

INCOME OPPORTUNITY REALTY INVESTORS INC /TX/

Form 10-Q/A

September 07, 2005

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

(Mark One)

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

**For the quarter year ended March 31, 2005**

**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 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. **Yes**  **No**

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 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 April 30, 2005, there were 1,389,345 shares of common stock outstanding.

DOCUMENTS INCORPORATED BY REFERENCE

None

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**SIGNATURE**

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**AMENDMENT NO. 1 TO  
QUARTERLY REPORT ON FORM 10-Q FOR  
INCOME OPPORTUNITY REALTY INVESTORS, INC.  
FOR THE QUARTER ENDED MARCH 31, 2005**

The undersigned Registrant hereby amends the following items, exhibits, or other portions of its Quarterly Report on Form 10-Q for the quarter year ended March 31, 2005 as set forth below and as reflected in the substituted pages attached hereto which replace the same numbered pages in the original filing (this Amendment No. 1 is necessary by virtue of an identified accounting error in the financial statements related to formation of certain partnerships with Metra Capital LLC in April 2002, which error evolved in the establishment of the process relating to accounting for a deferral of operating income or expense from the properties in question until the sale of the applicable property; the error correction necessitates the changes described below):

Pages 2-5 Part I, Item 1. Financial Statements. The consolidated balance sheets, consolidated statements of operations, consolidated statements of stockholders' equity and consolidated statements of cash flows have been revised in the following respects:

Decrease in interest expense by \$65,000 from a reported \$936,000 to \$871,000.

Decrease in advisory fee by \$1,000 from a reported \$167,000 to \$166,000.

Increase in net income fee by \$12,000 from a reported \$12,000 to \$24,000.

Decrease in total other expense by \$54,000 from a reported \$1,434,000 to \$1,380,000.

Increase in net income by \$54,000 from a reported \$239,000 to \$293,000.

Increase in net income per share by \$0.04 from a reported \$0.17/sh to \$0.21/sh.

Decrease in other assets by \$210,000 from a reported \$3,244,000 to \$3,034,000 (includes \$105,000 decrease in 2004 and \$73,000 decrease in 2003).

Decrease in total assets by \$210,000 from a reported \$91,006,000 to \$90,796,000 (includes \$105,000 decrease in 2004 and \$73,000 decrease in 2003).

Decrease in payable to affiliates by \$26,000 from a reported \$1,523,000 to \$1,497,000 (includes \$15,000 decrease in 2004 and \$22,000 decrease in 2003).

Increase in other liabilities by \$263,000 from a reported \$1,081,000 to \$1,344,000 (includes \$26,000 decrease in 2004 and \$385,000 increase in 2003).

Increase in accumulated deficit by \$447,000 from a reported \$17,967,000 to \$18,414,000 (includes \$64,000 increase in 2004 and \$436,000 increase in 2003).

Such changes are necessitated on the basis of an accounting error relating to the Metra Transactions described in Notes 5 and 6 to the consolidated financial statements.

Pages 8-9 Part I, Item 1. Financial Statements. This item within these pages has been amended to conform the appropriate references to the financial statement as stated above.

Pages 11-13 Part I, Item 2. Management's Discussion and Analysis of Results of Operations. This item within these pages has been amended to conform the appropriate references to the financial statement as stated above.

Pages 13-14 Part I, Item 4. Controls and Procedures This item has been revised to disclose the identification of a control deficiency in internal controls over financial reporting as of April 2002 which continued through March 2005, which was an error in the recordation of an April 2002 transaction.

Pages 15 Item 1. Legal Proceedings. The last sentence under the paragraph subcaptioned *Innovo Realty, Inc.* has been changed to substitute the amount of \$162,000 for \$56,000 so that such last sentence will read, Of the payment, the Company will recognize expense of \$162,000 and a reduction of \$1,476,000 in liabilities during the second quarter of 2005.

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## PART I. FINANCIAL INFORMATION

**ITEM 1. FINANCIAL STATEMENTS**

The accompanying Consolidated Financial Statements as of and for the three months ended March 31, 2005, have not been audited by independent certified public accountants, but in the opinion of the management of Income Opportunity Realty Investors, Inc. ( IORI ), all adjustments (consisting of normal recurring accruals) necessary for a fair presentation of IORI 's consolidated financial position, consolidated results of operations and consolidated cash flows at the dates and for the periods indicated, have been included.

