|
| Income (loss) before gains on sale of real estate | \$ (7)      | \$ 862*     | \$ (9)      |

|                             |        |          |     |        |
|-----------------------------|--------|----------|-----|--------|
| Gain on sale of real estate |        |          | 383 |        |
| Net income (loss)           | \$ (7) | \$ 1,245 |     | \$ (9) |

\* Includes the \$1.3 million gain from the sale of IORI s investment in Tri-City.

## NOTE 5. NOTES AND INTEREST PAYABLE

Scheduled notes payable principal payments are due as follows:

|            |           |
|------------|-----------|
| 2006       | 6,101     |
| 2007       | 717       |
| 2008       | 2,833     |
| 2009       | 742       |
| Thereafter | 27,503    |
|            | \$ 44,342 |

Notes payable at December 31, 2003, bear interest at rates ranging from 4.47% to 10.5% and mature between 2003 and 2025. The mortgages are collateralized by deeds of trust on real estate with a net carrying value of \$50.4 million. In April 2002, the Company transferred all of its residential properties to partnerships formed with Metra Capital LLC ( Metra ). The properties included the 60-unit Brighton Court, the 92-unit Del Mar, the 68-unit Enclave, the 280-unit Meridian, the 57-unit Signature, and the 114-unit Sinclair, all located in Midland, Texas, and the 106-unit Treehouse located in San Antonio, Texas. Innovo Realty, Inc., a subsidiary of Innovo Group, Inc. ( Innovo ) is a limited partner in the partnerships that purchased the properties. A former director of ARI, a related party, controlled approximately 11.67% of the outstanding common stock of Innovo. The transfer constituted 23% of the total assets of the Company as of December 31, 2001. The transfer price for the properties totaled \$26.2 million, of which the Company received \$5.3 million in cash after the payment of \$15.9 million in debt and various closing costs. Management determined to account for the transaction as a refinancing transaction (rather than a sale) in accordance with SFAS 66 Accounting for Sales of Real Estate. At the time of the transaction in April 2002, ARI was a related party to the Company by virtue of ARI's subsidiaries' ownership of approximately 28.5% of the then outstanding common stock of the Company, and the fact that ARI and the Company had the same persons as executive officers. The compensation price for the properties transferred totaled \$26.2 million and possible additional contingent consideration depending upon the sale price of the properties by the Metra partnerships. The Company also received \$5.2 million in value of 8% in non-recourse, non-convertible preferred stock of Innovo. Based upon the prospect of additional consideration, ultimate continued involvement through the preferred stock and the related-party nature of the former ARI director's involvement, as well as the Company retaining a right to approve the price of any ultimate sale by a Metra partnership of the properties, and a process by which the Company effectively guaranteed a preferential return to the Metra investors, management determined that the transaction must be classified as a financing transaction and not a sale. The Company continued to be able to exert control over the Metra partnerships, and no sale was recorded. The Treehouse property was subsequently sold to a non-related party in February 2004, and all of its debts have been repaid to the lenders at the time of the sale. During August 2004, certain entities, including the Company, instituted an action in a Texas state court against Innovo and Metra and others over the process, as well as distribution questions. During April 2005, a resolution of the litigation occurred settling all liabilities remaining from the original partnership arrangements which included a return of the Metra investor equity, prepayment of prospective asset management fees and miscellaneous fees and transaction costs from the Company and the other plaintiffs as a payment of the Preferential Return along with the delegation of management to another entity. Of the payment made, the Company recognized expense of \$56,000 and a reduction of \$1,476,000 in liabilities during the second quarter of 2005. In 2003, IORI refinanced the following properties:

| Property         | Location | Sq.Ft/<br>Acres | Debt<br>Incurred | Debt<br>Discharged | Net Cash<br>Received/<br>(Paid) | Interest<br>Rate | Maturity<br>Date |
|------------------|----------|-----------------|------------------|--------------------|---------------------------------|------------------|------------------|
| Office Building  | Farmers  | 40,066          | \$ 2,436         | \$ 1,778           | 547                             | 6.25%            | 10/08            |
| 2010 Valley View | Branch,  |                 |                  |                    |                                 |                  |                  |

|                |                                |        |    |       |    |       |          |       |
|----------------|--------------------------------|--------|----|-------|----|-------|----------|-------|
| Travelers Land | TX<br>Farmers<br>Branch,<br>TX | 97,361 | \$ | 5,000 | \$ | 4,225 | 6.00%(1) | 12/06 |
|----------------|--------------------------------|--------|----|-------|----|-------|----------|-------|

