

AMERICAN REALTY INVESTORS INC

Form 10-K/A

April 07, 2005

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-K/A

(Amendment No. 1)

x **ANNUAL REPORT PURSUANT TO SECTIONS 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the Year Ended December 31, 2004

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

Commission File Number 001-15663

American Realty Investors, Inc.

(Exact Name of Registrant as Specified in Its Charter)

Nevada

75-2847135

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(State or Other Jurisdiction of
Incorporation or Organization)

(I.R.S. Employer
Identification No.)

1800 Valley View Lane, Suite 300,

Dallas, Texas

75234

(Address of Principal Executive Offices)

(Zip Code)

(469) 522-4200

(Registrant's Telephone Number, Including Area Code)

Securities Registered Pursuant to Section 12(b) of the Act:

Title of each class

Name of each exchange on which registered

Common Stock, \$.01 par value

New York 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 at least the past 90 days. Yes No

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

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

The aggregate market value of the 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 New York Stock Exchange as of June 30, 2004 (the last business day of the Registrant's most recently completed second fiscal quarter) was \$19,911,105 based upon a total of 2,204,995 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 24, 2005, there were 10,895,972 shares of common stock outstanding, including 746,972 shares issued to and owned by Transcontinental Realty Investors, Inc.

Documents Incorporated by Reference:

Consolidated Financial Statements of Income Opportunity Realty Investors, Inc.; Commission File No. 001-14784

Executive Vice President and

Chief Financial Officer

(Principal Financial and Accounting

Officer and Acting Principal

Executive Officer)

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FORWARD LOOKING STATEMENTS

Certain Statements in this Form 10-K are forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995, Section 27A of the Securities Act of 1933, and Section 21E of the Securities Exchange Act of 1934. The words estimate, plan, intend, expect, anticipate, believe, and similar expressions are intended to identify forward-looking statements. The forward-looking statements are found at various places throughout this Report and in the documents incorporated herein by reference. The Company disclaims any intention or obligations to update or revise any forward-looking statements, whether as a result of new information, future events or otherwise. Although we believe that our expectations are based upon reasonable assumptions, we can give no assurance that our goals will be achieved. Important factors that could cause our actual results to differ from estimates or projections contained in any forward-looking statements are described under Risk Factors Related to ARI's Business beginning on page 5.

PART I

ITEM 1. BUSINESS

The predecessor to American Realty Investors, Inc. (ARI or the Company or we or us) was organized in 1961 to provide investors with a professionally managed, diversified portfolio of equity real estate and mortgage loan investments selected to provide opportunities for capital appreciation as well as current income.

On October 23, 2001, ARI, Transcontinental Realty Investors, Inc. (TCI), and Income Opportunity Realty Investors, Inc. (IORI) jointly announced a preliminary agreement with the plaintiff's legal counsel of the derivative action entitled *Olive et al. V. National Income Realty Trust, et al.* for a complete settlement of all disputes in the lawsuit (the Olive Litigation). In February 2002, the court granted final approval of the proposed settlement (the Olive Settlement). Under the Olive Settlement, 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 shares of IORI and TCI not currently owned by ARI. On November 15, 2002, ARI commenced the tender offers for the IORI and TCI shares. The tender offers were completed on March 19, 2003. ARI paid \$19.00 cash per IORI share and \$17.50 cash per TCI share for the stock held by unaffiliated stockholders. Pursuant to the tender offers, ARI subsidiaries acquired 265,036 IORI shares and 1,213,226 TCI shares. The completion of the tender offer fulfilled the obligations under the Olive Settlement, and the Olive Litigation originally filed in February 1990 was dismissed with prejudice.

After the tender offer, ARI subsidiaries owned 64.8% of the outstanding shares of TCI and 62.5% of the outstanding shares of IORI (46.9% owned directly by ARI subsidiaries and 15.6% through TCI's ownership of IORI shares). ARI began consolidation of TCI's and IORI's accounts and operations effective March 31, 2003. The effect of consolidating TCI's and IORI's operations from the completion of the tender offer through March 31, 2003 was determined to be immaterial. Through June 30, 2003, ARI had the same advisor as TCI and IORI, and TCI and IORI had the same board of directors. At December 31, 2004, ARI and TCI have the same Board of Directors, and one director of ARI (Ted Stokely) serves as a director of IORI. Effective July 1, 2003, ARI and TCI have the same advisor.

On June 2, 2003, ARI subsidiaries exchanged all of their 674,971 IORI shares with Basic Capital Management, Inc. (BCM), receiving 650,000 TCI shares from BCM. After the exchange, ARI subsidiaries owned 72.9% of the outstanding shares of TCI. On June 30, 2003, ARI sold a participating interest in \$5.8 million of its \$15.5 million line of credit receivable from One Realco Corporation (One Realco) to BCM, receiving 314,141 TCI shares from BCM (See NOTE 3. NOTES AND INTEREST RECEIVABLE). After the transaction, ARI subsidiaries owned 76.8%

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of the outstanding shares of TCI. In December 2003, ARI subsidiaries purchased 88,600 TCI shares in open market transactions and 204,633 TCI shares in transactions with related parties for a total of \$1.4 million. At December 31, 2004, ARI subsidiaries owned 82.2% of the outstanding shares of TCI. ARI no longer directly owns any IORI shares. At December 31, 2004, TCI owned 24.0% of IORI shares. ARI ceased consolidation of IORI's accounts and operations effective June 2, 2003.

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Effective July 1, 2003, Prime Asset Management, Inc. (PAMI) became the advisor to ARI and TCI. PAMI is owned by Realty Advisors, Inc. (80%) and Syntek West, Inc. (Syntek West) (20%), related parties. Syntek West is owned by Gene Phillips. Effective August 18, 2003, PAMI changed its name to Prime Income Asset Management, Inc. (PIAMI). On October 1, 2003, Prime Income Asset Management, LLC (Prime), which is 100% owned by PIAMI, replaced PIAMI as the advisor to ARI and TCI.

Business Plan and Investment Policy

ARI's primary business is investing in equity interests in real estate (including equity securities of real estate-related entities), leases, joint venture development projects, and partnerships and, to a lesser extent, financing real estate and real estate activities through investments in mortgage loans, including first, wraparound and junior mortgage loans. Information regarding the real estate and mortgage notes receivable portfolios of ARI is set forth in ITEM 2. PROPERTIES, NOTE 3. NOTES AND INTEREST RECEIVABLE and in Schedules III and IV to the Consolidated Financial Statements included in ITEM 8. CONSOLIDATED FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA. ARI has six operating segments: apartments, commercial properties, hotels, land ownership, quick-service restaurants, and notes receivables. See NOTE 18 OPERATING SEGMENTS to the Consolidated Financial Statements.

ARI's business objective is to maximize long-term profitability for its stockholders by investing in commercial real estate through the ownership, management, development, and acquisition of apartments, commercial properties, hotels, and land. ARI intends to achieve this objective through offering properties in multiple markets and operating as a leading landlord within the industry. ARI believes that this objective will provide the benefits of enhanced investment opportunities, economies of scale, risk diversification, both in terms of geographic market and real estate product type, and access to capital. In pursuing its business objective, ARI seeks to achieve a combination of internal and external growth, maintain a strong balance sheet, and pursue a strategy of financial flexibility. When ARI's marketing efforts identify opportunities, ARI will in appropriate instances, pursue those opportunities. ARI seeks to maximize the profitability of its apartments and commercial properties by endeavoring to maintain high occupancy levels while obtaining competitive rental rates, controlling costs and focusing on customer service efforts.

Current general economic conditions have resulted in downward pressure on rental rates, and market rental rates have declined on a year-to-year basis. ARI seeks to generate increased cash flow from apartments and commercial properties in operation through annual contractual increases in rental rates under leases. ARI also seeks to identify the best practices across operating platforms in order to enhance cost savings and other efficiencies. ARI and its subsidiaries employ an annual capital improvement and preventive maintenance program designed to reduce the operating costs of the apartments and commercial properties and maintain the long-term value of those real estate assets.

ARI also pursues attractive development opportunities, focusing primarily upon new construction or development, either directly or in concert with unaffiliated parties or affiliates. A summary of the properties under construction is set forth under ITEM 2. PROPERTIES below.

ARI also seeks to acquire properties consistent with its business objectives and strategies. ARI executes its acquisition strategy by purchasing properties which management believes will create stockholder value over the long-term. During the year ended December 31, 2004, ARI, through its subsidiaries, acquired 19 properties and disposed of 31 properties. ARI's subsidiaries dispose of properties and land held for development, which no longer fit within ARI's business plan or with respect to which management believes it can optimize cash proceeds.

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Although ARI seeks to maximize long-term profitability for its stockholders through the development, acquisition and disposition of properties, ARI intends to continue to pursue its development, acquisition and disposition strategies. ARI at all times, and currently, is in various stages of discussions and negotiations with

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respect to development, acquisition and disposition projects. The consummation of any current or future development, acquisition or disposition, if any, and the pace at which any may be completed cannot be assured or predicted.

Substantially all properties are owned by separate subsidiaries of ARI, many of which are single-asset entities. This structure permits greater access to financing for individual properties and permits flexibility in the type of transaction available for future disposition of each property by permitting a sale of either the asset or the equity ownership in the entity owning the asset. From time-to-time, subsidiaries have invested in joint ventures with others, which creates the possibility of risks that do not exist with properties solely owned by an ARI subsidiary. In those instances where other participants are involved, those other participants may, at any time, have business, economic or other objectives that are inconsistent with ARI's objectives, which may require a different action for the operation or ultimate disposition of the asset in question.

Real estate generally cannot be sold quickly. ARI and its subsidiaries may not be able to dispose of properties promptly in response to economic or other conditions. To offset this challenge, selective dispositions have been a part of ARI's strategy to create an efficient portfolio and provide additional sources of capital for future use. See the discussion under LIQUIDITY AND CAPITAL RESOURCES in MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS for information concerning sales of properties during the past three years. Similarly, ARI and its subsidiaries finance acquisitions at times through non-recourse mortgages, internally generated funds, and to a lesser extent, property sales. Those sources provide the bulk of funds for future acquisitions. ARI, from time-to-time, acquires properties subject to existing indebtedness by a subsidiary assuming such indebtedness. When properties are acquired in such manner, ARI and its subsidiaries customarily seek to refinance the asset in order to properly leverage the asset for future operation.

ARI, through its subsidiary, Milano Restaurants International Corporation (MRI), operates and franchises several quick-service restaurant concepts including pizzerias featuring pizza delivery, carryout and dine-in under the trademarks Me-N-Ed's Pizzerias, Me-N-Ed's Slices, and Angelo & Vito's Pizzerias. The first Me-N-Ed's Pizzeria opened in 1958. At December 31, 2004, there were 60 restaurants in operation, consisting of 41 owned and 19 franchised. Two of the restaurants were located in Texas and the remainder were in California. In addition to the Pizzerias, MRI has developed two new concepts: Pizzeria del Pane, a bakery/café concept and Zia Mia's Cucina Italiana, a full service Italian restaurant. The initial locations for each of the concepts opened in 2004.

ARI's businesses are not seasonal. With regard to real estate investments, ARI is seeking both current income and capital appreciation. ARI's plan of operation is to continue, to the extent its liquidity permits, to make equity investments in income producing real estate such as hotels, apartments, or commercial properties, or equity securities of real estate-related entities. ARI also intends to continue to pursue higher risk, higher reward investments, such as improved and unimproved land where it can obtain financing of substantially all of a property's purchase price. ARI intends to seek selected dispositions of certain of its assets, in particular, selected income producing properties in stabilized markets and certain of its land holdings where the prices obtainable for such assets justify their disposition. ARI has determined that it will no longer actively seek to fund or purchase mortgage loans. However, it may, in selected instances, originate mortgage loans or it may provide purchase money financing in conjunction with a property sale. See ITEM 2. PROPERTIES, NOTE 3. NOTES AND INTEREST RECEIVABLE and Schedules III and IV to the Consolidated Financial Statements included in ITEM 8. CONSOLIDATED FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA.

ARI's Board of Directors has broad authority under ARI's governing documents to make all types of investments, and may devote available assets to particular investments or types of investments, without restriction on the amount or percentage of assets that may be allocated to a single investment or to any particular type of investment, and without limit on the percentage of securities of any one issuer that may be acquired. Investment objectives and policies may be changed at any time by the Board without stockholder approval.

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The specific composition from time-to-time of ARI's real estate portfolio owned through subsidiaries depends largely on the judgment of management as to changing investment opportunities and the level of risk associated with specific investments or types of investments. Management intends to attempt to maintain a real estate portfolio diversified by location and type of property.