INCOME OPPORTUNITY REALTY INVESTORS, INC.  
CONSOLIDATED BALANCE SHEETS

	<b>March 31, 2005 (Restated)</b>	<b>December 31, 2004 (Restated)</b>
	<b>(dollars in thousands, except per share)</b>	
<b>Assets</b>		
Real estate held for investment	\$ 35,033	\$ 34,988
Less accumulated depreciation	(3,796)	(3,620)
	31,237	31,368
Related Party Notes and interest receivable	55,454	54,911
Investment in real estate partnerships	596	604
Cash and cash equivalents	214	399
Receivables from affiliates	261	261
Other assets	3,034	3,095
	\$ 90,796	\$ 90,638
<b>Liabilities and Stockholders Equity</b>		
<b>Liabilities</b>		
Notes and interest payable	\$ 44,372	\$ 44,571
Payables to affiliates	1,497	1,248
Other liabilities	1,344	1,529
	47,213	\$ 47,348
<b>Commitments and contingencies</b>		
<b>Stockholders equity</b>		
Common Stock, \$.01 par value; authorized, 10,000,000 shares; issued and outstanding 1,389,345 shares in 2005 and 1,438,945 shares in 2004	14	14
Paid-in capital	61,983	61,983
Accumulated deficit	(18,414)	(18,707)
	43,583	43,290
	\$ 90,796	\$ 90,638

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

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INCOME OPPORTUNITY REALTY INVESTORS, INC.  
CONSOLIDATED STATEMENTS OF OPERATIONS

	<b>For the Three Months Ended March 31, (dollars in thousands, except per share)</b>	
	<b>2005 (Restated)</b>	<b>2004 (Restated)</b>
Property revenue		
Rents	\$ 1,529	\$ 2,136
Property expense		
Property operations (including \$29 in 2005 and \$32 in 2004 to affiliates and related parties)	821	1,211
Operating income	708	925
Other income (loss)		
Interest	974	598
Equity in loss of equity partnerships	(9)	(1)
	965	597
Other expense		
Interest	871	1,118
Depreciation	177	342
Advisory fee to affiliate	166	192
Net income fee to affiliate	24	215
General and administrative	142	270
	1,380	2,137
Net income (loss) from continuing operations	293	(615)
Discontinued operations:		
Loss from discontinued operations		(128)
Gain on sale of operations		3,257
		3,129
Net income	\$ 293	\$ 2,514
Earnings (loss) per share		
Net income (loss) from continuing operations	\$ 0.21	\$ (0.42)
Discontinued operations		2.17

Net income	\$	0.21	\$	1.75
Weighted average common shares used in computing earnings per share		1,389,345		1,438,945

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

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INCOME OPPORTUNITY REALTY INVESTORS, INC.  
 CONSOLIDATED STATEMENT OF STOCKHOLDERS EQUITY  
 For the Three Months Ended March 31, 2005

	<b>Common Stock Shares</b>	<b>Amount</b>	<b>Paid-in Capital</b>	<b>Accumulated Deficit</b>	<b>Stockholders Equity</b>
			<b>(dollars in thousands)</b>		
Balance, January 1, 2005 (as restated)	1,389,345	\$ 14	\$ 61,983	\$ (18,707)	\$ 43,290
Net income (as restated)				293	293
Balance, March 31, 2005 (as restated)	1,389,345	\$ 14	\$ 61,983	\$ (18,414)	\$ 43,583

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

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

	<b>For the Three Months Ended March 31,</b>	
	<b>2005</b>	<b>2004</b>
	<b>(Restated)</b>	<b>(Restated)</b>
	<b>(dollars in thousands)</b>	
<b>Cash Flows from Operating Activities</b>		
Net income/(loss)	\$ 293	\$ 2,514
Reconciliation of net income (loss) to net cash used by operating activities		
Adjustments to reconcile net income (loss) to net cash used in operating activities		
Depreciation and amortization	246	347
Gain on sale of real estate		(3,257)
Loss of equity partnerships	9	1
(Increase) decrease in interest receivable	(543)	209
Decrease (Increase) in other assets	298	(129)
(Decrease) Increase in interest payable	(125)	17
(Decrease) Increase in other liabilities	(538)	385
 Net cash provided by (used in) operating activities	 (360)	 87
 <b>Cash Flows from Investing Activities</b>		
Funding of equity partnerships		
Real estate improvements		
Proceeds from sale of real estate		1,437
Advances from (payments to) advisor	249	(2,082)

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

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INCOME OPPORTUNITY INVESTORS, INC.  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

**NOTE 1. BASIS OF PRESENTATION**

The accompanying Consolidated Financial Statements have been prepared in accordance with generally accepted accounting principles for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and notes required by generally accepted accounting principles for complete financial statements. Operating results for the three-month period ended March 31, 2005, are not necessarily indicative of the results that may be expected for the year ending December 31, 2005. For further information, refer to the Consolidated Financial Statements and notes thereto included in IORI's Annual Report on Form 10-K for the year ended December 31, 2004 (the "2004 Form 10-K"). Dollar amounts in tables are in thousands, except per share amounts.