(1) Variable Rate

**NOTE 6. RELATED PARTY TRANSACTIONS**

In January 2002, IORI purchased 100% of the outstanding common shares of Rosedale Corporation ( Rosedale ), a wholly-owned subsidiary of American Realty Investors, Inc. ( ARI ), a related party, for \$5.1 million cash. Rosedale owned the 83,331 sq. ft. Rosedale Towers Office Building in Roseville, Minnesota. ARI guaranteed that the asset would produce at least a 12% return annually of the purchase price for a period of three years from the purchase date. If the asset failed to produce the 12% return, ARI agreed to pay IORI any shortfall. Management recorded this related party transaction as a note receivable from ARI. In the first quarter of 2002, after reviewing the property's fair value after costs to sell, even though ARI has guaranteed the 12% return, IORI recognized a provision for loss on the note receivable of \$767,000. In December 2002, the Rosedale Towers Office Building was sold for \$7.2 million. ARI received \$3.5 million of the proceeds after the payment of the first lien debt and various closing costs, and IORI recognized an additional loss of \$801,000 on this note. The \$3.5 million received by ARI is included within other assets in the accompanying Consolidated Balance Sheet. In the second quarter of 2003, IORI received a \$2.0 million paydown from ARI on the receivable. In the third quarter of 2003, the remaining \$1.5 million was collected.

On December 30, 2003, a Promissory Note in the amount of \$6.3 million given by Housing to NLP was assigned from ARI to IORI. On December 30, 2003, a Promissory Note in the amount of \$2.0 million given by Housing to NLP was assigned from ARI to IORI. These assignments were payments aggregating \$8.3 million plus accrued interest of \$386,000 on certain intercompany receivables due to IORI.

On December 18, 2003, IORI purchased 100% of the outstanding common shares of Transcontinental Brewery Corporation ( Brewery ), a wholly-owned subsidiary of TCI, a related party, for \$4.0 million for a reduction of intercompany debt in the same amount. Brewery owns the 19.96 acres of land and the 133,000 sq. ft. Eagle Crest Warehouse Building in Farmers Branch, Texas.

On December 18, 2003, IORI purchased 100% of the outstanding common shares of Transcontinental Treehouse Corporation ( Treehouse-IR ), a wholly-owned subsidiary of TCI, for \$7.5 million for a reduction of intercompany debt in the amount of \$2.4 million subject to mortgage lien in the amount of \$5.1 million. Treehouse-IR owns the 153,072 sq. ft. Treehouse Apartments Building in Irving, Texas.

On December 18, 2003, IORI purchased 100% of the outstanding common shares of Transcontinental Parkway Corporation ( Parkway ), a wholly-owned subsidiary of TCI, for \$4.0 million for reduction of intercompany debt in the amount of \$2.4 million subject to mortgage lien in the amount of \$1.6 million. Parkway owns the 28,374 sq. ft. Parkway Shopping Center in Dallas, Texas.

On September 19, 2002, IORI's Board of Directors authorized the Chief Financial Officer of the Company to advance funds either to or from the Company, through the advisor, in an amount up to \$5.0 million on the condition that such advances shall be repaid in cash or transfers of assets within 90 days.

The following table reconciles the beginning and ending balances of Accounts Receivable from Affiliates as of December 31, 2003 (as Restated).

|                            | <b>SWI</b> | <b>BCM</b> | <b>ARI</b> | <b>TCI</b> |
|----------------------------|------------|------------|------------|------------|
| Balance, December 31, 2002 |            | \$ 1,696   | \$ 3,541   | \$ 5,260   |
| Cash transfers             | 15,209     | 5,017      |            |            |
| Cash repayments            | (3,881)    | (3,937)    | (3,494)    | (1,000)    |
| Other additions            | 2,926      | 784        | 367        | 1          |
| Other repayments           | (13,930)   | (3,560)    | (47)       | (4,000)    |
| Balance, December 31, 2003 | 324        | \$         | \$ 367     | \$ 261     |

*Returns on Metra Properties.* As described more fully in Note 5, IORI sold all of its residential properties during 2002 to partnerships controlled by Metra. The partnership agreement for each of these partnerships states that the Metra Partners, as defined, receive cash flow distributions at least quarterly in an amount sufficient to provide them with a fifteen percent cumulative compounded annual rate of return on their invested capital, as well as a cumulative annual amount of 0.50% of the average outstanding balance of the mortgage indebtedness secured by any of these residential



properties. These distributions to the Metra Partners have priority over distributions to any of the other partners.

**NOTE 7. DIVIDENDS**

Dividends of \$685,000 (\$.45 per share) were paid in 2000.

It was reported to the Internal Revenue Service that 100% of the dividends paid in 2000 represented capital gains. In December 2000, the Board of Directors determined not to pay a fourth quarter dividend to holders of IORI's Common Stock. The non-payment decision was based on the Board determining that IORI needed to retain cash for acquisitions that were anticipated in 2001 and that IORI had no REIT taxable income that required a distribution. No dividends were declared or paid in 2003 or 2002. Management expects to pay no dividends in 2004.