In addition to its equity investments in real estate, ARI and/or its subsidiaries have also invested in private and open market purchases of the equity securities of IORI and TCI, both affiliates of ARI. See ITEM 2. **PROPERTIES** Investments in Real Estate Companies.

Risk Factors Related to ARI's Business

Adverse events concerning existing tenants, or negative market conditions that may affect existing tenants could have an adverse impact on ARI's ability to attract new tenants, relet space, collect rent or renew leases, and thus could adversely affect cash flow from operations and inhibit growth. Cash flow from operations depends on the ability to lease space to tenants on economically favorable terms. ARI could be adversely affected by various facts and events over which there is limited control, such as:

lack of demand for space in areas where the properties are located;

inability to retain existing tenants and attract new tenants;

oversupply of or reduced demand for space and changes in market rental rates;

defaults by tenants or failure to pay rent on a timely basis;

the need to periodically renovate and repair marketable space;

physical damage to properties;

economic or physical decline of the areas where properties are located;

potential risk of functional obsolescence of properties over time.

At any time, any tenant may experience a downturn in its business that may weaken its financial condition. As a result, a tenant may delay a lease commencement, fail to make rental payments when due, decline to extend a lease upon its expiration, become insolvent or declare bankruptcy. Any tenant bankruptcy or insolvency, leasing delay or failure to make rental payments when due could result in the termination of the tenant's lease and material losses to the Company.

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If tenants do not renew their leases as they expire, ARI may not be able to rent the space. Furthermore, leases that are renewed, and some new leases for space that is relet, may have terms that are less economically favorable than current lease terms, or may require ARI to incur significant costs, such as renovations, tenant improvements, or lease transaction costs.

Any of these events could adversely affect cash flow from operations and ARI's ability to make expected distributions to shareholders and service indebtedness.

A significant portion of the costs, such as real estate taxes, insurance costs, and debt service payments, generally are not reduced when circumstances cause a decrease in cash flow from the properties.

ARI may not be able to compete successfully with other entities that operate in our industry. ARI experiences a great deal of competition in attracting tenants for the properties and in locating land to develop and properties to acquire.

In ARI's effort to lease these properties, ARI competes for tenants with a broad spectrum of other landlords in each of the markets. These competitors include, among others, publicly-held REITs, privately-held entities, individual property owners and tenants who wish to sublease their space. Some of these competitors may be able to offer prospective tenants more attractive financial terms than ARI is able to offer.

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If the availability of land or high quality properties in ARI's markets diminishes, operating results could be adversely affected.

ARI may experience increased operating costs, which could adversely affect our operations. ARI's properties are subject to increases in operating expenses such as insurance, cleaning, electricity, heating, ventilation and air conditioning, administrative costs and other costs associated with security, landscaping, repairs, and maintenance of the properties. While current tenants generally are obligated to pay a significant portion of these costs, there is no assurance that these tenants will make such payments or agree to pay these costs upon renewal or new tenants will agree to pay these costs. If operating expenses increase in ARI's markets, ARI may not be able to increase rents or reimbursements in all of these markets to meet increased expenses, without at the same time decreasing occupancy rates. If this occurs, ARI's ability to make distributions to shareholders and service indebtedness could be adversely affected.

ARI's ability to achieve growth in operating income depends in part on the ability to develop properties, which may suffer under certain circumstances. ARI intends to continue to develop properties where warranted by market conditions. The decline in demand for real estate has reduced the amount of development ARI is undertaking. ARI has a number of ongoing development and land projects being readied for development.

Additionally, general construction and development activities include the following risks:

construction and leasing of a property may not be completed on schedule, which could result in increased expenses and construction costs, and would result in reduced profitability for that property;

construction costs may exceed original estimates due to increases in interest rates and increased materials, labor or other costs, possibly making the property unprofitable because of inability to increase rents to compensate for the increase in construction costs;

some developments may fail to achieve expectations, possibly making them unprofitable;

ARI may be unable to obtain, or face delays in obtaining, required zoning, land-use, building, occupancy, and other governmental permits and authorizations, which could result in increased costs and could require ARI to abandon their activities entirely with respect to a project;

ARI may abandon development opportunities after the initial exploration, which may result in failure to recover costs already incurred. If ARI determines to alter or discontinue its development efforts, future costs of the investment may be expensed as incurred rather than capitalized and ARI may determine the investment is impaired resulting in a loss;

ARI may expend funds on and devote management's time to projects which we do not complete;

occupancy rates and rents at newly-completed properties may fluctuate depending on a number of factors, including market and economic conditions, which may result in lower than projected rental rates with the result that the investment is not profitable.

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ARI faces risks associated with property acquisitions. ARI acquires individual properties and portfolios of properties, and intends to continue to do so. The acquisition activities and their success are subject to the following risks:

when ARI is able to locate a desired property, competition from other real estate investors may significantly increase the purchase price;

acquired properties may fail to perform as expected;

the actual costs of repositioning or redeveloping acquired properties may be higher than the estimates;

acquired properties may be located in new markets where ARI faces risks associated with an incomplete knowledge or understanding of the local market, a limited number of established business relationships in the area and a relative unfamiliarity with local governmental and permitting procedures;

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ARI may be unable to quickly and efficiently integrate new acquisitions, particularly acquisitions of portfolios of properties, into existing operations, and results of operations and financial condition could be adversely affected.

ARI may acquire properties subject to liabilities and without any recourse, or with only limited recourse, with respect to unknown liabilities. As a result, if a liability were asserted against ARI based upon ownership of those properties, ARI might have to pay substantial sums to settle it, which could adversely affect cash flow.

Many of ARI's properties are concentrated in our primary markets, and may suffer economic harm as a result of adverse conditions in those markets. ARI's properties are located principally in specific geographic areas in the Southwestern, Southeastern, and Midwestern United States. Due to the concentration of properties in these areas, performance is dependent on economic conditions. These areas have experienced periods of economic decline.

ARI is highly leveraged and may not be able to meet our debt service obligations. ARI had total indebtedness at December 31, 2004 of approximately \$958.6 million. Substantially all assets have been pledged to secure debt. These borrowings increase the risk of loss because they represent a prior claim on assets and require fixed payments regardless of profitability. ARI's highly leveraged position makes it vulnerable to changes in economic conditions and may limit the ability to capitalize on significant business opportunities in the future.

The Company may not be able to access financial markets to obtain capital on a timely basis, or on acceptable terms. ARI relies on proceeds from property dispositions and third party capital sources for a portion of its capital needs, including capital for acquisitions and development. The public debt and equity markets are among the sources relied on. There is no guarantee ARI will be able to access these markets, or any other source of capital. The ability to access the public debt and equity markets depends on a variety of factors, including:

general economic conditions affecting these markets;

ARI's own financial structure and performance;

the market's opinion of REITs and real estate companies in general;

the market's opinion of REITs and real estate companies that own properties like ARI.

ARI may suffer adverse effects as a result of terms of and covenants relating to the Company's indebtedness. Required payments on ARI's indebtedness generally are not reduced if the economic performance of the portfolio declines. If the economic performance declines, net income, cash flow from operations and cash available for distribution to stockholders will be reduced. If payments on debt cannot be made, ARI could sustain a loss, or in the case of mortgages, suffer foreclosures by mortgagees or suffer judgments. Further, some obligations contain cross-default and/or cross-acceleration provisions, which means that a default on one obligation may constitute a default on other obligations.

ARI anticipates only a small portion of the principal of our debt will be repaid prior to maturity. Therefore, ARI is likely to need to refinance at least a portion of its outstanding debt as it matures. There is a risk that ARI may not be able to refinance existing debt or the terms of any

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refinancing will not be as favorable as the terms of the existing debt. If principal payments due at maturity cannot be refinanced, extended or repaid with proceeds from other sources, such as the proceeds of sales of assets or new equity securities, cash flow will not be sufficient to repay all maturing debt in years when significant balloon payments come due.

ARI's credit facilities and unsecured debt securities contain customary restrictions, requirements and other limitations on the ability to incur indebtedness, including total debt to asset ratios, secured debt to total asset ratios, debt service coverage ratios, and minimum ratios of unencumbered assets to unsecured debt, which ARI must maintain. ARI's continued ability to borrow is subject to compliance with financial and other covenants. In

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addition, failure to comply with such covenants could cause a default under credit facilities, and ARI may then be required to repay such debt with capital from other sources. Under those circumstances, other sources of capital may not be available, or be available only on unattractive terms.

The degree of leverage could affect ARI's ability to obtain additional financing for working capital, capital expenditures, acquisitions, development, or other general corporate purposes. The degree of leverage could also make ARI more vulnerable to a downturn in business or the economy or could affect the market price the common stock.

An increase in interest rates would increase interest costs on variable rate debt and could adversely impact the ability to refinance existing debt. ARI currently has, and may incur more, indebtedness that bears interest at variable rates. Accordingly, if interest rates increase, so will the interest costs, which would adversely affect cash flow and the ability to pay principal and interest on ARI's debt and the ability to make distributions to shareholders. Further, rising interest rates could limit ARI's ability to refinance existing debt when it matures.

Unbudgeted capital expenditures or cost overruns could adversely affect business operations and cash flow. If capital expenditures on ongoing or planned development projects, renovations, or condominium conversions exceed our expectations, the additional cost of these expenditures could have an adverse effect on business operations and cash flow. In addition, ARI might not have access to funds on a timely basis to meet the unexpected expenditures.

Construction costs are funded in large part through construction financing, which the Company often guarantees, and the Company's obligation to pay interest on this financing continues until the rental project is completed, leased up, and permanent financing is obtained, or the for sale project is sold out. Unexpected delays in completion of one or more ongoing projects could also have a significant adverse impact on business operations and cash flow.

ARI may need to sell properties from time-to-time for cash flow purposes. Because of the lack of liquidity of real estate investments generally, ARI's ability to respond to changing circumstances may be impaired. Real estate investments generally cannot be sold quickly. In the event that ARI must sell assets to generate cash flow, ARI cannot predict whether there will be a market for those assets in the time period desired or need to sell them, or whether ARI will be able to sell them at a price that will allow the Company to fully recoup the investment. ARI may not be able to realize the full potential value of the assets, and may incur costs related to the early pay-off of the debt secured by such assets.

The Company intends to devote increasing resources to the development of new projects. ARI plans to continue developing new projects as opportunities arise in the future. Development and construction activities entail a number of risks, including but not limited to the following:

ARI may abandon a project after spending non-recoverable time and money determining its feasibility;

Construction costs may materially exceed original estimates;

The revenue from a new project may not be enough to make it profitable or generate a positive cash flow;

ARI may not be able to obtain financing on favorable terms for development of a property, if at all;

The Company may not complete construction and lease-ups on schedule, resulting in increased development or carrying costs;

ARI may not be able to obtain, or may be delayed in obtaining, necessary governmental permits.

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The overall business is subject to all of the risks associated with the real estate industry. ARI is subject to all risks incident to investment in real estate, many of which relate to the general lack of liquidity of real estate investments, including, but not limited to:

changes in general or local economic conditions: because ARI's real estate assets are concentrated in the Southwest, Southeast, and Midwest any deterioration in the general economic conditions in any of those states could have an adverse effect on business and assets in that state;

changes in interest rates may make the ability to satisfy debt service requirements materially more burdensome;

lack of availability of financing may render the purchase, sale or refinancing of a property more difficult or unattractive;

changes in real estate and zoning laws;

increases in real estate taxes and insurance costs;

federal or local economic or rent control, and

floods, earthquakes and other similar natural disasters.

Risks Related to the Real Estate Industry

Real estate investments are illiquid, and the Company may not be able to sell our properties if and when we determine it is appropriate to do so. Real estate generally cannot be sold quickly. ARI may not be able to dispose of properties promptly in response to economic or other conditions. In addition, provisions of the Internal Revenue Code limit ARI's ability to sell properties in some situations when it may be economically advantageous to do so, thereby adversely affecting returns to stockholders and adversely impacting the ability to meet ARI's obligations to the holders of other securities.