Certain balances for 2004 have been reclassified to conform to the 2005 presentation.

**NOTE 2. REAL ESTATE**

For the quarter ended March 31, 2005, IORI did not sell any properties.

In 2004, IORI sold the following property:

Property	Location	Sq.Ft.	Sales Price	Net Cash Received	Debt Discharged	Gain on Sale
<i>First Quarter</i>						
<b>Apartment Building</b>						
	San Antonio,	88,957				
Treehouse	TX	Sq.Ft.	\$ 5,400	\$ 1,100	\$ 3,747	\$ 3,257

**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.

On September 30, 2004, a Secured Promissory Note in the amount of \$1,222,500 given by Unified Housing Foundation, Inc. ( UHF ) for Unified Housing of Parkside Crossing, LLC to Regis Realty I, LLC ( Regis I ) and the accrued interest receivable of \$112,878 were assigned from Regis I to IORI as a paydown in the amount of \$1,335,378 of certain intercompany receivables.

On September 30, 2004, a Secured Promissory Note in the amount of \$1,053,616 given by UHF for Unified Housing of Temple, LLC to Regis I and the accrued interest receivable of \$98,338 were assigned from Regis I to IORI as a paydown in the amount of \$1,151,954 of certain intercompany receivables.

On September 30, 2004, a Secured Promissory Note in the amount of \$835,658 given by UHF for Unified Housing of Terrell, LLC to Regis I and the accrued interest receivable of \$80,223 were assigned from Regis I to IORI as a paydown in the amount of \$915,881 of certain intercompany receivables.

On September 30, 2004, a Secured Promissory Note in the amount of \$1,770,000 given by UHF for Housing for Seniors of Lewisville, LLC to Regis I and the accrued interest receivable of \$174,640 were assigned from Regis I to IORI as a paydown in the amount of \$1,944,640 of certain intercompany receivables.

On May 24, 2004, a Secured Promissory Note in the amount of \$2,990,000 given by UHF for Unified Housing of McKinney, LLC ( UHM ) to Transcontinental Eldorado, Inc. was assigned from Transcontinental Realty Investors, Inc. ( TCI ) to IORI as a partial payment for TCI's repurchase of 100% of the outstanding common shares of Transcontinental Treehouse Corporation ( Treehouse-IR ) from IORI.

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On December 30, 2003, a Secured Promissory Note in the amount of \$6,363,360 given by Housing for Seniors of Humble, LLC ( Humble ) to NLP Lakeshore Villas, LLC ( NLP ) was assigned from American Realty Investors, Inc. ( ARI ) to IORI as a paydown in the amount of \$6,363,360 of certain intercompany receivables.

On December 30, 2003, a Secured Promissory Note in the amount of \$2,000,000 given by Humble to NLP was assigned from ARI to IORI as additional paydown in the amount of \$2,000,000 of certain intercompany receivables.

On October 14, 2003, IORI purchased, sold, and conveyed an office building known as One Hickory Centre, and sold 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 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 bears interest at 5.5% per annum. 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. As with the prior transaction, the difference between the purchase price and the promissory note represented adjustments for various prorations. The note bears interest at 5.5% 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 bears interest at 5.5% per annum.

**NOTE 4. RECEIVABLE FROM AND PAYABLE TO AFFILIATES**

*Related Party.* 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 without interest, 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. From time-to-time, IORI and its affiliates and related parties have made unsecured advances to each other to fund their respective operations, which generally have not had specific repayment terms and have been reflected in IORI's financial statements as other assets. At March 31, 2005 and 2004, IORI held a receivable of \$261,000 from TCI. IORI had payables of \$1.5 million and \$1.3 million to SWI at March 31, 2005 and December 31, 2004, respectively. See also NOTE 6. RELATED PARTY TRANSACTIONS .

**NOTE 5. NOTES AND INTEREST PAYABLE**

In April 2002, IORI sold all of its residential properties to partnerships controlled by Metra Capital, LLC ( Metra ). These properties include: the 60 unit Brighton Court, the 92 unit Del Mar, the 68 unit Enclave, the 280 unit Meridian, the 57 unit Signature, the 114 unit Sinclair, 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. Joseph Mizrachi, a former director of ARI, a related party, controlled approximately 11.67% of the outstanding common stock of Innovo. The sale constituted 23% of the total assets of IORI as of December 31, 2001. The sales price for the properties totaled \$26.2 million. IORI received \$5.4 million in cash after the payoff of \$16.1 million in debt and various closing costs. Management has determined to account for this sale as a refinancing transaction, in accordance with SFAS No. 66, Accounting for Sales of Real Estate. IORI continues to report the assets and the new debt incurred by the Metra partnerships on the IORI financial statements. The debt on the properties totaled \$21.4 million at the time of sale, and it bears interest at 7.57% per annum, requires monthly interest only payments of \$113,000 and matures in May 2012. IORI also received \$5.2 million of 8% non-recourse, non-convertible Series A Preferred Stock ( Preferred Shares ) of Innovo. 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 sale. See also ITEM 1. LEGAL PROCEEDINGS in PART II. OTHER INFORMATION concerning resolution of other litigation and a reduction of liabilities of \$1,476,000.