**NOTE 8. RENTS UNDER OPERATING LEASES**

Operations include the leasing of office buildings. The leases thereon expire at various dates through 2011. The following is a schedule of minimum future rents on non-cancelable operating leases as of December 31, 2003:

|            |           |
|------------|-----------|
| 2004       | \$ 2,354  |
| 2005       | 2,298     |
| 2006       | 1,762     |
| 2007       | 1,389     |
| 2008       | 1,182     |
| Thereafter | 1,888     |
|            | \$ 10,873 |

**NOTE 9. ADVISORY AGREEMENT**

SWI is 100% owned by Gene E. Phillips. Mr. Phillips is a Chairman, a President, a Chief Executive Officer, and a Director, and is involved in daily consultation with the officers of SWI and has significant influence over the conduct of SWI's business, including the rendering of advisory services and the making of investment decisions for itself and for IORI.

Under the Advisory Agreement, SWI is required to annually formulate and submit for Board approval a budget and business plan containing a twelve-month forecast of operations and cash flow, a general plan for asset sales and purchases, borrowing activity and other investments. SWI is required to report quarterly to the Board on IORI's performance against the business plan. In addition, all transactions require prior Board approval, unless they are explicitly provided for in the approved business plan or are made pursuant to authority expressly delegated to SWI by the Board.

The Advisory Agreement also requires prior Board approval for the retention of all consultants and third party professionals other than legal counsel. The Advisory Agreement provides that SWI shall be deemed to be in a fiduciary relationship to the stockholders and contains a broad standard governing SWI's liability for losses incurred by IORI.

The Advisory Agreement provides for SWI to be responsible for IORI's day-to-day operations and to receive an advisory fee comprised of a gross asset fee of .0625% per month (.75% per annum) of the average of the gross asset value (total assets less allowance for amortization, depreciation or depletion and valuation reserves) and an annual net income fee equal to 7.5% per annum of net income.

The Advisory Agreement also provides for SWI to receive an annual incentive sales fee. SWI or an affiliate of SWI is to receive an acquisition commission for supervising the purchase or long-term lease of real estate. SWI or an affiliate of SWI is to receive a mortgage or loan acquisition fee with respect to the purchase of any existing mortgage loan. SWI or an affiliate of SWI also is to receive a mortgage brokerage and equity refinancing fee for obtaining loans or refinancing of IORI's properties. In addition, SWI receives reimbursement of certain expenses incurred by it, in the performance of advisory services for IORI.

The Advisory Agreement requires SWI or any affiliate of SWI to pay to IORI one-half of any compensation received from third parties with respect to the origination, placement or brokerage of any loan made by IORI.

Under the Advisory Agreement all or a portion of the annual advisory fee must be refunded by SWI if the Operating Expenses of IORI (as defined in the Advisory Agreement) exceed certain limits specified in the Advisory Agreement.

The effect of this limitation was to

require SWI to refund \$227,000 of the 2003 annual advisory fee, \$68,000 of the 2002 annual advisory fee, and \$256,000 of the 2001 annual advisory fee.

Additionally, if management was to request that SWI render services other than those required by the Advisory Agreement, SWI or an affiliate of BCM would be separately compensated for such additional services on terms to be agreed upon from time to time. As discussed in NOTE 9. PROPERTY MANAGEMENT, Triad Realty Services, Ltd. ( Triad ), an affiliate of SWI, provides property management services and, as discussed in NOTE 11. REAL ESTATE BROKERAGE, Regis Realty, Inc. ( Regis ), a related party, provided, on a non-exclusive basis, brokerage services. SWI may assign the Advisory Agreement only with the prior consent of IORI.

**NOTE 10. PROPERTY MANAGEMENT**

Triad provides property management services for a fee of 5% or less of the monthly gross rents collected on residential properties and 3% or less of the monthly gross rents collected on commercial properties under its management. Triad subcontracts with other entities for property-level management services at various rates. The general partner of Triad is BCM. The limited partner of Triad is Highland Realty Services, Inc. ( Highland ), a related party. Triad subcontracted to Regis, which is owned by Highland, the property-level management and leasing of IORI's five office buildings and the commercial property owned by Eton Square, until December 2002. Since January 1, 2003, Regis Realty I, LLC, which is owned by Highland, provided property management services. Regis was and Regis Realty I, LLC is entitled to receive property and construction management fees and leasing commissions in accordance with the terms of its property-level management agreement with Triad.

**NOTE 11. REAL ESTATE BROKERAGE**

Regis also provided brokerage services on a non-exclusive basis until December 2003. Regis was and Regis Realty I, LLC is entitled to receive a commission for property purchases and sales in accordance with a sliding scale of total brokerage fees to be paid by IORI.