Management of the Company

Although the Board of Directors is directly responsible for managing the affairs of ARI and for setting the policies, which guide it, its day-to-day operations are performed by Prime, a contractual advisor under the supervision of the Board. The duties of Prime include, among other things, locating, investigating, evaluating, and recommending real estate and mortgage note investments and sales opportunities, as well as financing and refinancing sources. Prime also serves as a consultant in connection with ARI's business plan and investment policy decisions made by the Board. Prime is indirectly owned by Gene E. Phillips (20%) and by a trust for the children of Gene E. Phillips (80%). Mr. Phillips is not an officer or director of Prime, but serves as a representative of the trust, is involved in daily consultation with the officers of Prime, and has significant influence over the conduct of Prime's business, including the rendering of advisory services and the making of investment decisions for itself and ARI. As of March 24, 2005, PIAMI, Prime's parent, owned 1,437,208 shares of ARI's Common Stock, approximately 13.2% of the shares then outstanding. Prime is more fully described in ITEM 10. DIRECTORS, EXECUTIVE OFFICERS AND ADVISOR OF THE

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REGISTRANT The Advisor.

Prime has been providing advisory services to ARI since October 1, 2003. Prime also serves as advisor to TCI. The officers of ARI are also officers of IORI, TCI, and Prime. The directors of ARI also serve as directors of TCI. The Chairman of the Board of Directors of ARI also serves as the Chairman of the Board of Directors of TCI and IORI. Affiliates of Prime have provided property management services to ARI. Currently, Triad Realty Services, Ltd. (Triad), an affiliate, and Carmel Realty, Inc. (Carmel) provide such property management services. Triad and Carmel subcontract with other entities for property-level management services. The general partner of Triad is BCM. The limited partner of Triad is Highland Realty Services, Inc. (Highland). Triad subcontracts the property-level management and leasing of 30 of ARI s commercial properties (shopping centers, office buildings and industrial warehouses) to Regis Realty I, LLC (Regis I) which is owned by Highland.

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Regis I receives property and construction management fees and leasing commissions in accordance with the terms of its property-level management agreement with Triad. Since January 1, 2003, Regis Hotel I, LLC, has managed ARI's 11 hotels. The sole member of Regis I and Regis Hotel I, LLC is Highland. Carmel is a company previously owned by First Equity Properties, Inc., which is a company affiliated with Prime. On May 1, 2004, Regis I acquired the ownership of Carmel.

Regis I is also entitled to receive real estate brokerage commissions in accordance with the terms of the Advisory Agreement as discussed in ITEM 10. DIRECTORS, EXECUTIVE OFFICERS AND ADVISOR OF THE REGISTRANT The Advisor.

ARI has no employees itself, but MRI has 843 employees. Employees of Prime render services to ARI.

Competition

Real Estate. The real estate business is highly competitive, and ARI competes with numerous entities engaged in real estate activities (including certain entities described in ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS Related Party Transactions), some of which have greater financial resources than ARI. Management believes that success against such competition is dependent upon the geographic location of the property, the performance of property-level managers in areas such as marketing, collections and control of operating expenses, the amount of new construction in the area, and the maintenance and appearance of the property. Additional competitive factors with respect to commercial properties are the ease of access to the property, the adequacy of related facilities, such as parking, and sensitivity to market conditions in setting rent levels. With respect to apartments, competition is also based upon the design and mix of the units and the ability to provide a community atmosphere for the tenants. With respect to hotels, competition is also based upon the market served, i.e., transient, commercial or group users. Management believes that beyond general economic circumstances and trends, the rate at which properties are renovated or the rate new properties are developed in the vicinity of each of ARI's properties, in particular its improved and unimproved land, are also competitive factors. See also Risk Factors Related to ARI's Business.

To the extent that ARI seeks to sell any of its properties, the sales prices for the properties may be affected by competition from other real estate entities and financial institutions, also attempting to sell properties in areas where ARI's properties are located, as well as aggressive buyers attempting to dominate or penetrate a particular market.

As described above and in ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS Related Party Transactions, the officers of ARI also serve as officers of IORI (with the exception of the CFO) and TCI, both of which have business objectives similar to ARI's. ARI's officers and advisor owe fiduciary duties to both IORI and TCI as well as to ARI under applicable law. In determining whether a particular investment opportunity will be allocated to ARI, IORI, or TCI, management and the advisor consider the respective investment objectives of each and the appropriateness of a particular investment in light of the existing real estate and mortgage notes receivable portfolios of each. To the extent that any particular investment opportunity is appropriate to more than one of the entities, the investment opportunity will be allocated to the entity, which has had funds available for investment for the longest period of time, or, if appropriate, the investment may be shared among all or some of the entities.

In addition, also as described in ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS, ARI competes with entities, which are affiliates of Prime having similar investment objectives in the purchasing, selling, leasing, and financing of real estate and real estate-related investments. In resolving any potential conflicts of interest which may arise, Prime has informed ARI that it intends to continue to

exercise its best judgment as to what is fair and reasonable under the circumstances in accordance with applicable law.

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ARI is subject to all the risks incident to ownership and financing of real estate and interests therein, many of which relate to the general illiquidity of real estate investments. These risks include, but are not limited to, changes in general or local economic conditions, changes in interest rates and availability of permanent mortgage financing which may render the purchase, sale, or refinancing of a property difficult or unattractive, and which may make debt service burdensome, changes in real estate and zoning laws, increases in real estate taxes, federal or local economic or rent controls, floods, earthquakes, hurricanes and other acts of God and other factors beyond the control of management or the advisor. The illiquidity of real estate investments may also impair the ability of management to respond promptly to changing circumstances. Management believes that such risks are partially mitigated by the diversification by geographic region and property type of ARI's real estate and mortgage notes receivable portfolios. However, to the extent that property sales, new property investments, in particular improved and unimproved land, or mortgage lending are concentrated in any particular region, the advantages of geographic diversification are mitigated.

Virtually all of ARI's real estate, equity security holdings in IORI and TCI and its portfolio of equity securities are held subject to secured indebtedness. Such borrowings increase the risk of loss because they represent a prior claim on ARI's assets and require fixed payments regardless of profitability. In the event of default, the lender may foreclose on the assets securing such indebtedness, and ARI could lose its investment in the pledged assets.

Pizza Parlors. The pizza parlor business is highly competitive and is affected by changes in consumer tastes and eating habits, as well as national, regional, and local economic conditions, and demographic trends. The performance of an individual pizza parlor can be affected by changes in traffic patterns, demographics, and the type, number and location of competing restaurants.

The quick-service restaurant industry is extremely competitive with respect to price, service, location, and food quality. MRI and its franchisees compete with a variety of other restaurants in the quick-service restaurant industry; including those that offer dine-in, carryout, and delivery services. These competitors include national and regional chains, franchisees of other restaurant chains, and local owner-operated restaurants. Some of these competitors have been in existence longer and have an established market presence in certain geographic regions, and some have substantially greater financial, marketing, and other resources than MRI and its franchisees. MRI competes for qualified franchisees with many other restaurant concepts, including national and regional restaurant chains.

MRI's success is largely dependent upon the efforts of its management and other key personnel. The loss of the service of one or more members of management could have an adverse effect on MRI's operations. Significant transitions in management involve important risks, including potential loss of key personnel, difficulties in implementing changes to operational strategies and maintaining relationships with franchisees.

At December 31, 2004, MRI owned and operated 41 and franchised 19 pizza parlors. The results achieved by MRI's relatively small pizza parlor base may not be indicative of the results of a larger number of pizza parlors in a more geographically dispersed area. Because of MRI's relatively small pizza parlor base, an unsuccessful pizza parlor has a more significant effect on MRI's results of operations than would be the case in a company owning more pizza parlors.

MRI's existing pizza parlors, both owned and franchised, are located in California or Texas. At December 31, 2004, there were 58 pizza parlors in California and two in Texas. Accordingly, MRI's results of operations may be affected by economic or other conditions in those regions. Also, given MRI's present geographic concentration, publicity relating to MRI's pizza parlors could have a more pronounced effect on MRI's overall sales than might be the case if MRI's pizza parlors were geographically dispersed.

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All of MRI s owned pizza parlors are operated on premises leased from third parties. Most of the pizza parlor leases provide for a minimum annual rent. There can be no assurance that MRI will be able to renew leases

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upon expiration or that the lease terms on renewal will be as favorable as the current lease terms. In 2004, MRI closed one company-owned store, opened two new franchise stores, reopened a remodeled franchised store, with two franchise stores leaving the system. In 2005, three new franchise stores are scheduled to open.

In July 2003, ARI sold its interest in MRI to Gruppa Florentina, LLC (Gruppa), for \$18.5 million, receiving \$7.4 million in cash after debt assumption and providing purchase money financing of \$2.3 million. ARI owns 20.0% of Gruppa, thereby retaining a 20.0% interest in MRI. ARI remains as the guarantor of \$8.7 million of assumed debt and is one of the guarantors of \$7.5 million in new debt obtained by Gruppa. Due to the debt guarantees and ARI's continuing ownership interest in MRI, management has determined that this should be accounted for as a financing transaction. In September 2003, ARI sold the note to Syntek West for \$2.3 million, plus accrued and unpaid interest, to reduce affiliate debt.

Available Information

ARI maintains an internet site at <http://www.amrealtytrust.com>. Available through the website, free of charge, are Annual Reports on Form 10-K, Quarterly Reports on Form 10-Q, Current Reports on Form 8-K, reports filed pursuant to Section 16, and amendments to those reports as soon as reasonably practicable after they are electronically filed or furnished to the Securities and Exchange Commission. In addition, ARI has posted the charters for the Audit Committee, Compensation Committee, and Governance and Nominating Committee, as well as the Code of Business Conduct and Ethics, Corporate Governance Guidelines on Director Independence, and other information on the website. These charters and principles are not incorporated in this Report by reference. ARI will also provide a copy of these documents free of charge to stockholders upon written request. ARI issues Annual Reports containing audited financial statements to its common stockholders.

ITEM 2. PROPERTIES

ARI's principal offices are located at 1800 Valley View Lane, Suite 300, Dallas, Texas 75234 and are, in the opinion of management, suitable and adequate for ARI's present operations.

Details of ARI's and its subsidiaries' real estate and mortgage notes receivable portfolios at December 31, 2004, are set forth in SCHEDULES III and IV, respectively, to the Consolidated Financial Statements included in ITEM 8. CONSOLIDATED FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA. The discussions set forth below under the headings Real Estate and Mortgage Loans provide certain summary information concerning ARI's real estate and mortgage notes receivable portfolios.

At December 31, 2004, no single asset accounted for 10.0% or more of total assets. At December 31, 2004, 82.6% of ARI's assets consisted of real estate, and 6.1% consisted of notes and interest receivable. The remaining 11.3% of ARI's assets were cash, cash equivalents, marketable equity securities, pizza parlor equipment, investments in equity investees, goodwill and other intangibles, and other assets. The percentage of assets invested in any one category is subject to change and no assurance can be given that the composition of ARI's assets in the future will approximate the percentages listed above.

ARI's real estate is geographically diverse, with concentrations in the Southwest, Southeast, and Midwest regions. At December 31, 2004, ARI's real estate was located in all geographic regions of the continental United States, other than the Northeast region, as shown more specifically in

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the table under Real Estate below. ARI also holds mortgage notes receivable secured by real estate located in the Southwest, Southeast, Pacific and Midwest regions of the continental United States. See SCHEDULE IV to the Consolidated Financial Statements included in ITEM 8.

FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA for a detailed description of ARI's notes receivable portfolio.

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Geographic Regions

Excluded from above are 78 parcels of improved and unimproved land, and a single-family residence, as described below.

Real Estate

At December 31, 2004, 83.1% of ARI's assets were invested in real estate and the equity securities of IORI. ARI invests in real estate located throughout the continental United States, either on a leveraged or non-leveraged basis. ARI's real estate portfolio consists of properties held for investment, properties held for sale, investments in partnerships, and investments in equity securities of IORI.

Types of Real Estate Investments. ARI's real estate consists of apartments, commercial properties (office buildings, industrial warehouses, shopping centers, and a merchandise mart), hotels, and improved and unimproved land. In selecting real estate for investment, the location, age and type of property, gross rents, lease terms, financial and business standing of tenants, operating expenses, fixed charges, land values, and physical condition are among the factors considered. Properties may be purchased subject to debt, or existing debt may be assumed and properties may be mortgaged, pledged or otherwise collateralized to obtain financing. The Board of Directors may alter the types of and criteria for selecting new real estate investments and for obtaining financing without a vote of stockholders.

Although ARI has typically invested in developed real estate, it may also invest in new construction or development either directly or in partnership with unaffiliated parties or affiliates (subject to approval by the Board of Directors). To the extent that it invests in construction and development projects, such as the apartments described below, ARI is subject to business risks, which include cost overruns and construction delays, associated with higher risk projects.