The dividend on the Preferred Shares was to be funded entirely and solely through member distributions from cash flows generated by the operation and subsequent sale of the sold properties. In the event the cash flows for the properties are insufficient to cover the 8% annual dividend, Innovo was to have no obligation to cover any shortfall.

The Preferred Shares have a mandatory redemption feature and are redeemable from the cash proceeds received by Innovo from the operation and sale of the properties. All member distributions that are in excess of current and accrued 8%

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dividends must be used by Innovo to redeem the Preferred Shares. Since redemption of these shares is subject to the above future events, management has not recorded any basis in the Preferred Shares.

**NOTE 6. RELATED PARTY TRANSACTIONS**

On September 30, 2004, a Secured Promissory Note in the amount of \$1,222,500 given by Unified Housing Foundation, Inc. ( UHF ) for Unified Housing of Parkside Crossing, LLC to Regis Realty I, LLC ( Regis I ) and the accrued interest receivable of \$112,878 were assigned from Regis I to IORI as a paydown in the amount of \$1,335,378 of certain intercompany receivables.

On September 30, 2004, a Secured Promissory Note in the amount of \$1,053,616 given by UHF for Unified Housing of Temple, LLC to Regis I and the accrued interest receivable of \$98,338 were assigned from Regis I to IORI as a paydown in the amount of \$1,151,954 of certain intercompany receivables.

On September 30, 2004, a Secured Promissory Note in the amount of \$835,658 given by UHF for Unified Housing of Terrell, LLC to Regis I and the accrued interest receivable of \$80,223 were assigned from Regis I to IORI as a paydown in the amount of \$915,881 of certain intercompany receivables.

On September 30, 2004, a Secured Promissory Note in the amount of \$1,770,000 given by UHF for Housing for Seniors of Lewisville, LLC to Regis I and the accrued interest receivable of \$174,640 were assigned from Regis I to IORI as a paydown in the amount of \$1,944,640 of certain intercompany receivables.

On May 24, 2004, a Secured Promissory Note in the amount of \$2,990,000 given by UHF for UHM to Transcontinental Eldorado, Inc. was assigned from TCI to IORI as a partial payment for TCI s repurchase of 100% of the outstanding common shares of Treehouse-IR from IORI.

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

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 March 31, 2005.

	SWI	TCI
Balance, December 31, 2004 (as restated)	(1,248)	\$ 261
Cash transfers	553	
Cash repayments	(592)	
Other additions		
Other repayments (as restated)	(210)	
Balance, March 31, 2005 (as restated)	(1,497)	\$ 261

*Returns on Metra Properties.* As described 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 are to have priority over distributions to any of the other partners. See also ITEM 1. LEGAL PROCEEDINGS in PART II. OTHER INFORMATION concerning resolution of other litigation and a reduction of liabilities of \$1,476,000.



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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 \$965,000 and \$579,000 for 2005 and 2004, respectively. Expenses that are not reflected in the segments are general and administrative expenses, advisory fees, and net income fees totaling \$321,000 and \$678,000 for 2005 and 2004, respectively. Excluded from operating segment assets are assets of \$59.8 million at March 31, 2005 and \$52.8 million at March 31, 2004, 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 and assets of each operating segment.

	Three Months Ended			
	March 31, 2005 (Restated)			
	Land	Commercial Properties	Apartments	Total
Rents	\$	\$ 322	\$ 1,207	\$ 1,529
Property operating expenses		211	610	821
Operating income (loss)	\$	\$ 111	\$ 597	\$ 708
Depreciation	\$	\$ 66	\$ 111	\$ 177
Interest	221	326	324	871
Real estate improvements		45		45
Assets		12,979	18,258	31,237

	Three Months Ended			
	March 31, 2004 (Restated)			
	Land	Commercial Properties	Apartments	Total
Rents	\$	\$ 722	\$ 1,414	\$ 2,136
Property operating expenses		388	823	1,211
Operating income (loss)	\$	\$ 334	\$ 591	\$ 925
Depreciation	\$	\$ 188	\$ 154	\$ 342
Interest	325	324	469	1,118
Real estate improvements				
Assets	44	21,917	26,149	48,110