**NOTE 12. ADVISORY FEES, PROPERTY MANAGEMENT FEES, ETC.**

Fees and cost reimbursements to SWI/BCM and its affiliates:

|   | <b>2003</b>       | <b>2002</b> | <b>2001</b> |
|---|-------------------|-------------|-------------|
|   | <b>(Restated)</b> |             |             |
| <b>Fees</b>                                 |                   |             |             |
| Advisory                                    | \$ 424            | \$ 714      | \$ 817      |
| Net income                                  | 109               | 169         |             |
| Property acquisition                        |                   |             |             |
| Mortgage brokerage and equity refinancing   | 547               | 262         | 99          |
| Property & Construction Mgt. & Leasing Comm | 323               | 0           | 0           |
|   | \$ 1,403          | \$ 1,145    | \$ 916      |
| Cost reimbursements                         | \$ 173            | \$ 246      | \$ 323      |

**NOTE 13. INCOME TAXES**

For the years 2002 and 2001, IORI elected and qualified to be treated as a Real Estate Investment Trust ( REIT ), as defined in Sections 856 through 860 of the Internal Revenue Code of 1986, as amended (the Code ), and as such, was not taxed for federal income tax purposes on that portion of its taxable income which is distributed to stockholders. Due to the completion of the tender offer by ARI, an affiliate, and the resulting concentration of ownership, IORI no longer met the requirements for tax treatment as a REIT under the Code as of January 1, 2003, and is prohibited for re-qualifying for REIT status for at least five years.

IORI had net income for federal income tax purposes before the application of operating loss carryforwards in 2003 and 2002 and had a net loss for federal income tax purposes in 2001. Therefore, IORI recorded no provision for income taxes. IORI's tax basis in its net assets differs from the amount at which its net assets are reported for financial statement purposes, principally due to the accounting for gains and losses on property sales, depreciation on owned

properties and investments in joint venture partnerships. At December 31, 2003, IORI's tax basis in its net assets was exceeded by their net basis for financial statement purposes by approximately \$14.4 million and IORI's tax basis in its net mortgage liabilities was exceeded by their net basis for financial statement purposes by

approximately \$21.3 million. As a result, aggregate future income for income tax purposes will be less than such amount for financial statement purposes by approximately \$6.9 million. Additionally, at December 31, 2003, IORI has current and prior tax net operating loss carryforwards of \$2.3 million expiring through the year 2021.

As a result of IORI's election to be treated as a REIT for income tax purposes for years 2002 and 2001 and its then intention to distribute its REIT taxable income, if any, in future years, no deferred tax asset, liability or valuation allowance was recorded. At December 31, 2003, IORI had a net deferred tax asset of \$3.5 million due to tax deductions available to it in future years. However, as management cannot determine that it is more likely than not that IORI will realize the benefit of the deferred tax asset, a 100% valuation allowance has been established.

**NOTE 14. OPERATING SEGMENTS**

Significant differences among the accounting policies of the operating segments as compared to the Consolidated Financial Statements principally involve the calculation and allocation of general and administrative expenses. Management evaluates the performance of the operating segments and allocates resources to each of them based on their operating income and cash flow. Items of income that are not reflected in the segments are interest, and equity in partnerships totaling \$619,000, \$1.1 million, \$185,000 for 2003, 2002 and 2001, respectively. Expenses/(Gains) that are not reflected in the segments are general and administrative expenses, advisory and net income fees, provision for loss, and provision for asset impairment totaling \$2.2 million, \$3.5 million, and \$1.6 million for 2003, 2002 and 2001, respectively. Excluded from operating segment assets are assets of \$50.8 million at December 31, 2003, \$15.4 million at December 31, 2002, and \$4.4 million at December 31, 2001, which are not identifiable with an operating segment. There are no intersegment revenues and expenses and all business is conducted in the United States. Presented below is the operating income of each operating segment.

| <b>2003 (as restated)</b>   | <b>Land</b> | <b>Commercial Properties</b> | <b>Apartments</b> | <b>Total</b> |
|-----------------------------|-------------|------------------------------|-------------------|--------------|
| Rents                       | \$          | \$ 2,456                     | \$ 5,358          | \$ 7,814     |
| Property operating expenses |             | 1,091                        | 3,471             | 4,560        |
| Operating income (loss)     | \$          | \$ 1,365                     | \$ 1,887          | \$ 3,254     |
| Depreciation                | \$          | \$ 794                       | \$ 405            | \$ 1,199     |
| Interest                    |             | 623                          | 1,940             | 2,563        |
| Real estate improvements    |             | 494                          |                   | 494          |
| Assets                      | 44          | 22,105                       | 28,216            | 50,365       |

|                |  | <b>Commercial Properties</b> | <b>Total</b> |
|----------------|--|------------------------------|--------------|
| Property Sales |  |                              |              |
| Sales price    |  | \$ 55,700                    | \$ 55,700    |
| Cost of sale   |  | 51,874                       | 51,874       |
| Gain on sale   |  | \$ 3,824                     | \$ 3,824     |

|                             | <b>Land</b> | <b>Commercial Properties</b> | <b>Apartments</b> | <b>Total</b> |
|-----------------------------|-------------|------------------------------|-------------------|--------------|
| 2002                        |             |                              |                   |              |
| Rents                       | \$          | \$ 2,394                     | \$ 5,345          | \$ 7,739     |
| Property operating expenses |             | 1,030                        | 2,789             | 3,819        |
| Operating income            | \$          | \$ 1,364                     | \$ 2,556          | \$ 3,920     |