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At December 31, 2004, ARI had the following properties under construction:

| <u>Property</u> | <u>Location</u> | <u>Units</u> | <u>Amount Expended</u> | <u>Additional Amount to Expend</u> | <u>Construction Loan Funding</u> |
|---|--------------------|--------------|------------------------|------------------------------------|----------------------------------|
| Apartments | | | | | |
| Blue Lake Villas II | Waxahachie, TX | 76 Units | \$ 4,454 | \$ 217 | \$ 4,234 |
| Bluffs at Vista Ridge | Lewisville, TX | 272 Units | 17,239 | 3,347 | 15,500 |
| Bridges on Kinsey | Tyler, TX | 232 Units | 11,572 | 4,509 | 14,477 |
| Dakota Arms | Lubbock, TX | 208 Units | 12,611 | 1,326 | 12,549 |
| Kingsland Ranch | Houston, TX | 398 Units | 24,573 | 1,081 | 23,000 |
| Laguna Vista | Farmers Branch, TX | 206 Units | 3,432 | 17,673 | 17,741 |
| Lake Forest | Houston, TX | 240 Units | 13,919 | 519 | 12,815 |
| Parc at Maumelle | Maumelle, AR | 240 Units | 4,502 | 14,196 | 16,829 |
| Stonebridge at City Park (formerly 288 City Park) | Houston, TX | 240 Units | 15,486 | 1,201 | 15,005 |
| Vistas of Vance Jackson | San Antonio, TX | 240 Units | 13,393 | 4,708 | 16,056 |
| Wildflower Villas | Temple, TX | 220 Units | 9,377 | 6,220 | 14,073 |

In 2004, ARI completed the 248 unit DeSoto Ranch Apartments in DeSoto, Texas, the 314 unit Verandas at Cityview Apartments in Fort Worth, Texas, the 216 unit Mariposa Villas (Echo Valley) in Dallas, Texas, the 176 unit Breakwater Bay Apartments in Beaumont, Texas, the 156 unit Capitol Hill Apartments in Little Rock, Arkansas and the 332 unit Vistas of Pinnacle Park Apartments in Dallas, Texas.

In the opinion of management, the properties owned by ARI are adequately covered by insurance.

The following table sets forth the percentages, by property type and geographic region, of owned real estate (excluding 78 parcels of improved and unimproved land, a hotel in Wroclaw, Poland and a single-family residence, described below) at December 31, 2004.

| <u>Region</u> | <u>Apartments</u> | <u>Commercial Properties</u> | <u>Hotels</u> |
|---------------|-------------------|------------------------------|---------------|
| Midwest | 5% | 15% | 11% |
| Mountain | | 19 | 11 |
| Pacific | | 1 | 49 |
| Southeast | 10 | 10 | 29 |
| Southwest | 85 | 55 | |
| | <u>100%</u> | <u>100%</u> | <u>100%</u> |

The foregoing table is based solely on the number of apartment units, amount of commercial square footage, and number of hotel rooms owned, and does not reflect the value of ARI's investment in each region. See SCHEDULE III to the Consolidated Financial Statements included in ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA for a detailed description of owned real estate.

Excluded from the table above are a 165 room hotel in Wroclaw, Poland, a single family residence in Dallas, Texas, and 78 parcels of improved and unimproved land consisting of: four parcels in Austin, Texas, totaling 484.2 acres; a 7.6 acre parcel in Carrollton, Texas; two parcels in Collin County, Texas, totaling 53.1 acres; seven parcels in Dallas County, Texas, totaling 392.4 acres; six parcels in Dallas, Texas, totaling 61.1 acres; a 13.9 acre parcel in Denton, Texas; a 105.4 acre parcel in Denton County, Texas; a 202.0 acre parcel in Desoto, Texas; 18 parcels in Farmers Branch, Texas, totaling 494.8 acres; a 18.9 acre parcel in Fort Wayne, Indiana; a 4.7 acre parcel in Fruitland Park, Florida; four parcels in Ft. Worth, Texas, totaling 86.3 acres; a 13.9 acre parcel in Grand Prairie, Texas; a 130.6 acre parcel in Harris County, Texas; two parcels in Houston, Texas,

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totaling 38.2 acres; a 16.9 acre parcel in Humble, Texas; four parcels in Irving, Texas, totaling 39.9 acres; a 52.9 acre parcel in Kent, Ohio; six parcels in Las Colinas, Texas, totaling 351.2 acres; a 79.0 acre parcel in Lewisville, Texas; a 2.9 acre parcel in Lubbock, Texas; a 10.8 acre parcel in Maumelle, Arkansas; a 127.4 acre parcel in Nashville, Tennessee; a 0.4 acre parcel in New Orleans, Louisiana; a 110.05 acre parcel in Palm Desert, California; a 11.8 acre parcel in Plano, Texas; a 21.9 acre parcel in Pulaski County, Arkansas; a 20.1 acre parcel in Rogers, Arkansas; a 0.7 acre parcel in San Angelo, Texas; a 20.7 acre parcel in Siskiyou County, California; a 4.0 acre parcel in Springfield, Virginia; two parcels in Tarrant County, Texas, totaling 31.3 acres; and a 63.3 acre parcel in Travis County, Texas. See SCHEDULE III to the Consolidated Financial Statements included in ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA for a detailed description of ARI's real estate portfolio.

A summary of the activity in the owned real estate portfolio during 2004 is as follows:

| | |
|---|-------|
| Owned properties at January 1, 2004 | 216 |
| Properties purchased (excluding additions to existing land parcels) | 19 |
| Properties sold (excluding partial sales) | (31) |
| | <hr/> |
| Owned properties at December 31, 2004 | 204 |
| | <hr/> |

Operating Properties. Set forth below are ARI's operating properties and the monthly rental rate for apartments, the average annual rental rate for commercial properties, the average daily room rate and room revenue divided by total available rooms for hotels, and occupancy at December 31, 2004, 2003 and 2002 for apartments and commercial properties and average occupancy during 2004, 2003 and 2002 for hotels. The 2002 information for the properties added through the consolidation of TCI, as identified with (T), is provided for comparative purposes only.

| Property | Location | Units/Square Footage | Rent Per | | | Occupancy % | | |
|---------------------------|--------------------|---------------------------|----------|--------|--------|-------------|------|------|
| | | | 2004 | 2003 | 2002 | 2004 | 2003 | 2002 |
| Apartments | | | | | | | | |
| 4400 (T) | Midland, TX | 92 Units/94,472 Sq. Ft. | \$.51 | \$.49 | \$.49 | 97 | 86 | 86 |
| Apple Lane (T) | Lawrence, KS | 75 Units/30,000 Sq. Ft. | 1.08 | 1.05 | 1.04 | 100 | 100 | 93 |
| Arbor Point (T) | Odessa, TX | 195 Units/178,920 Sq. Ft. | .47 | .45 | .43 | 90 | 95 | 87 |
| Arlington Place | Pasadena, TX | 230 Units/205,476 Sq. Ft. | .76 | .76 | .75 | 97 | 97 | 94 |
| Ashton Way (T) | Midland, TX | 178 Units/138,964 Sq. Ft. | .45 | .43 | .43 | 95 | 87 | 82 |
| Autumn Chase (T) | Midland, TX | 64 Units/58,652 Sq. Ft. | .57 | .55 | .54 | 98 | 98 | 98 |
| Bay Walk (T) | Galveston, TX | 192 Units/153,120 Sq. Ft. | .75 | .75 | .74 | 90 | 95 | 95 |
| Blue Lake Villas (T) | Waxahachie, TX | 186 Units/169,746 Sq. Ft. | .91 | .91 | * | 90 | 92 | * |
| Bluffs at Vista Ridge (T) | Lewisville, TX | 272 Units/257,432 Sq. Ft. | ** | ** | ** | ** | ** | ** |
| Breakwater Bay (T) | Beaumont, TX | 176 Units/145,688 Sq. Ft. | .93 | * | * | 87 | * | * |
| Bridgestone | Friendswood, TX | 76 Units/65,519 Sq. Ft. | .74 | .74 | .74 | 96 | 96 | 92 |
| By the Sea (T) | Corpus Christi, TX | 153 Units/123,945 Sq. Ft. | .88 | .88 | .86 | 96 | 91 | 88 |
| Capitol Hill (T) | Little Rock, AR | 156 Units/151,116 Sq. Ft. | .88 | * | * | 70 | * | * |
| Château | Bellevue, NE | 115 Units/99,220 Sq. Ft. | .73 | .73 | .71 | 86 | 86 | 96 |
| Château Bayou | Ocean Springs, MS | 122 Units/105,536 Sq. Ft. | .67 | .67 | .67 | 94 | 94 | 94 |
| Courtyard (T) | Midland, TX | 133 Units/111,576 Sq. Ft. | .47 | .46 | .45 | 94 | 99 | 93 |
| Coventry (T) | Midland, TX | 120 Units/105,608 Sq. Ft. | .45 | .44 | .43 | 96 | 84 | 91 |
| DeSoto Ranch (T) | DeSoto, TX | 248 Units/240,718 Sq. Ft. | .95 | .94 | * | 98 | 98 | * |

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| | | | | | | | | |
|----------------------------|-----------------|---------------------------|-----|-----|-----|----|----|----|
| El Chapparral (T) | San Antonio, TX | 190 Units/174,220 Sq. Ft. | .95 | .73 | .72 | 94 | 96 | 79 |
| Fairway View Estates (T) | El Paso, TX | 264 Units/204,000 Sq. Ft. | .65 | .64 | .63 | 90 | 96 | 92 |
| Fairways (T) | Longview, TX | 152 Units/134,176 Sq. Ft. | .59 | .58 | .56 | 96 | 93 | 92 |
| Falcon Lakes (T) | Arlington, TX | 284 Units/207,960 Sq. Ft. | .96 | .96 | .97 | 94 | 94 | 11 |
| Fountain Lake (T) | Texas City, TX | 166 Units/161,220 Sq. Ft. | .62 | .62 | .62 | 86 | 96 | 89 |
| Fountains of Waterford (T) | Midland, TX | 172 Units/129,200 Sq. Ft. | .55 | .53 | .53 | 96 | 99 | 85 |
| Foxwood | Memphis, TN | 220 Units/212,000 Sq. Ft. | .61 | .61 | .61 | 83 | 83 | 85 |
| Governor s Square | Tallahassee, FL | 169 Units/146,550 Sq. Ft. | .73 | .73 | .66 | 95 | 95 | 95 |
| Harper s Ferry (T) | Lafayette, LA | 122 Units/112,500 Sq. Ft. | .61 | .60 | .59 | 95 | 90 | 83 |