**NOTE 8. ADVISORY FEES, PROPERTY MANAGEMENT, ETC.**

Revenue, fees and cost reimbursements to its advisors and affiliates for the three months ended:

	For the Three Months Ended March 31,	
	2005 (Restated)	2004 (Restated)
Fees		
Advisory	\$ 166	\$ 192
Net income	24	215

Property and construction management and leasing commission	29	32
	\$ 219	\$ 439
Cost reimbursements	\$ 19	\$ 19

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**NOTE 9. DISCONTINUED OPERATIONS**

Effective January 1, 2002, IORI adopted Financial Accounting Standards No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets ( SFAS 144 ), 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 the properties intended to be sold are to be designated as held for sale on the balance sheet. In the event of a future asset sale, IORI is required to reclassify portions of previously reported operations to discontinued operations within the Statements of Operations. No property was sold during the three months ended March 31, 2005. The following table summarizes revenue and expense information for the properties sold.

	For the Three Months Ended March 31,	
	2005	2004
Revenue		

Discontinued operations have not been segregated in the consolidated statement of cash flows. Therefore, amounts for certain captions will not agree with respective consolidated statements of operations.

**NOTE 10. COMMITMENTS AND CONTINGENCIES**

*Liquidity.* Management anticipates that IORI will generate excess cash from operations in 2005 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 may selectively sell income producing assets, refinance real estate and/or 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.

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

**Introduction**

IORI invests in equity interests in real estate through acquisitions, leases and partnerships and also invests in mortgage loans. IORI is the successor to a California business trust organized on December 14, 1984, which commenced operations on April 10, 1985.

**Critical Accounting Policies**

Critical accounting policies are those that are both important to the presentation of IORI's financial condition and results of operations and require management's most difficult, complex or subjective judgments. IORI's critical accounting policies relate to the evaluation of impairment of long-lived assets and the evaluation of the collectibility of accounts and notes receivable.

If events or changes in circumstances indicate that the carrying value of a rental property to be held and used or land held for development may be impaired, management performs a recoverability analysis based on estimated undiscounted cash flows to be generated from the property in the future. If the analysis indicates that the carrying value is not recoverable from future cash flows, the property is written down to estimated fair value and an impairment loss is recognized. If management decides to sell rental properties or land held for development, management evaluates the recoverability of the carrying amounts of the assets. If the evaluation indicates that the carrying value is not recoverable from estimated net sales proceeds, the property is written down to estimated fair value less costs to sell and an impairment loss is recognized within income from continuing operations. IORI's estimates of cash flow and fair values of the properties are based on current market conditions and consider matters such as rental rates and occupancies for comparable properties, recent sales data for comparable properties and, where applicable, contracts or the results of negotiations with purchasers or prospective purchasers. IORI's estimates are subject to revision as market conditions and IORI's assessments of them change.

IORI's allowance for doubtful accounts receivable and notes receivable is established based on analysis of the risk of loss on specific accounts. The analysis places particular emphasis on past due accounts. Management considers such information as the nature and age of the receivable, the payment history of the tenant or other debtor, the financial condition of the tenant or other debtor and IORI's assessment of its ability to meet its lease or interest obligations. IORI's estimate of the required allowance, which is reviewed on a quarterly basis, is subject to revision as these factors change and is sensitive to the effects of economic and market conditions. Typically, IORI's notes receivable are collateralized by income producing real estate. IORI had notes receivable of \$55.5 million at March 31, 2005 and \$54.9 million at December 31, 2004.

**Liquidity and Capital Resources**

Cash and cash equivalents at March 31, 2005 were \$214,000, compared with \$399,000 at December 31, 2004. IORI's principal sources of cash have been and will continue to be property operations, proceeds from property sales, interest earned on notes receivable, financings and refinancings and partnership distributions. Management anticipates that IORI will generate excess cash from operations in 2005 due to increased rental receipts at its properties, however, such excess may not be sufficient to discharge all of IORI's debt obligations as they mature. Management may selectively sell income producing assets, refinance real estate and/or incur additional borrowings against real estate to meet its cash requirements.

The Company reported net income of \$293,000 for the three months ended March 31, 2005, which included the following changes: depreciation and amortization of \$246,000, decreases in other assets of \$298,000, increases in interest receivable of \$543,000, decreases in interest payable of \$125,000, loss on equity partnership of \$9,000, and decreases in other liabilities of \$538,000. Net cash used in operating activities amounted to \$360,000 for the three months ended March 31, 2005. During the quarter ended March 31, 2005, the decrease in other liabilities was primarily due to a decrease in prepaid property taxes and the decrease in other assets was primarily due to a decrease in deposits and accounts receivable. Net cash provided by investing activities of \$249,000 was the advances from SWI. Net cash used in financing activities of \$74,000 was the payments on notes payable.