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|                          |        |        |     |        |       |        |       |
|--------------------------|--------|--------|-----|--------|-------|--------|-------|
| Depreciation             | \$     | \$     | 739 | \$     | 477   | \$     | 1,216 |
| Interest                 |        |        | 605 |        | 1,674 |        | 2,279 |
| Real estate improvements |        |        | 240 |        |       |        | 240   |
| Assets                   | 24,929 | 28,688 |     | 21,133 |       | 74,750 |       |
|                          | 40     |        |     |        |       |        |       |

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|                | <b>Commercial<br/>Properties</b> | <b>Total</b> |
|----------------|----------------------------------|--------------|
| Property Sales |                                  |              |
| Sales price    | \$ 19,230                        | \$ 19,230    |
| Cost of sale   | 12,461                           | 12,461       |
| Gain on sale   | \$ 6,769                         | \$ 6,769     |

|                             | <b>Land</b> | <b>Commercial<br/>Properties</b> | <b>Apartments</b> | <b>Total</b> |
|-----------------------------|-------------|----------------------------------|-------------------|--------------|
| 2001                        |             |                                  |                   |              |
| Rents                       | \$          | \$ 2,277                         | \$ 5,045          | \$ 7,322     |
| Property operating expenses |             | 1,034                            | 2,667             | 3,701        |
| Operating income            | \$          | \$ 1,243                         | \$ 2,378          | \$ 3,621     |
| Depreciation                | \$          | \$ 1,056                         | \$ 512            | \$ 1,568     |
| Interest                    |             | 788                              | 1,361             | 2,149        |
| Real estate improvements    | 2,404       | 1,062                            |                   | 3,466        |
| Assets                      | 24,492      | 41,213                           | 21,610            | 87,315       |

**NOTE 15. DISCONTINUED OPERATIONS**

Effective January 1, 2002, IORI adopted Statement of Financial Accounting Standards No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets, which established a single accounting model for the impairment or disposal of long-lived assets, including discontinued operations. This statement requires that the operations related to properties that have been sold or properties that are intended to be sold be presented as discontinued operations in the statement of operations for all periods presented, and properties intended to be sold are to be designated as held-for-sale on the balance sheet.

For 2003, 2002, and 2001, income (loss) from discontinued operations relates to two properties that IORI sold during 2002 and four properties sold during 2003. The following table summarizes revenue and expense information for these properties sold.

|   | <b>2003</b> | <b>2002</b> | <b>2001</b> |
|---|-------------|-------------|-------------|
| Revenue   |             |             |             |
| Rental  | \$ 1,991    | \$ 2,660    | \$ 5,679    |
| Property operations                                       | 1,858       | 2,511       | 2,890       |
|   | 133         | 149         | 2,789       |
| Interest Income   | 462         |             |             |
| Expenses  |             |             |             |
| Interest  | 2,236       | 2,635       | 3,925       |
| Depreciation  | 357         | 650         | 859         |
|   | 2,593       | 3,285       | 4,784       |
| Net income (loss) from discontinued operations            | (1,998)     | (3,136)     | (1,995)     |
| Gain on sale of real estate                               | 3,824       | 6,769       |             |
| Equity in gain on sale of real estate by equity investees |             | 383         |             |



|  |          |          |            |
|--|----------|----------|------------|
| Net income (loss) from discontinued operations | \$ 1,826 | \$ 4,016 | \$ (1,995) |
|--|----------|----------|------------|

NOTE 16. *QUARTERLY DATA*

The following is a tabulation of quarterly results of operations for the years 2003, 2002 and 2001 (unaudited).

|  | <b>Three Months Ended</b> |                |                         |                        |
|--|---------------------------|----------------|-------------------------|------------------------|
|  | <b>March<br/>31</b>       | <b>June 30</b> | <b>September<br/>30</b> | <b>December<br/>31</b> |
| <b>2003 (as restated)</b>                    |                           |                |                         |                        |
| Rents  | \$ 1,942                  | \$ 1,958       | \$ 1,970                | \$ 1,944               |
| Property expense                             | 966                       | 1,012          | 1,182                   | 1,400                  |
| Operating income                             | 976                       | 946            | 788                     | 544                    |
| Interest income                              |                           | 614            | 12                      |                        |
| Income (loss) in equity partnerships         | (15)                      |                | (13)                    | 21                     |
| Recovery of A/R written off                  |                           | 1,569          |                         |                        |
| Other expense                                | 1,300                     | 1,982          | 1,325                   | 1,315                  |
| Net income (loss) from continuing operations | (339)                     | 1,147          | (538)                   | (750)                  |
|  | 41                        |                |                         |                        |