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| Property | Location | Units/Square Footage | Rent Per Square Foot | | | Occupancy % | | |
|-----------------------------|--------------------|---------------------------|-------------------------|-------|-------|-------------|------|------|
| | | | 2004 | 2003 | 2002 | 2004 | 2003 | 2002 |
| Heather Creek (T) | Mesquite, TX | 200 Units/170,212 Sq. Ft. | \$.94 | \$ * | \$ * | 93 | * | * |
| Hunters Glen (T) | Midland, TX | 260 Units/174,180 Sq. Ft. | .42 | .39 | .38 | 93 | 94 | 81 |
| Island Bay (T) | Galveston, TX | 458 Units/374,784 Sq. Ft. | .83 | .83 | .81 | 93 | 91 | 90 |
| Kingsland Ranch (T) | Houston, TX | 398 Units/350,574 Sq. Ft. | ** | ** | ** | ** | ** | ** |
| Limestone Canyon (T) | Austin, TX | 260 Units/216,000 Sq. Ft. | 1.06 | 1.06 | 1.06 | 96 | 91 | 88 |
| Limestone Ranch (T) | Lewisville, TX | 252 Units/219,600 Sq. Ft. | .95 | .94 | .94 | 95 | 91 | 91 |
| Longwood | Long Beach, MS | 200 Units/187,048 Sq. Ft. | .58 | .58 | * | 90 | 90 | * |
| Marina Landing (T) | Galveston, TX | 256 Units/205,504 Sq. Ft. | .83 | .83 | .82 | 92 | 95 | 96 |
| Mariposa Villas (T) | Dallas, TX | 216 Units/199,656 Sq. Ft. | .89 | .89 | * | 95 | 97 | * |
| Mediterranean Villas | San Antonio, TX | 140 Units/158,960 Sq. Ft. | .56 | .56 | .55 | 92 | 92 | 84 |
| Mountain Plaza (T) | El Paso, TX | 188 Units/220,710 Sq. Ft. | .52 | .52 | .51 | 90 | 94 | 97 |
| Oak Park IV (T) | Clute, TX | 108 Units/78,708 Sq. Ft. | .56 | .56 | .56 | 93 | 91 | 95 |
| Oak Tree | Grandview, MO | 189 Units/160,591 Sq. Ft. | .66 | .66 | .65 | 93 | 93 | 89 |
| Paramount Terrace (T) | Amarillo, TX | 181 Units/123,840 Sq. Ft. | .61 | .60 | .59 | 91 | 93 | 91 |
| Plantation (T) | Tulsa, OK | 138 Units/103,500 Sq. Ft. | .61 | .61 | .61 | 90 | 92 | 0 |
| Quail Oaks (T) | Balch Springs, TX | 131 Units/72,848 Sq. Ft. | .83 | .83 | .83 | 95 | 95 | 85 |
| Quail Pointe | Huntsville, AL | 184 Units/202,602 Sq. Ft. | .46 | .46 | .47 | 91 | 91 | 90 |
| River Oaks (T) | Wylie, TX | 180 Units/164,604 Sq. Ft. | .86 | .86 | * | 95 | 98 | * |
| Sendero Ridge (T) | San Antonio, TX | 384 Units/340,880 Sq. Ft. | 1.02 | 1.01 | * | 94 | 80 | * |
| Somerset (T) | Texas City, TX | 200 Units/163,368 Sq. Ft. | .68 | .68 | .68 | 85 | 88 | 87 |
| Southgate (T) | Odessa, TX | 180 Units/151,656 Sq. Ft. | .46 | .43 | .43 | 98 | 93 | 90 |
| Spy Glass (T) | Mansfield, TX | 256 Units/239,264 Sq. Ft. | .96 | .95 | * | 92 | 97 | * |
| Sunchase (T) | Odessa, TX | 300 Units/223,048 Sq. Ft. | .51 | .49 | .49 | 97 | 96 | 91 |
| Sun Hollow | El Paso, TX | 216 Units/156,000 Sq. Ft. | .74 | .74 | .72 | 92 | 92 | 91 |
| Sunset | Odessa, TX | 240 Units/160,400 Sq. Ft. | .50 | .50 | .47 | 100 | 100 | 89 |
| Terrace Hills (T) | El Paso, TX | 310 Units/233,192 Sq. Ft. | .70 | .70 | .69 | 94 | 96 | 93 |
| Timbers (T) | Tyler, TX | 180 Units/101,666 Sq. Ft. | .60 | .60 | .59 | 96 | 92 | 93 |
| Tivoli (T) | Dallas, TX | 190 Units/168,862 Sq. Ft. | .95 | .95 | .96 | 92 | 92 | 27 |
| Treehouse (T) | Irving, TX | 160 Units/153,072 Sq. Ft. | .80 | *** | .80 | 96 | *** | 94 |
| Verandas at City View (T) | Fort Worth, TX | 314 Units/295,170 Sq. Ft. | .92 | .60 | * | 93 | 92 | * |
| Villa Del Mar | Wichita, KS | 162 Units/128,004 Sq. Ft. | .62 | .62 | .62 | 89 | 89 | 86 |
| Villager | Ft. Walton, FL | 33 Units/22,840 Sq. Ft. | .79 | .79 | .77 | 100 | 100 | 88 |
| Vistas of Pinnacle Park (T) | Dallas, TX | 332 Units/276,928 Sq. Ft. | .91 | * | * | 96 | * | * |
| Waters Edge III | Gulfport, MS | 238 Units/212,216 Sq. Ft. | .64 | .64 | .63 | 91 | 91 | 90 |
| Waters Edge IV | Gulfport, MS | 80 Units/76,400 Sq. Ft. | .76 | .76 | .76 | 94 | 94 | 74 |
| Westwood | Mary Ester, FL | 120 Units/93,000 Sq. Ft. | .74 | .74 | .72 | 100 | 100 | 98 |
| Westwood (T) | Odessa, TX | 79 Units/49,001 Sq. Ft. | .46 | .44 | .49 | 91 | 100 | 80 |
| Whispering Pines | Topeka, KS | 320 Units/299,264 Sq. Ft. | .55 | .55 | .54 | 91 | 91 | 91 |
| Willow Creek (T) | El Paso, TX | 112 Units/103,140 Sq. Ft. | .58 | .57 | .55 | 97 | 96 | 94 |
| Willo-Wick Gardens (T) | Pensacola, FL | 152 Units/153,360 Sq. Ft. | .55 | .55 | .54 | 95 | 91 | 84 |
| Windsong (T) | Ft. Worth, TX | 188 Units/169,464 Sq. Ft. | .89 | * | * | 91 | * | * |
| Windsor Tower | Ocala, FL | 64 Units/66,000 Sq. Ft. | .56 | .56 | .55 | 98 | 98 | 97 |
| Woodhollow | San Antonio, TX | 546 Units/348,692 Sq. Ft. | .71 | .71 | .68 | 79 | 79 | 84 |
| Woodlake | Carrollton, TX | 256 Units/210,208 Sq. Ft. | .87 | .87 | .85 | 92 | 92 | 89 |
| Woodview (T) | Odessa, TX | 232 Units/165,840 Sq. Ft. | .53 | .52 | .51 | 93 | 94 | 85 |
| Office Buildings | | | | | | | | |
| 1010 Common (T) | New Orleans, LA | 494,579 Sq. Ft. | 14.08 | 13.63 | 12.77 | 84 | 82 | 74 |
| 225 Baronne (T) | New Orleans, LA | 416,834 Sq. Ft. | 10.70 | 10.63 | 9.89 | 69 | 65 | 76 |
| 9033 Wilshire (T) | Los Angeles, CA | 44,253 Sq. Ft. | 33.75 | 30.16 | 29.24 | 70 | 70 | 63 |
| Amoco (T) | New Orleans, LA | 378,244 Sq. Ft. | 13.66 | 13.37 | 12.73 | 69 | 78 | 79 |
| Bay Plaza (T) | Tampa, FL | 75,780 Sq. Ft. | 13.96 | 14.98 | 15.85 | 54 | 80 | 86 |
| Bay Plaza II (T) | Tampa, FL | 78,882 Sq. Ft. | 12.79 | 13.23 | 13.01 | 77 | 78 | 72 |
| Cooley Building | Farmers Branch, TX | 27,000 Sq. Ft. | 12.63 | 12.63 | 11.49 | 100 | 100 | 100 |
| Durham Center | Durham, NC | 207,171 Sq. Ft. | 17.73 | 17.73 | 17.79 | 83 | 83 | 98 |
| Eton Square (T) | Tulsa, OK | 222,654 Sq. Ft. | 11.09 | 11.60 | 11.35 | 75 | 38 | 42 |
| Executive Court | Memphis, TN | 41,840 Sq. Ft. | 8.00 | 8.00 | 11.24 | | | |

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| | | | | | | | | |
|---------------------|--------------------|-----------------|-------|-------|-------|----|----|----|
| Forum (T) | Richmond, VA | 79,791 Sq. Ft. | 13.68 | 14.23 | 15.32 | 76 | 61 | 60 |
| Four Hickory Centre | Farmers Branch, TX | 226,911 Sq. Ft. | 18.70 | 18.70 | * | 4 | 4 | * |
| Institute Place (T) | Chicago, IL | 144,915 Sq. Ft. | 16.67 | 17.21 | 17.13 | 69 | 83 | 88 |

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| Property | Location | Units/Square Footage | Rent Per Square Foot | | | Occupancy % | | |
|--------------------------------|----------------------|----------------------|----------------------|----------|----------|-------------|------|------|
| | | | 2004 | 2003 | 2002 | 2004 | 2003 | 2002 |
| Lexington Center (T) | Colorado Springs, CO | 74,603 Sq. Ft. | \$ 10.56 | \$ 12.33 | \$ 13.41 | 58 | 70 | 84 |
| One Hickory Centre | Farmers Branch, TX | 102,615 Sq. Ft. | 20.34 | 20.34 | 20.42 | 74 | 74 | 74 |
| Parkway North (T) | Dallas, TX | 71,041 Sq. Ft. | 16.58 | 18.08 | 17.41 | 60 | 64 | 72 |
| Signature Athletic Club (T) | Dallas, TX | 56,532 Sq. Ft. | 10.00 | **** | **** | 100 | **** | **** |
| Two Hickory Centre | Farmers Branch, TX | 96,127 Sq. Ft. | 21.47 | 21.47 | 21.23 | 100 | 100 | 93 |
| University Square | Anchorage, AK | 22,260 Sq. Ft. | 14.64 | 14.64 | 15.54 | 100 | 100 | 100 |
| Westgrove Air Plaza (T) | Addison, TX | 78,326 Sq. Ft. | 12.68 | 13.26 | 13.96 | 74 | 94 | 66 |
| Industrial Warehouses | | | | | | | | |
| 5360 Tulane (T) | Atlanta, GA | 30,000 Sq. Ft. | 2.85 | 2.80 | 2.75 | 100 | 65 | 100 |
| 5700 Tulane (T) | Atlanta, GA | 67,850 Sq. Ft. | 1.88 | 2.14 | 2.45 | 65 | 65 | 12 |
| Addison Hanger (T) | Addison, TX | 23,650 Sq. Ft. | 7.54 | 7.94 | 8.12 | 67 | 100 | 98 |
| Addison Hanger II (T) | Addison, TX | 29,000 Sq. Ft. | 9.24 | 9.64 | 9.33 | 92 | 92 | 97 |
| Encon (T) | Fort Worth, TX | 256,410 Sq. Ft. | 3.12 | 3.17 | 3.17 | 100 | 100 | 100 |
| Space Center (T) | San Antonio, TX | 101,500 Sq. Ft. | 3.41 | 3.43 | 3.46 | 61 | 84 | 84 |
| Shopping Centers | | | | | | | | |
| Bridgeview Plaza (T) | LaCrosse, WI | 116,008 Sq. Ft. | 6.97 | 7.25 | * | 89 | 90 | * |
| Cross County Mall | Mattoon, IL | 304,575 Sq. Ft. | 5.44 | 5.44 | 5.34 | 88 | 88 | 87 |
| Cullman (T) | Cullman, AL | 92,466 Sq. Ft. | 3.55 | 3.53 | 3.39 | 27 | 95 | 91 |
| Dunes Plaza (T) | Michigan City, IN | 223,869 Sq. Ft. | 5.91 | 5.51 | 5.83 | 64 | 61 | 69 |
| Promenade (T) | Highland Ranch, CO | 133,558 Sq. Ft. | 10.45 | 10.94 | 12.41 | 85 | 79 | 81 |
| Merchandise Mart | | | | | | | | |
| Denver Mart | Denver, CO | 509,508 Sq. Ft. | 11.75 | 11.75 | 11.48 | 92 | 92 | 92 |
| Single Family Residence | | | | | | | | |
| Tavel Circle | Dallas, TX | 2,271 Sq. Ft. | | | | | | |

| Property | Location | Rooms | Average Room Rate | | | Occupancy % | | | Total Room Revenues Divided By Total Available Rooms | | |
|--------------------------------|--------------------|-----------|-------------------|----------|----------|-------------|------|------|--|----------|----------|
| | | | 2004 | 2003 | 2002 | 2004 | 2003 | 2002 | 2004 | 2003 | 2002 |
| Hotels | | | | | | | | | | | |
| Akademia (T) | Wroclaw, Poland | 165 Rooms | \$ 55.33 | \$ 47.78 | \$ 48.92 | 65 | 51 | 33 | \$ 35.98 | \$ 46.86 | \$ 15.97 |
| Best Western | Virginia Beach, VA | 110 Rooms | 108.92 | 108.92 | 105.78 | 65 | 65 | 69 | 70.56 | 70.56 | 72.79 |
| Château Inn | Fresno, CA | 78 Rooms | 63.42 | 63.42 | 61.89 | 58 | 58 | 53 | 36.52 | 36.52 | 32.56 |
| City Suites (T) | Chicago, IL | 45 Rooms | 126.29 | 120.16 | 131.46 | 58 | 58 | 56 | 71.60 | 76.78 | 73.38 |
| Majestic Inn (T) | San Francisco, CA | 57 Rooms | 129.43 | 107.67 | 141.62 | 50 | 52 | 37 | 64.10 | 66.68 | 52.25 |
| Picadilly Airport | Fresno, CA | 185 Rooms | 79.25 | 79.25 | 75.18 | 63 | 63 | 61 | 50.04 | 50.04 | 45.83 |
| Picadilly Shaw | Fresno, CA | 194 Rooms | 81.19 | 81.19 | 78.24 | 69 | 69 | 69 | 55.70 | 55.70 | 53.87 |
| Picadilly University | Fresno, CA | 190 Rooms | 68.21 | 68.21 | 69.58 | 63 | 63 | 59 | 43.03 | 43.03 | 40.93 |
| Quality Inn | Denver, CO | 161 Rooms | 56.10 | 56.10 | 53.62 | 55 | 55 | 60 | 30.80 | 30.80 | 32.13 |
| The Majestic (T) | Chicago, IL | 55 Rooms | 129.64 | 124.47 | 133.79 | 52 | 48 | 52 | 65.91 | 57.86 | 64.31 |
| Williamsburg Hospitality House | Williamsburg, VA | 296 Rooms | 93.97 | 93.97 | 99.79 | 53 | 53 | 49 | 49.98 | 49.98 | 48.86 |
| Willows (T) | Chicago, IL | 52 Rooms | 119.84 | 121.24 | 129.76 | 57 | 53 | 49 | 67.62 | 69.54 | 63.35 |

* Property was purchased or constructed in 2003 or 2004.