Management reviews the carrying values of IORI's properties at least annually and whenever events or a change in circumstances indicate that impairment may exist. Impairment is considered to exist if, in the case of a property, the

future

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cash flow from the property (undiscounted and without interest) is less than the carrying amount of the property. If impairment is found to exist, a provision for loss is recorded by a charge against earnings. The property review generally includes selective property inspections, discussions with the manager of the property, visits to selected properties in the area and a review of the following: (1) the property's current rents compared to market rents, (2) the property's expenses, (3) the property's maintenance requirements and (4) the property's cash flows.

**Results of Operations**

For the first quarter of 2005, IORI had a net income of \$293,000 as compared to \$2.5 million for the corresponding period in 2004. The net income in 2004 was boosted by the gain on sale of a property totaling \$3.3 million. No property was sold in 2005. Fluctuations in components of revenue and expense between the 2005 and 2004 periods are discussed below.

Rents for the first quarter of 2005, decreased to \$1.5 million versus \$2.1 million in the corresponding period in 2004. The decrease in 2005 from 2004 was primarily due to sale of properties throughout 2004. Rental income during the remaining periods of 2005 is expected to increase if IORI purchases more properties.

Property operations expense was \$821,000 in 2005 versus \$1.2 million in 2004. Property operations expense is expected to increase during the remaining quarters of 2005 if IORI purchases more properties.

Interest income was \$974,000 in 2005 versus \$598,000 in 2004. The increase in 2005 from 2004 was due to additional interest earned from the additional notes receivable obtained from affiliates of IORI. Interest income is expected to exceed the previous year in the remaining quarters of 2005 due to the increase in notes receivable during 2004.

Interest expense was \$871,000 in 2005 versus \$1.1 million in 2004. The decrease in 2005 from 2004 was primarily due to the retirement of four notes payable from sale of properties during 2004.

Depreciation expense was \$177,000 in 2005 versus \$342,000 in 2004. The decrease in 2005 from 2004 was due to sale of properties and fully depreciated tenant improvements in 2004.

Advisory fee to affiliate was \$166,000 in 2005 versus 192,000 in 2004. The decrease in 2005 from 2004 was due to changes in gross assets, the basis of the fee. See NOTE 8. ADVISORY FEES.

IORI paid a net income fee of \$24,000 in 2005. The net income fee is based on 7.5% of IORI's net income.

General and administrative expense was \$142,000 in 2005 versus \$270,000 in 2004. The decrease in 2005 from 2004 was primarily due to a decrease in property insurance and rental expense.

**Related Party Transactions**

Historically, IORI, ARI, Regis I, and TCI have each engaged in and may continue to engage in business transactions, including real estate partnerships with related parties. Management believes that all of the related party transactions represented the best investments available at the time and were at least as advantageous to IORI, ARI, Regis I, and TCI as could have been obtained from unrelated third parties.

**Taxes**

For the tax years prior to 2003, IORI elected and qualified to be treated as a Real Estate Investment Trust ( REIT ), as defined in Sections 856 and 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 a 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.

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Financial statement income varies from taxable income principally due to the accounting for income and losses of investees, gains and losses from asset sales, depreciation on owned properties, amortization of discounts on notes receivable and payable and the difference in the allowance for estimated losses. IORI had a loss for federal income tax purposes after the use of net operating loss carryforwards in the first quarter of 2005 and the first quarter of 2004; therefore, it recorded no provision for income taxes.

At March 31, 2005, IORI had a net deferred tax asset of \$2.4 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.

**Inflation**

The effects of inflation on IORI's operations are not quantifiable. Revenues from apartment operations tend to fluctuate proportionately with inflationary increases and decreases in housing costs. Fluctuations in the rate of inflation also affect the sales value of properties and the ultimate gain to be realized from property sales. To the extent that inflation affects interest rates, earnings from short-term investments and the cost of new financings, as well as the cost of variable interest rate debt, will be affected.

**Environmental Matters**

Under various federal, state and local environmental laws, ordinances and regulations, IORI may be potentially liable for removal or remediation costs, as well as certain other potential costs, relating to hazardous or toxic substances (including governmental fines and injuries to persons and property) where property-level managers have arranged for the removal, disposal or treatment of hazardous or toxic substances. In addition, certain environmental laws impose liability for release of asbestos-containing materials into the air and third parties may seek recovery for personal injury associated with such materials.

Management is not aware of any environmental liability relating to the above matters that would have a material adverse effect on IORI's business, assets or results of operations.

**ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES REGARDING MARKET RISK**

At March 31, 2005, IORI's exposure to a change in interest rates on its debt is as follows:

	Balance	Weighted Average Interest Rate	Effect of 1% Increase In Base Rates
Wholly-owned debt:			
Variable rate	\$ 10,133	7.87%	\$ 101
Total decrease in IORI's annual Net income			\$ 101
Per share			\$ 0.07

**ITEM 4. CONTROLS AND PROCEDURES**

- (a) As of the end of the period covered by this report, IORI carried out an evaluation, under the supervision and with the participation of IORI's management, including IORI's Acting Principal Executive Officer and principal accounting officer, of the effectiveness of the design and operation of IORI's disclosure controls and procedures pursuant to Exchange Act Rule 13a-14. Based upon the evaluation, at the time of filing of its Form 10-Q for the quarter ended March 31, 2005, IORI's Acting Principal Executive Officer and principal accounting officer concluded that IORI's disclosure controls and procedures were then effective in timely alerting him to material information relating to IORI (including its consolidated subsidiaries) required to be included in IORI's periodic

SEC filings.



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However, subsequent to the filing of the original Form 10-Q for the quarter ended March 31, 2005, IORI and its accountants identified a control deficiency in its internal controls over financial reporting as of April 2002 (which was not material in 2002) which continued undetected through March 2005, which constituted a material weakness (starting in 2003) within the meaning of the Public Company Accounting Oversight Board Auditing Standard No. 2. A material weakness is a control deficiency, or combination of control deficiencies, that results in more than a remote likelihood that a material misstatement of an annual or interim financial statement will not be prevented or detected. The material weakness related to IORI's accounting for the Metra transaction in April 2002 which included a deferral of operating income and/or expense until the time of ultimate sale of a property to an independent third party purchaser. As a result, an error was discovered that affected the consolidated balance sheet, consolidated statement of operations, consolidated statements of stockholders equity and consolidated statements of cash flows for 2002 and subsequent periods. The amounts for 2002 were not material, but the amounts for 2003 were material which caused the need for correction of the 2003 financial statements. That correction caused IORI to file an amendment on Form 10-K/A for the years ended December 31, 2003 and December 31, 2004, and a subsequent Form 10-Q/A for the quarter ended March 31, 2005 in order to restate such 2003 annual financial statements in its prior filings and to carry forward such changes in current filings. The error also caused IORI's acting principal executive officer and principal financial officer to re-evaluate and reconsider the effect on the adequacy of IORI's disclosure controls and procedures as of the end of the period covered by the original Form 10-K for the period ended December 31, 2004. Based upon such error, IORI's disclosure controls and procedures involving review of all material historical transactions and supporting documents could have an impact on any current reporting periods were not effective to detect such error. Beginning after that second quarter of 2005, IORI concluded that Management will review all material historical transactions and supporting documents that could have a continuing impact upon any current reporting periods, will review quarterly on a sampling basis all non-material historical transactions that are included in financial statements for any current reporting period, and will continue the process of reviewing all current transactions included in current reporting period financial statements. Management also believes that the transaction involving the error was uniquely complex and is not likely to be repeated, but Management is working with its outside consultant for guidance about other possible control procedures to ensure that in the future errors will be detected and material misstatement of annual or interim financial statements will be prevented.

**WARNING CONCERNING FORWARD LOOKING STATEMENTS**

This quarterly report on Form 10-Q and IORI's 2004 Form 10-K, referred to herein, contain forward looking statements within the meaning of the Private Securities Litigation Reform Act of 1995 and federal securities laws. These statements concern the intent, belief or expectations of IORI's officers with respect to IORI's ability to lease its properties, tenant's ability to pay rents, purchase of additional properties, ability to pay interest and debt principal and make distributions, policies and plans regarding investments and financings, and other matters. Also, words such as believe, expect, anticipate, intend, plan, estimate, or similar expressions identify forward looking statements. results may differ materially from those contained in or implied by the forward looking statements as a result of various factors. Such factors include, without limitation, the impact of changes in the economy and the capital markets on IORI and its tenants, competition within the real estate industry or those industries in which its tenants operate, and changes in federal, state and local legislation. For example: Some of IORI's tenants may not renew expiring leases and IORI may be unable to locate new tenants to maintain the historical occupancy rates of the properties; rents which IORI can achieve at its properties may decline; tenants may experience losses and become unable to pay rents; and IORI may be unable to identify or to negotiate acceptable purchase prices for new properties. These results could occur due to many different circumstances, some of which, such as changes in IORI's tenants' financial conditions or needs for leased space, or changes in the capital markets or the economy, generally, are beyond IORI's control. Forward looking statements are only expressions of IORI's present expectations and intentions. Forward looking statements are not guaranteed to occur, and they may not occur. You should not place undue reliance upon forward looking statements.