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|                                      | <b>Three Months Ended</b> |             |                  |                 |
|--------------------------------------|---------------------------|-------------|------------------|-----------------|
|                                      | <b>March</b>              | <b>June</b> | <b>September</b> | <b>December</b> |
| <b>2003 (as restated)</b>            | <b>31</b>                 | <b>30</b>   | <b>30</b>        | <b>31</b>       |
| Discontinued operations              | (588)                     | (491)       | (541)            | 3,446           |
| Net income (loss)                    | \$ (927)                  | \$ 656      | \$ (1,079)       | \$ 2,696        |
| Earnings per share Net income (loss) | \$ (0.64)                 | \$ 0.46     | \$ (.75)         | \$ 1.87         |

|                                      | <b>Three Months Ended</b> |                |                  |                 |
|--------------------------------------|---------------------------|----------------|------------------|-----------------|
|                                      | <b>March</b>              | <b>June 30</b> | <b>September</b> | <b>December</b> |
| <b>2002</b>                          | <b>31</b>                 | <b>30</b>      | <b>30</b>        | <b>31</b>       |
| Rents                                | \$ 1,892                  | \$ 1,888       | \$ 2,061         | \$ 1,898        |
| Property expense                     | 801                       | 896            | 1,137            | 985             |
| Operating income                     | 1,091                     | 992            | 924              | 913             |
| Interest income                      | 37                        | 310            | 185              | (262)           |
| Income (loss) in equity partnerships | (17)                      | 48             | 60               | 771             |
| Other expense                        | 2,393                     | 1,519          | 1,055            | 2,016           |
| Net loss from continuing operations  | (1,282)                   | (169)          | 114              | (594)           |
| Discontinued operations              | 6,355                     | (718)          | (1,355)          | (266)           |
| Net income (loss)                    | \$ 5,073                  | \$ (887)       | \$ (1,241)       | \$ (860)        |
| Earnings per share Net income (loss) | \$ 3.53                   | \$ (.62)       | \$ (.86)         | \$ (.60)        |

|  | <b>Three Months Ended</b> |                |                  |                 |
|--|---------------------------|----------------|------------------|-----------------|
|  | <b>March</b>              | <b>June 30</b> | <b>September</b> | <b>December</b> |
| <b>2001</b>                                  | <b>31</b>                 | <b>30</b>      | <b>30</b>        | <b>31</b>       |
| Rents  | \$ 1,814                  | \$ 1,806       | \$ 1,802         | \$ 1,900        |
| Property expense                             | 907                       | 889            | 1,013            | 892             |
| Operating income                             | 907                       | 917            | 789              | 1,008           |
| Interest income                              | 72                        | 62             | 8                | 52              |
| Income (loss) in equity partnerships         | 9                         | (6)            | (30)             | 18              |
| Other expense                                | 1,328                     | 1,327          | 1,406            | 1,212           |
| Net income (loss) from continuing operations | (340)                     | (354)          | (639)            | (134)           |
| Discontinued operations                      | (377)                     | (378)          | (1,110)          | (130)           |
| Net income (loss)                            | \$ (717)                  | \$ (732)       | \$ (1,749)       | \$ (264)        |
| Earnings per share Net income (loss)         | \$ (.47)                  | \$ (.49)       | \$ (1.16)        | \$ (.18)        |

In the third quarter of 2003, the Mowry Building was sold, and an impairment loss on sale of real estate of 848,000 was recognized. In the fourth quarter of 2003, La Mesa Village, Travelers Land, and One Hickory Centre were sold. \$3.8 million gain was recognized on the sale of La Mesa Village. Travelers Land had \$59,000 deferred capital loss on sale.

**NOTE 17. COMMITMENTS AND CONTINGENCIES AND LIQUIDITY**

*Olive Litigation.* In February 1990, IORI, together with National Income Realty Trust, Continental Mortgage and Equity Trust ( CMET ) and TCI, three real estate entities with, at the time, the same officers, directors or trustees and advisor as IORI, entered into a settlement (the Settlement ) of a class and derivative action entitled *Olive et al. v. National Income Realty Trust et al.* (the Olive Litigation ), relating to the operation and management of each of the entities. On April 23, 1990, the Court granted final approval of the terms of the Settlement. The Settlement was modified in 1994 (the Modification ), which was amended on January 27, 1997 by Amendment to the Modification effective January 9, 1994 (the First Amendment ).

In October 2000, plaintiffs counsel asserted that the stock option agreement to purchase TCI shares, which was entered into by IORI and an affiliate of IORI, American Realty Investors, Inc. ( ARI ), in October 2000 with an investment fund, breached a provision of the Modification. As a result of this assertion, IORI assigned all of its rights to purchase the TCI shares under this stock option agreement to ARI.

The Board believes that all provisions of the Settlement, the Modification and First Amendment terminated on April 28, 1999. However, in September 2000, the Court ruled that certain provisions of the Modification continue to be effective after the termination date. This ruling was appealed to the United States Court of Appeals for the Ninth Circuit by IORI and TCI.

On October 23, 2001, IORI, TCI and ARI jointly announced a preliminary agreement with the plaintiff s legal counsel for complete settlement of all disputes in the lawsuit. In February 2002, the court granted final approval of the proposed settlement (the Second

Amendment ). Under the Second Amendment, the appeal was dismissed and ARI agreed to either (i) acquire all of the outstanding shares of IORI and TCI not currently owned by ARI for a cash payment or shares of ARI preferred stock or (ii) make a tender offer for all of the outstanding common shares of IORI and TCI not currently owned by ARI. At the time, IORI had the same board as TCI and the same advisor as TCI and ARI. Earl D. Cecil and Ted P. Stokely who served as Directors of IORI and TCI, were also directors of ARI.