** Property was under construction at December 31, 2004.

*** Property was sold in 2003 and repurchased in 2004.

**** No applicable data for Signature Athletic Club. ARI sold the Athletic Club in November 2004, but retained the Signature office building.

Occupancy presented above and throughout this ITEM 2. is without reference to whether leases in effect are at, below or above market rates.

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In 2004, ARI purchased the following properties:

| Property | Location | Units/Acres | Purchase Price | Net Cash Paid/(Received) | Debt Incurred | Interest Rate | Maturity Date |
|--|--------------------|--------------------|-----------------------|---------------------------------|----------------------|----------------------|----------------------|
| Apartments | | | | | | | |
| 288 City Park ⁽¹⁾ | Houston, TX | 240 Units | \$ 3,056 | \$ 612 | \$ 2,444 | 5.95% | 04/45 |
| Blue Lake Villas II ⁽¹⁾ | Waxahachie, TX | 70 Units | 729 | (164) | 729 | 5.80 | 04/45 |
| Bridges on Kinsey ⁽¹⁾ | Tyler, TX | 232 Units | 2,291 | 596 | 1,687 | 5.74 | 08/45 |
| Dakota Arms ⁽¹⁾ | Lubbock, TX | 208 Units | 2,472 | 681 | 1,791 | 5.85 | 06/45 |
| Laguna Vista ⁽¹⁾ | Farmers Branch, TX | 206 Units | 2,424 | 902 | 1,522 | 5.50 | 09/46 |
| Lake Forest ⁽¹⁾ | Houston, TX | 240 Units | 2,316 | (470) | 2,316 | 5.60 | 03/45 |
| Parc at Maumelle ⁽¹⁾ | Maumelle, AR | 240 Units | 3,120 | 916 | 2,204 | 5.37 | 07/46 |
| Treehouse ⁽³⁾ | Irving, TX | 160 Units | 7,519 | (498) | 5,027 ⁽⁴⁾ | 5.00 | 08/13 |
| Vistas of Vance Jackson ⁽¹⁾ | San Antonio, TX | 240 Units | 3,550 | 771 | 2,779 | 5.78 | 06/45 |
| Wildflower Villas ⁽¹⁾ | Temple, TX | 220 Units | 2,045 | 79 | 1,996 | 5.99 | 10/45 |
| Land | | | | | | | |
| Cooks Lane | Ft. Worth, TX | 21.9 Acres | 1,000 | 1,034 | | | |
| Denton-Coonrod | Denton, TX | 13.9 Acres | 1,644 | 1,046 | 840 | 6.25 | 11/06 |
| DeSoto | DeSoto, TX | 202.0 Acres | 2,516 | 1,364 | 1,265 | 6.25 | 11/06 |
| Granbury Station | Ft. Worth, TX | 15.7 Acres | 923 | 236 | 738 | 7.00 | 09/07 |
| Ladue | Farmers Branch, TX | 8.0 Acres | 1,743 | 659 | 1,206 | 6.65 ⁽²⁾ | 06/06 |
| Las Colinas | Irving, TX | 45.5 Acres | 4,802 | 1,674 | 3,121 | 7.00 | 12/06 |
| Las Colinas ⁽⁵⁾ | Irving, TX | 268.0 Acres | 4,687 | 159 | | | |
| Lubbock | Lubbock, TX | 2.9 Acres | 224 | 224 | | | |
| Meloy Road | Kent, OH | 54.2 Acres | 4,900 | 343 | 4,900 | 5.00 ⁽²⁾ | 01/06 |
| Railroad | Dallas, TX | 0.3 Acres | 708 | 704 | | | |
| Rogers | Rogers, AR | 20.1 Acres | 1,390 | 619 | 1,130 | 10.50 | 04/05 |
| West End | Dallas, TX | 0.2 Acres | 71 | 71 | | | |

(1) Initial construction loan funding to purchase land and begin apartment construction. Does not represent actual units purchased.

(2) Variable interest rate.

(3) Purchased from IORI, a related party, for assumption of debt and a note receivable, less \$498 in cash received.

(4) Assumed debt of seller.

(5) Obtained in exchange for 13.0 acres of Las Colinas land.

In 2004, ARI sold the following properties:

| Property | Location | Units/Sq.Ft./Acres | Sales Price | Net Cash Received/(Paid) | Debt Discharged | Gain/(Loss) on Sale |
|------------------------------------|------------------|---------------------------|--------------------|---------------------------------|--------------------------|----------------------------|
| Apartments | | | | | | |
| Cliffs of El Dorado ⁽⁵⁾ | McKinney, TX | 208 Units | \$ 13,442 | \$ 10 | \$ 10,323 ⁽¹⁾ | \$ |
| Falcon House | Ft. Walton, FL | 82 Units | 3,330 | 1,178 | 1,950 ⁽¹⁾ | 1,209 |
| In the Pines | Gainesville, FL | 242 Units | 11,300 | 3,247 | 5,201 | 5,517 |
| La Mirada | Jacksonville, FL | 320 Units | 10,500 | 2,576 | 7,098 | 7,576 |
| Park Avenue | Tallahassee, FL | 121 Units | 6,225 | 926 | 4,320 ⁽¹⁾ | 3,922 |
| Sandstone | Mesa, AZ | 238 Units | 8,650 | 2,920 | 5,531 | 1,688 |
| Tiberon Trails | Merrillville, IN | 376 Units | 10,325 | 2,869 | 6,189 ⁽¹⁾ | 49 |
| Industrial Warehouses | | | | | | |

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| | | | | | | |
|-------------------|-------------------|-----------------|--------|-------|-------|-------------------------|
| Kelly (Cash Road) | Dallas, TX | 97,150 Sq. Ft. | 1,500 | 1,077 | 422 | 454 |
| Kelly (Pinewood) | Dallas, TX | 100,000 Sq. Ft. | 1,650 | 65 | 65 | 153 |
| Ogden Industrial | Ogden, UT | 107,112 Sq. Ft. | 2,600 | 668 | 668 | 1,474 |
| Texstar Warehouse | Arlington, TX | 97,846 Sq. Ft. | 2,400 | | | (3) |
| Land | | | | | | |
| Allen | Collin County, TX | 492.5 Acres | 19,962 | 7,956 | 4,088 | \$ 7,915 ⁽²⁾ |
| Marine Creek | Ft. Worth, TX | 10.7 Acres | 1,488 | 1,198 | 991 | (7) |
| Mason Goodrich | Houston, TX | 5.7 Acres | 686 | 45 | 588 | 379 |

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| Property | Location | Units/Sq.Ft./ Acres | Sales Price | Net Cash Received/ (Paid) | Debt Discharged | Gain/ (Loss) on Sale |
|--|--------------------|--------------------------------|------------------------|--|----------------------------|-------------------------------------|
| Mason Goodrich | Houston, TX | 8.0 Acres | \$ 1,045 | \$ 251 | \$ 200 | \$ 617 |
| Mason Goodrich | Houston, TX | 4.0 Acres | 523 | 33 | 436 | 306 |
| Mason Goodrich | Houston, TX | 2.4 Acres | 250 | 15 | 200 | 115 |
| Mason Goodrich | Houston, TX | 5.0 Acres | 515 | 466 | | 254 |
| Mason Goodrich | Houston, TX | 12.0 Acres | 1,492 | 1,338 | | 854 |
| Meloy Road | Kent, OH | 1.3 Acres | 135 | | 135 | 11 |
| Rasor | Plano, TX | 24.5 Acres | 2,600 | 2,600 | 1,260 | 220 |
| Red Cross | Dallas, TX | 2.9 Acres | 8,500 | 2,842 | 4,450 | |
| Vineyards | Tarrant County, TX | 1.6 Acres | 1,307 | (275) | 548 | 677 |
| Vineyards II | Tarrant County, TX | 1.5 Acres | 1,239 | (261) | 200 | 551 |
| Vista Ridge | Lewisville, TX | 1.3 Acres | 310 | 259 | | 131 |
| Office Buildings | | | | | | |
| 4135 Beltline | Addison, TX | 90,000 Sq. Ft. | 4,900 | 2,472 | 2,009 | 337 |
| Ambulatory Surgery Center | Sterling, VA | 33,832 Sq. Ft. | 8,675 | 5,448 | 2,899 | 784 |
| Atrium | Palm Beach, FL | 74,603 Sq. Ft. | 5,775 | 1,842 | 3,772 | 708 |
| Brandeis ⁽⁶⁾ | Omaha, NE | 319,234 Sq. Ft. | | | | (92) |
| Centura Tower ⁽⁴⁾ | Farmers Branch, TX | 410,901 Sq. Ft. | 84,075 | 36,350 | 49,878 | 38,154 |
| Corporate Pointe | Chantilly, VA | 65,918 Sq. Ft. | 9,000 | 5,025 | 3,585 | 5,533 |
| Countryside Harmon | Sterling, VA | 72,062 Sq. Ft. | 9,150 | 4,608 | 3,865 | 1,931 |
| Countryside Mimado | Sterling, VA | 35,127 Sq. Ft. | 4,000 | 102 | 941 | 72 |
| Countryside Retail | Sterling, VA | 133,422 Sq. Ft. | 27,100 | 3,408 | 3,408 | 6,807 |
| One Steeplechase | Sterling, VA | 103,376 Sq. Ft. | 11,900 | 3,743 | 7,654 | 6,786 |
| Venture Center | Atlanta, GA | 38,272 Sq. Ft. | 4,000 | 997 | 2,550 | 1,381 |
| Shopping Centers | | | | | | |
| Collection | Denver, CO | 267,812 Sq. Ft. | 21,200 | 6,703 | 13,153 | 3,314 |
| K-Mart | Cary, NC | 92,033 Sq. Ft. | 3,200 | | 1,677 ⁽¹⁾ | ⁽³⁾ |
| Plaza on Bachman Creek | Dallas, TX | 80,278 Sq. Ft. | 7,850 | 1,808 | 5,358 | 4,073 |
| Sadler Square | Amelia Island, FL | 70,295 Sq. Ft. | 4,500 | 1,876 | 2,680 | 1,897 |
| Other | | | | | | |
| Signature Athletic Club ⁽²⁾ | Dallas, TX | N/A | 120 | (154) | 88 | (47) |

(1) Debt assumed by purchaser.

(2) Signature Athletic Club was sold for the assumption of capital leases by purchaser. Net cash paid is from prepaid dues and unearned revenues due purchaser.

(3) Sold to BCM, a related party, for assumption of debt and a secured note receivable. See NOTE 3. NOTES AND INTEREST RECEIVABLE. Gain of \$1,157 (Texstar) and \$521 (K-Mart) deferred until sale to unrelated party.

(4) ARI sold a 95% limited partnership interest, retaining a 1% general partner and 4% limited partner interest.

(5) Sold to Unified Housing Foundation, Inc. (UHF), a related party, in 2003. See NOTE 9. RELATED PARTY TRANSACTIONS. Gain of \$2,542 deferred until sale to unrelated party.

(6) Returned to lender. See NOTE 7. NOTES AND INTEREST PAYABLE.

(7) Sold to UHF. Gain of \$581 deferred until sale to unrelated party.