**Table of Contents****PART II. OTHER INFORMATION****Item 1. Legal Proceedings.**

*Innovo Realty, Inc.* On August 10, 2004, three entities, including the Company, instituted an action in Texas State District Court as Cause No. 2004-60231-393 styled *American Realty Investors, Inc., Transcontinental Realty Investors, Inc. and Income Opportunity Realty Investors, Inc., Plaintiffs v. Innovo Realty, Inc. and Innovo Group, Inc., Involuntary Plaintiffs v. Innovo Realty, Inc., Metra Capital LLC, Innovo Group, Inc., Joseph Mizrachi, Simon Mizrachi, Herbert Guez, Third Millennium Partners LLC, Third Millennium Partners, Inc., Third Millennium Group LLC and Sunridge Management, Inc., Defendants*. Plaintiffs' complaint alleges that a former director of American Realty Investors, Inc. (ARI), and others, offered a plan to the Plaintiffs to create one or more joint venture arrangements with one or more of the Plaintiffs to pursue alternative forms of financing or refinancing portions of Plaintiffs' real estate portfolios, which entailed the creation of 22 separate limited partnerships to acquire 28 separate apartment complexes in three states (Texas, Florida and Louisiana), the general partners of which are affiliates of, or are controlled by, the former director of ARI. During April 2005, resolution of the litigation occurred, settling all liabilities remaining from the original partnership arrangements which included a return of investor equity, prospective asset management fees and miscellaneous fees and transactions costs from the Plaintiffs as prepayment of a preferred return, along with a delegation of management to another entity, and a motion to dismiss the action as a part of the resolution. Of the prepayment, the Company will recognize expense of \$162,000 and a reduction of \$1,476,000 in liabilities during the second quarter of 2005.

*Sunset Management LLC*. On October 5, 2004, Sunset Management LLC (Sunset) filed a complaint as a purported stockholder's derivative action on behalf of Transcontinental Realty Investors, Inc. in the United States District Court for the Northern District of Texas, Dallas Division, against American Realty Investors, Inc., Basic Capital Management, Inc., Prime Income Asset Management, Inc., Prime Income Asset Management LLC, Income Opportunity Realty Investors, Inc., United Housing Foundation (United), Regis Realty, Inc., Transcontinental Realty Investors, Inc. and Transcontinental Realty Investors, Inc.'s current directors and officers and others. Sunset's complaint filed as Case No. 304CV02162-B styled *Sunset Management LLC, derivatively on behalf of Transcontinental Realty Investors, Inc. v. American Realty Investors, Inc., et al.*, raises a number of allegations previously raised by Sunset in four other cases which, as rulings have occurred, have resulted in a denial of Sunset's requested relief. The Defendants on November 8, 2004 filed a Motion to Dismiss the case pursuant to Rules 12 and 23.1 of the Federal Rules of Civil Procedure on the basis that Sunset's allegations are insufficient to evade the stringent demand requirement under the futility exceptions for stockholder derivative actions, and that Sunset cannot fairly and adequately represent the interests of other stockholders. One of the individual Defendants also filed on January 4, 2005 a Motion to Disqualify Sunset's Counsel. On January 4, 2005, Defendants filed a Motion to Stay Discovery and for Protective Order, which Motion was granted on March 30, 2005 by the issuance of an Order by the Court granting the Motion for Protective Order and staying all discovery in the action pending further Order of the Court, if appropriate, following the Court's ruling on the Defendants' Motion to Dismiss. The Sunset complaint makes no real allegations against the Company and seeks no specified relief against the Company. The Sunset complaint does allege that as of March 1, 2003, Transcontinental Realty Investors, Inc. owned 24% of the stock of the Company, and that all of the defendants have in their various capacities breached fiduciary duties to Transcontinental Realty Investors, Inc. The Company and its subsidiaries, from time to time, have been involved in various items of litigation incidental to and in the ordinary course of its business and, in the opinion of management, the outcome of such litigation will not have a material adverse impact upon the Company's financial condition, results of operations or liquidity.

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

During the period of time covered by this Report, the Company did not repurchase any of its equity securities. The following table sets for a summary by month for the quarter indicating no repurchases were made, and that at the end of the period covered by this Report, a specified number of shares may yet be purchased under the program specified below:

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**SIGNATURE**

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: September 7, 2005.

INCOME OPPORTUNITY REALTY INVESTORS, INC.

By: /s/ Robert N. Crouch II

Robert N. Crouch II  
Executive Vice President, Chief Financial Officer,  
and Acting Principal Executive Officer