On November 15, 2002, ARI commenced, through subsidiaries, a tender offer for shares of common stock of TCI and IORI. The price per share was \$17.50 for TCI shares and \$19.00 for IORI shares. The tender offers were completed on March 19, 2003. ARI acquired 265,036 shares of IORI and 1,213,226 TCI shares. The completion of the tender offer fulfilled the obligations under the Second Amendment and the Olive Litigation was dismissed with prejudice.

*Liquidity.* Management anticipates that IORI will generate excess cash from operations in 2003 due to increased rental rates and occupancy at its properties, however, such excess may not be sufficient to discharge all of IORI's debt obligations as they mature. Management intends to selectively sell income producing real estate, refinance real estate and incur additional borrowings against real estate to meet its cash requirements.

*Other Litigation.* IORI is also involved in various other lawsuits arising in the ordinary course of business. Management is of the opinion that the outcome of these lawsuits will have no material impact on the Company's financial condition, results of operations or liquidity.

#### NOTE 18. CORRECTION OF PREVIOUSLY FILED FINANCIAL STATEMENTS

The Company identified an accounting error in the financial statements related to the total Metra transactions. The error involved the establishment of an incorrect process involving the deferral of operating income or expense from the Metra properties until the sale of the property. The result is the Company concluded that changes should be made to its financial statements for the year ending December 31, 2003. The resulting impact in these financial statements was to decrease net income for the year ended December 31, 2003 by \$436,000 from a reported \$1,782,000 to \$1,346,000, and a decrease of net income on a per share basis from a reported \$1.24 per share to \$0.94 per share. This decrease resulted from an increase in interest expense of approximately \$458,000, decrease of net income fee to affiliate of \$21,000, and a decrease of advisory fee to affiliate of \$1,000. Total assets decreased by approximately \$51,000 due to an increase of receivable from affiliate for \$22,000 and an decrease in other assets of \$73,000, and total liabilities increase by \$385,000 due to a decrease in other liabilities of \$385,000.

SCHEDULE III  
INCOME OPPORTUNITY REALTY INVESTORS, INC.  
REAL ESTATE AND ACCUMULATED DEPRECIATION  
December 31, 2003

| Property/Location                                    | Encumbrances | Initial Cost |                         | Cost Capitalized Subsequent to Acquisition | Gross Amount Carried at End of Year (1) |                         | Total     |
|--|--------------|--------------|-------------------------|--|---|-------------------------|-----------|
|  |              | Land         | Building & Improvements |  | Land                                    | Building & Improvements |           |
| <b>Properties Held For Investment</b>                |              |              |                         |  |   |                         |           |
| Apartments   |              |              |                         |  |   |                         |           |
| Brighton Court, Midland, TX                          | \$ 2,843     | \$ 339       | \$ 3,051                | \$   | \$ 339                                  | \$ 3,051                | \$ 3,390  |
| Del Mar, Midland, TX                                 | 2,725        | 324          | 2,919                   |  | 324                                     | 2,919                   | 3,243     |
| Enclave, Midland, TX                                 | 2,882        | 324          | 2,919                   |  | 324                                     | 2,919                   | 3,243     |
| Meridian, Midland, TX                                | 4,502        | 1,138        | 4,552                   |  | 1,138                                   | 4,552                   | 5,690     |
| Signature Place, Midland, TX                         | 2,410        | 265          | 2,388                   |  | 265                                     | 2,388                   | 2,653     |
| Sinclair Place, Midland, TX                          | 2,054        | 221          | 1,990                   |  | 221                                     | 1,990                   | 2,211     |
| Treehouse, San Antonio, TX                           | 3,752        | 375          | 2,124                   | 259  | 375                                     | 2,383                   | 2,758     |
| Treehouse, Irving, TX                                | 5,083        | 716          | 6,771                   |  | 716                                     | 6,771                   | 7,487     |
| Office Buildings 2010                                |              |              |                         |  |   |                         |           |
| Valley View, Farmers Branch, TX                      | 2,425        | 120          | 479                     | 2,979                                      | 120                                     | 3,458                   | 3,578     |
| Akard Plaza, Dallas, TX                              | 1,966        | 734          | 2,936                   | 454  | 734                                     | 3,390                   | 4,124     |
| Chuck Yeager, Chantilly, VA                          | 4,336        | 1,080        | 4,321                   | 1,566                                      | 1,080                                   | 5,887                   | 6,967     |
| Parkway Ctr, Farmers Branch, TX                      | 1,631        | 333          | 3,511                   |  | 333                                     | 3,511                   | 3,844     |
| Industrial Warehouse Eagle Crest, Farmers Branch, TX |              | 2,129        | 1,906                   |  | 2,129                                   | 1,906                   | 4,035     |
| Land Frankel, Midland County, TX                     |              | 44           |                         |  | 44                                      |                         | 44        |
| 3 HickoryCtr, FarmersBranch, TX                      |              | 2,804        |                         | 296  | 3,100                                   |                         | 3,100     |
|  | \$ 36,609    | \$ 10,946    | \$ 39,867               | \$ 5,554                                   | \$ 11,242                               | \$ 45,125               | \$ 56,367 |