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In 2004, ARI financed/refinanced or obtained second mortgage financing on the following:

| Property | Location | Units/Sq. Ft. Rooms/Acres | Debt Incurred | Debt Discharged | Net Cash Received/ (Paid) | Interest Rate | Maturity Date |
|--------------------------------|--------------------|--------------------------------------|--------------------------|----------------------------|--|--------------------------|--------------------------|
| Apartments | | | | | | | |
| Mountain Plaza | El Paso, TX | 188 Units | \$ 5,184 | \$ 4,257 | \$ 370 | 5.16% | 12/34 |
| Treehouse | Irving, TX | 160 Units | 5,780 | 5,027 | 138 | 5.06 | 07/34 |
| Villager | Fort Walton, FL | 33 Units | 804 | 507 | 129 | 5.15 | 06/34 |
| Waters Edge III | Gulfport, MS | 238 Units | 3,250 | | (5) | 12.50 | 12/04(9) |
| Hotels | | | | | | | |
| City Suites | Chicago, IL | 45 Rooms | 3,640 | | 3,548 | 6.75(1) | 09/09 |
| Majestic Inn | San Francisco, CA | 57 Rooms | 2,000(8) | 5,138 | (1,238) | 5.75(1) | 10/05 |
| Williamsburg Hospitality House | Williamsburg, VA | 296 Rooms | 11,500 | 12,332 | (13,689)(3) | 7.00(1) | 03/05(10) |
| Willows | Chicago, IL | 52 Rooms | 3,500 | | 3,411 | 6.75(1) | 09/09 |
| Land | | | | | | | |
| Bonneau | Dallas County, TX | 8.4 Acres | 9,661(6) | 10,283(7) | 76 | 6.75(1) | 09/05 |
| Centura | Farmers Branch, TX | 8.8 Acres | 4,485 | 4,000 | (183) | 7.00(1) | 02/05(11) |
| Chase Oaks | Plano, TX | 5.8 Acres | (6) | | | | |
| Cooks Lane | Ft. Worth, TX | 23.2 Acres | 550 | | | 6.75 | 11/06 |
| Dalho | Farmers Branch, TX | 2.9 Acres | (6) | | | | |
| Dominion/Hollywood | Farmers Branch, TX | 66.1 Acres | 6,985 | 6,222 | (67) | 7.00(1) | 02/05(12) |
| HSM | Farmers Branch, TX | 6.2 Acres | (6) | | | | |
| JHL Connell | Carrollton, TX | 7.6 Acres | (6) | | | | |
| Katy | Harris County, TX | 130.6 Acres | 7,500 | | (75)(4) | 6.00(1) | 02/07 |
| Lacy Longhorn | Farmers Branch, TX | 17.1 Acres | 1,965 | 1,800 | 78 | 4.03(1) | 07/07 |
| Las Colinas | Las Colinas, TX | 1.5 Acres | (6) | | | | |
| Marine Creek | Ft. Worth, TX | 28.4 Acres | 1,785 | | 1,746 | 4.03(1) | 07/07 |
| Mason/Goodrich | Houston, TX | 39.4 Acres | 2,133 | 714 | 1,345 | 6.00(1) | 08/05 |
| Stagliano | Farmers Branch, TX | 3.2 Acres | (6) | | | | |
| Vista Ridge | Lewisville, TX | 64.9 Acres | (6) | | | | |
| Walker | Dallas County, TX | 132.6 Acres | 8,750 | 7,950 | 264 | 5.90(1) | 06/06 |
| Office Buildings | | | | | | | |
| 225 Baronne | New Orleans, LA | 416,834 Sq. Ft. | 500(8) | | | 5.75(1) | 10/05 |
| 1010 Common | New Orleans, LA | 494,579 Sq. Ft. | 16,250 | 8,000 | 7,829 | 4.03(1) | 07/07 |
| Amoco | New Orleans, LA | 378,244 Sq. Ft. | 1,500(8) | | | 5.75(1) | 10/05 |
| Centura Tower | Farmers Branch, TX | 410,901 Sq. Ft. | 34,000(2) | 36,889 | (4,588) | 5.50(1) | 04/06 |
| Centura Tower | Farmers Branch, TX | 410,901 Sq. Ft. | 3,800(2) | | 3,737 | 5.75(1) | 04/06 |
| Centura Tower | Farmers Branch, TX | 410,901 Sq. Ft. | 50,000 | 37,594 | 2,989 | 4.94 | 10/09 |
| Cooley | Farmers Branch, TX | 27,000 Sq. Ft. | 2,600 | 1,726 | 811 | 5.50(1) | 09/06 |
| Two Hickory Centre | Farmers Branch, TX | 96,127 Sq. Ft. | 7,500 | 7,500 | (164) | 3.60(1) | 05/06 |
| Warehouses | | | | | | | |
| Addison Hangers I & II | Addison, TX | 52,650 Sq. Ft. | 4,500 | 2,592 | 1,635 | 10.00 | 09/14 |

(1) Variable interest rate.

(2) Repaid with proceeds of subsequent \$50,000 loan.

(3) Cash of \$10,961 was received by an affiliate, increasing ARI's affiliate receivable.

(4) Cash of \$7,400 was received by an affiliate, increasing ARI's affiliate receivable.

(5) Cash of \$3,250 was received by an affiliate, increasing ARI's affiliate receivable.

(6) Single note, with all properties as collateral.

(7) Debt forgiveness of \$2,268 recognized.

(8) The Majestic Inn, 225 Baronne Office Building and Amoco Office Building are cross collateralized. The debt incurred on 225 Baronne and Amoco are 2nd lien loans.

(9) Repaid in December 2004.

(10) Maturity date extended to September 2005.

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- (11) Repaid in February 2005.
- (12) Maturity date extended to February 2006.
- (13) The Addison Hangers were sold in September 2004 to a third party but were then leased back for 10 years on a triple net lease basis. This transaction has been recorded as a financing transaction for accounting purposes.

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Land Properties. Set forth below are ARI's land properties, consisting of both improved and unimproved land:

| Property | Location | Acres |
|---------------------|--------------------|--------------|
| 1013 Common | New Orleans, LA | 0.4 |
| 2301 Valley Branch | Farmers Branch, TX | 23.8 |
| 2524 Valley View | Farmers Branch, TX | 0.5 |
| Alamo Springs | Dallas, TX | 0.7 |
| Backlick | Springfield, VA | 4.0 |
| Bee Street | Farmers Branch, TX | 0.5 |
| Bonneau | Dallas County, TX | 8.4 |
| Centura | Farmers Branch, TX | 8.8 |
| Chase Oaks | Plano, TX | 11.8 |
| Cooks Lane | Ft. Worth, TX | 23.2 |
| Croslin | Dallas County, TX | 0.8 |
| Dalho | Farmers Branch, TX | 3.4 |
| Denton-Coonrod | Denton, TX | 82.2 |
| DeSoto | DeSoto, TX | 21.9 |
| Dominion | Dallas, TX | 14.4 |
| Elm Fork | Denton County, TX | 105.4 |
| Fiesta | San Angelo, TX | 0.7 |
| Folsom | Dallas, TX | 36.8 |
| Fort Wayne | Fort Wayne, IN | 23.2 |
| Fruitland | Fruitland Park, FL | 4.7 |
| FRWM Cummings | Farmers Branch, TX | 6.5 |
| Granbury Station | Ft. Worth, TX | 15.7 |
| Hollywood Casino | Farmers Branch, TX | 42.8 |
| HSM | Farmers Branch, TX | 6.2 |
| JHL Connell | Carrollton, TX | 7.6 |
| Katrina | Palm Desert, CA | 110.5 |
| Katy Road | Harris County, TX | 130.6 |
| Kelly | Dallas County, TX | 0.8 |
| Lacy Longhorn | Farmers Branch, TX | 17.1 |
| LaDue | Farmers Branch, TX | 8.0 |
| Lakeshore Villas | Humble, TX | 16.9 |
| Lamar/Parmer | Austin, TX | 17.1 |
| Las Colinas | Las Colinas, TX | 1.6 |
| Las Colinas | Las Colinas, TX | 4.7 |
| LCLLP | Las Colinas, TX | 45.5 |
| Lemmon Carlisle | Dallas, TX | 2.1 |
| Leone | Irving, TX | 8.2 |
| Limestone Canyon II | Austin, TX | 10.0 |
| Lubbock | Lubbock, TX | 2.9 |
| Manhattan | Farmers Branch, TX | 108.9 |
| Marine Creek | Ft. Worth, TX | 43.3 |
| Mason Park | Houston, TX | 18.0 |
| Mason/Goodrich | Houston, TX | 20.2 |
| Maumelle | Maumelle, AR | 10.8 |
| McKinney 36 | Collin County, TX | 34.6 |
| McKinney Corners II | Collin County, TX | 18.5 |
| Meloy | Kent, OH | 52.9 |
| Mendoza | Dallas County, TX | 0.4 |

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| <u>Property</u> | <u>Location</u> | <u>Acres</u> |
|-------------------|---------------------|--------------|
| Mira Lago | Farmers Branch, TX | 8.9 |
| Nashville | Nashville, TN | 127.4 |
| Pac Trust | Farmers Branch, TX | 7.1 |
| Payne | Las Colinas, TX | 268.0 |
| Pioneer Crossing | Austin, TX | 439.1 |
| Pulaski | Pulaski County, AR | 21.9 |
| Railroad | Dallas, TX | 3 |
| Rochelle I | Las Colinas, TX | 10.1 |
| Rochelle II | Las Colinas, TX | 21.3 |
| Rogers | Rogers, AR | 20.1 |
| Round Mountain | Austin, TX | 18.0 |
| Seminary West | Ft. Worth, TX | 5.4 |
| Sheffield Village | Grand Prairie, TX | 13.9 |
| Siskiyou | Siskiyou County, CA | 20.7 |
| Sladek | Travis County, TX | 63.3 |
| Stagliano | Farmers Branch, TX | 3.2 |
| Thompson | Farmers Branch, TX | 4.0 |
| Thompson II | Dallas County, TX | 3.3 |
| Tomlin | Farmers Branch, TX | 9.2 |
| Travelers | Farmers Branch, TX | 202.0 |
| Valley Ranch | Irving, TX | 6.8 |
| Valley Ranch III | Irving, TX | 12.5 |
| Valley Ranch IV | Irving, TX | 12.4 |
| Valley View 34 | Farmers Branch, TX | 33.9 |
| Valwood | Dallas County, TX | 246.1 |
| Vineyards | Tarrant County, TX | 14.2 |
| Vineyards II | Tarrant County, TX | 17.1 |
| Vista Ridge | Lewisville, TX | 79.0 |
| Walker | Dallas County, TX | 132.6 |
| West End | Dallas, TX | 6.8 |

Partnership Properties. ARI accounts for partnership properties using the equity method. ARI had no property information for properties owned by partnerships.

ARI is a 30% general partner in Sacramento Nine (SAC 9), which owned the Prospect Park #29 Office Building. In December 2004, SAC 9 sold the Prospect Park #29 office building for \$3.7 million, of which ARI received \$1.1 million after closing costs and fees. ARI recognized a gain on the sale of investment in SAC 9 of \$882,000 relating to this transaction.

In December 2004, ARI sold a 95% interest in Garden Centura, L.P. that owns the 410,901 sq. ft. Centura Tower office building located in Farmers Branch, Texas. ARI retained a non-controlling 1% general partner and 4% limited partner interest in Garden Centura, L.P. ARI will account for its investment in this partnership on the cost basis.

Mortgage Loans

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In addition to real estate, a portion of ARI's assets are invested in mortgage notes receivable, secured by income-producing real estate, unimproved land and partnership interests. Management expects that the percentage of ARI's assets invested in mortgage loans will decline, as ARI will no longer seek to fund or acquire new mortgage loans. However, ARI may, in selected instances, originate mortgage loans or it may provide purchase money financing in conjunction with a property sale. Management intends to service and hold for investment the mortgage notes currently in the portfolio. Mortgage notes receivable consist primarily of first mortgage loans.

Types of Properties Subject to Mortgages. The types of properties securing mortgage notes receivable at December 31, 2004, consisted of one apartment, four commercial buildings, unimproved land and partnership

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interests. The type of properties subject to mortgages in which ARI invests may be altered without a vote of stockholders.

As of December 31, 2004, the obligors on \$43.3 million or 59.0% of the mortgage notes receivable portfolio were affiliates of ARI. Also at that date, \$6.6 million or 8.9% of the mortgage notes receivable portfolio was non-performing.