| Property/Location  | Accumulated<br>Depreciation | Date of<br>Construction<br>(dollars in thousands) | Date<br>Acquired | Life<br>on<br>Which<br>Depreciation<br>in<br>Latest<br>Statement<br>of<br>Operation<br>is<br>Computed |
|--|-----------------------------|---|------------------|---|
| <b>Properties Held For Investment</b>                    |                             |   |                  |   |
| Apartments   |                             |   |                  |   |
| Brighton Court, Midland, TX                              | \$ 267                      | 1983  | 06/00            | 40 years  |
| Del Mar, Midland, TX                                     | 255                         | 1983  | 06/00            | 40 years  |
| Enclave, Midland, TX                                     | 255                         | 1983  | 06/00            | 40 years  |
| Meridian, Midland, TX                                    | 455                         | 1983  | 12/99            | 40 years  |
| Signature Place, Midland, TX                             | 174                         | 1983  | 06/00            | 40 years  |
| Sinclair Place, Midland, TX                              | 209                         | 1983  | 06/00            | 40 years  |
| Treehouse, San Antonio, TX                               | 844                         | 1975  | 09/89            | 5-40 years  |
| Treehouse, Irving, TX                                    |                             | 1974  | 12/03            | 5-40 years  |
| Office Buildings 2010 Valley View, Farmers<br>Branch, TX | 1,264                       | 1998  | 09/97            | 5-40 years  |
| Akard Plaza, Dallas, TX                                  | 785                         | 1984  | 12/97            | 5-40 years  |
| Chuck Yeager, Chantilly, VA                              | 1,494                       | 1991  | 01/97            | 5-40 years  |
| Parkway Ctr, Farmers Branch, TX                          |                             | 1979  | 12/03            | 5-40 years  |
| Industrial Warehouse Eagle Crest, Farmers<br>Branch, TX  |                             |   | 12/03            | 5-40 years  |
| Land Frankel, Midland County, TX                         |                             |   | 06/00            |   |
| 3 HickoryCtr, FarmersBranch, TX                          |                             |   |                  |   |
|  | \$ 6,002                    |   |                  |   |

(1) The aggregate cost for Federal income tax purposes is \$34.7 million.

## SCHEDULE III

INCOME OPPORTUNITY REALTY INVESTORS, INC.  
REAL ESTATE AND ACCUMULATED DEPRECIATION

|   | <b>2003</b>                   | <b>2002</b> | <b>2001</b> |
|---|-------------------------------|-------------|-------------|
|   | <b>(dollars in thousands)</b> |             |             |
| Reconciliation of Real Estate Balance at January 1,   | \$ 82,252                     | \$ 95,190   | \$ 91,837   |
| Additions   |                               |             |             |
| Acquisitions and Improvements                         | 15,365                        | 677         | 3,466       |
| Deductions  |                               |             |             |
| Retirements   |                               | (462)       | (113)       |
| Sale of real estate                                   | (41,250)                      | (13,153)    |             |
| Balance at December 31,                               | \$ 56,367                     | \$ 82,252   | \$ 95,190   |
| Reconciliation of Accumulated Depreciation Balance at |                               |             |             |
| January 1,  | \$ 7,502                      | \$ 7,875    | \$ 5,560    |
| Additions   |                               |             |             |
| Depreciation  | 1,552                         | 1,867       | 2,427       |
| Deductions  |                               |             |             |
| Retirements   |                               |             | (112)       |
| Sale of real estate                                   | (3,052)                       | (2,240)     |             |
| Balance at December 31,                               | \$ 6,002                      | \$ 7,502    | \$ 7,875    |

## SCHEDULE IV

INCOME OPPORTUNITY REALTY INVESTORS, INC.  
MORTGAGE LOANS ON REAL ESTATE

|  | <b>2003</b>                   | <b>2002</b> | <b>2001</b> |
|--|-------------------------------|-------------|-------------|
|  | <b>(dollars in thousands)</b> |             |             |
| Balance at January 1,                  | \$                            | \$ 500      | \$ 1,500    |
| Additions                              |                               |             |             |
| New mortgage loans                     | 45,531                        | 7,109       |             |
| Deductions                             |                               |             |             |
| Amounts charged off                    |                               | (1,568)     |             |
| Collections of principal by IORI       |                               | (500)       |             |
| Collections of principal by affiliates |                               | (5,541)     | (1,000)     |
| Balance at December 31,                | \$ 45,531                     | \$          | \$ 500      |