The following table sets forth the percentages (based on the outstanding mortgage loan balance at December 31, 2004), by property type and geographic region, of the income producing properties that serve as collateral for ARI's mortgage notes receivable. Excluded are \$55.5 million of mortgage notes that are secured by unimproved land and other security, or are unsecured. See SCHEDULE IV to the Consolidated Financial Statements included in ITEM 8. CONSOLIDATED FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA for additional details of ARI's mortgage notes receivable portfolio.

| <u>Region</u> | <u>Commercial Properties</u> |
|---------------|----------------------------------|
| Midwest | 5% |
| Southwest | 95 |
| | <u>100%</u> |

A summary of the activity in the mortgage notes receivable portfolio during 2004 is as follows:

| | |
|--|----------|
| Mortgage notes receivable at January 1, 2004 | 25 |
| Loans funded | 38 |
| Loans collected in full | (5) |
| Loans sold | (1) |
| | <u>—</u> |
| Mortgage notes receivable at December 31, 2004 | 57 |

During 2004, \$5.9 million in interest and \$11.6 million in principal were collected on mortgage notes receivable.

First Mortgage Loans. These loans generally provide for level periodic payments of principal and interest sufficient to substantially repay the loan at or prior to maturity, but may involve interest-only payments, moderate or negative amortization of principal, or all interest and a balloon principal payment at maturity. With respect to first mortgage loans, it is ARI's general policy to require that the borrower provide a title policy or an acceptable legal opinion of title as to the validity and the priority of ARI's mortgage lien over all other obligations, except liens arising from unpaid property taxes and other exceptions normally allowed by first mortgage lenders. ARI may grant participations in first mortgage loans that it originates to other lenders.

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The following discussion briefly describes first mortgage loans funded in 2004, as well as events during 2004 that affected previously funded first mortgage loans.

In March 2004, ARI sold an 8.0 acre tract of its Mason Goodrich land parcel for \$1.0 million, receiving \$251,000 after payment of closing costs and providing purchase money financing of \$523,000. The secured loan bears interest at 10.0% per annum, requires monthly payments of accrued interest and matures in March 2006. All principal and accrued but unpaid interest is due at maturity.

In March 2004, ARI sold 492.5 acres in Collin County, Texas for \$20.0 million, receiving \$8.0 million after payment of debt and closing costs, and providing purchase money financing of \$7.2 million for a portion of the land on a contingent basis. The secured note bore interest at 7.0% per annum and matured in September 2004.

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The purchaser extended the note to December 2004 with a \$1.1 million extension payment in September 2004. In December 2004, the note was collected in full, including accrued but unpaid interest.

In October 2004, ARI sold the In The Pines apartments to a third party and provided \$1.0 million of the purchase price as seller financing in the form of two notes. The first note bears interest at 7.0% per annum, requires monthly interest payments and matured in January 2005. The Purchaser extended this note to March 2005 by paying 1.0% of the outstanding principal balance as an extension fee and then extended the note an additional 30 days to April 2005 by paying an extension fee of 0.5% of the outstanding principal balance. In the event of a default, the note is also secured by membership rights in the purchaser's entity. The second note is unsecured; bears interest at 8.5% per annum, requires monthly interest payments and matured in January 2005. The Purchaser extended this note to March 2005 by paying 1.0% of the outstanding principal balance as an extension fee and then extended the note an additional 30 days to April 2005 by paying an extension fee of 0.5% of the outstanding principal balance.

In November 2004, ARI sold a 1.6 acre tract of its Vineyards II land parcel for \$2.5 million, paying \$536,000 after mortgage paydowns, closing costs, and providing purchase money financing of \$2.0 million. In November 2004, the note was sold to an unrelated party for \$2.0 million plus accrued and unpaid interest.

In March 2002, ARI sold the 174,513 sq. ft. Hartford Office Building in Dallas, Texas, for \$4.0 million and provided the \$4.0 million purchase price as seller financing and an additional \$1.4 million line of credit for leasehold improvements in the form of a first lien mortgage note. The note bears interest at a variable interest rate, currently 7.0% per annum, requires monthly payments of accrued interest and matures in March 2007. As of March 2005, ARI has funded \$788,000 of the additional line of credit.

In October 2002, ARI sold its Varner Road land parcel for \$3.7 million, receiving \$0.7 million after payment of closing costs and providing purchase money financing of \$2.8 million. The loan bore interest at 9.0% per annum, matured in October 2004 and required quarterly interest payments. All principal and accrued but unpaid interest were due at maturity. In October 2004, the note was collected in full, including accrued but unpaid interest.

In February 2003, ARI sold an 89.3 acre tract of its Katrina land parcel for \$8.5 million, paying \$410,000 after payment of closing costs and debt pay down and providing purchase money financing of \$5.6 million. The note bears interest at 8.0% per annum and matures three years after the recording of the Deed of Trust. Interest will begin accruing after improvements to the site have been completed by ARI. At April 2004, the improvements were begun. The future costs to ARI to complete the improvements, estimated to be \$2.5 million, were accrued in 2002. A principal payment of \$450,000 is due within ten days after a Tentative Parcel Map (the Map) is recorded. At March 2005, negotiations with the buyer to settle any further obligations are under way. Interest payments will be due on the first day of each calendar quarter, beginning with the first quarter following the completion of the site improvements.

Junior participations. In August 2001, ARI agreed to fund up to \$5.6 million secured by a second lien on an office building in Dallas, Texas. The note receivable bore interest at a variable rate, required monthly payments of accrued interest and matured in January 2003. As of March 2005, ARI has funded a total of \$4.3 million and the note is classified as non-performing. The collateral used to secure ARI's second lien was seized by the first lien holder. In March 2004, ARI agreed to accept an assignment of claims in litigation as security for the note. In December 2004, ARI agreed to a Modification Agreement with the borrower, which was effective November 1, 2003. As of the modified effective date, accrued interest of \$582,000 was applied to the principal balance of the note, the interest rate was set to a fixed rate of 9.0% per annum and all principal and interest is due November 2005. ARI also received Pledge and Security Agreements in various partnership interests belonging to the borrower and received various Assignments of Proceeds from sales in certain entities owned by the borrower. ARI also agreed to reduce

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accrued interest and principal by \$1.5 million from the receipt of notes receivable assigned to ARI by borrower and by \$605,000 from cash received. ARI also received \$1.4 million in January

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2005 that was applied to accrued interest and principal effective December 30, 2004. As a result of this modification, ARI has released \$1.4 million of allowance for loan losses to expense. The following notes were assigned to ARI as payment on the note:

\$678,000 from a partnership that owns an apartment building. This note is unsecured, bears no interest and has no maturity date. Distributions made from the partnership operations will be used to pay the principal on the note.

\$264,000 secured by a second lien on 13 acres of unimproved land. This note bears interest at 9.0% and matured in February 2003.

\$341,000 secured by a second lien on 23.3 acres of unimproved land. This note bears interest at 4.0% and is payable upon demand.

\$125,000 secured by a 100% interest in an affiliated company that owns an apartment building. This note bears interest at 12.0%, only requires payments if surplus cash is available and matures in April 2009.

In June 2003, ARI sold the 104 unit Willow Wick Apartments in North Augusta, South Carolina, for \$2.7 million and provided \$42,000 of the purchaser's closing costs as seller financing. The note bore interest at 5.0% per annum and required all interest and principal payments be paid at maturity in December 2003. This loan was extended until February 2004 and \$10,000 was received in March 2004. The note, including accrued and unpaid interest, was paid in June 2004. ARI discounted the note \$2,000 and recognized a loss of \$2,000.

In September 2003, ARI sold a 367.4 acre tract of its Pioneer Crossing land parcel for \$22.5 million, receiving \$4.9 million after payment of closing costs and providing purchase money financing of \$16.9 million. The note bears interest at 8.0% per annum, matures in September 2006 and requires quarterly payments of accrued interest beginning in January 2004. All principal and accrued but unpaid interest are due at maturity. In November 2003, ARI sold an interest in \$8.0 million of the note for \$7.5 million, receiving \$7.2 million in cash after payment of closing costs and debt paydown. In February 2004, ARI sold an additional interest in \$6.6 million of the note for \$6.3 million, receiving \$6.3 million in cash after payment of closing costs.

In December 2003, ARI sold a tract of Marine Creek land to a subsidiary of United Housing Foundation, Inc. (UHF) for \$1.5 million, receiving cash and a note receivable. This sale was not recognized as a sale at that time because UHF is a related party and ARI has continuing involvement and control. In February 2004, Marine Creek was refinanced by UHF, which paid in full ARI's note payable on the land. ARI recorded the sale of the land and received a note receivable of \$270,000, which was the difference between the sales price and the amount of ARI's note payable. The note bears interest at 6.0%, requires quarterly payments from available surplus cash and matures in December 2007. See Note 9. RELATED PARTY TRANSACTIONS.

Other. In July 2002, ARI entered into an agreement to fund up to \$300,000 under a revolving line of credit secured by 100% interest in a partnership of the borrower. The line of credit bears interest at 12.0% per annum, requires monthly payments of accrued interest, and matures in June 2005. ARI has funded the entire \$300,000.

In September 1999, in conjunction with the sale of two apartments in Austin, Texas, \$2.1 million in purchase money financing was provided, secured by limited partnership interests in two limited partnerships owned by the buyer. The financing bore interest at 16.0% per annum, required monthly payments of interest only at 6.0%, beginning in February 2000 and required a \$200,000 principal paydown in December 1999, which was not received, and matured in August 2000. ARI had the option of obtaining the buyer's general and limited partnership interests in the

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collateral partnerships in full satisfaction of the financing. In March 2000, ARI agreed to forbear foreclosing on the collateral securing the note and released one of the partnership interests, in exchange for a payment of \$250,000 and executed deeds of trusts on certain properties owned by the buyer. In March 2000, the borrower made a \$1.1 million payment, upon receipt of which ARI returned the deeds of trust. The borrower executed a replacement promissory note for the remaining note balance of \$1.0 million, which was unsecured, non-interest bearing and matured in April 2003. In April 2004, a demand letter was sent to the debtor. ARI initiated legal action in June 2004.

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Related Parties. In March 2004, ARI sold a K-Mart in Cary, North Carolina to BCM for \$3.2 million, including the assumption of debt. ARI also provided \$1.5 million of the purchase price as seller financing. The secured note bears interest at 2.0% over the prime rate, currently 7.75%, and matures in April 2005.

In March 2004, ARI sold the Texstar Warehouse in Arlington, Texas to BCM for \$2.4 million, including the assumption of debt. ARI also provided \$1.3 million of the purchase price as seller financing. The secured note bears interest at 2.0% over the prime rate, currently 7.75%, and matures in April 2005.

In October 2004, ARI contemplated the sale of the common stock of TCI Lexington Corporation, which owns the Lexington Center office building in Colorado Springs, Colorado, to One Realco Office Investors, Inc., a related party, for the assumption of debt of \$5.1 million, which was subject to lender approval, and a seller note of \$237,000. The assumption of debt by One Realco Office Investors, Inc. was not approved by the lender; therefore, the Board of Directors rescinded their approval of the transaction. ARI extended the loan on the Lexington Center with the lender in December 2004.

In October 2004, ARI advanced \$3.3 million to the Class A Limited Partners of Edina Park Plaza Associates, Limited Partnership, of which ARI is the general partner. The loans bear interest at 10.0% per annum and mature in September 2017. Interest due to ARI will be deducted from the quarterly return owed by ARI to the Class A Limited Partners, eliminating the quarterly payments. The outstanding principal is due at maturity.

In October 1999, ARI funded a \$4.7 million loan to Realty Advisors. The loan, to provide funds for acquisitions or working capital needs, was secured by all of the outstanding shares of common stock of American Reserve Life Insurance Company. The loan bore interest at 10.25% per annum and matured in November 2001. In January 2000, \$100,000 was collected. In November 2001, the maturity date was extended to November 2004. The collateral was changed to a pledge of 850,000 shares of ARI Common Stock owned by BCM. The interest rate was changed to 2.0% over the prime rate, currently 7.75% per annum, and the accrued but unpaid interest of \$1.0 million was added to the principal. The new principal balance is \$5.6 million. In September 2003, \$673,000 in accrued interest was collected. In August 2004, \$342,000 in accrued interest was collected. In November 2004, the maturity date was extended to November 2006. All principal and accrued interest are due at maturity.

In March 2001, ARI funded \$13.6 million of a \$15.0 million unsecured line of credit to One Realco. A wholly-owned subsidiary of One Realco owns approximately 2.2% of the outstanding shares of ARI's Common Stock. One Realco periodically borrows money to meet its cash obligations. The line of credit bore interest at 12.0% per annum. All principal and interest were due at maturity in February 2002. The line of credit is guaranteed by BCM. In June 2001, \$810,000 in principal and interest was collected. In December 2001, \$825,000 in principal and interest was collected. In February 2002, the line of credit was increased to \$18.0 million, accrued but unpaid interest of \$217,000 was added to the principal, and the maturity date was extended to February 2004. In March 2002, ARI funded an additional \$1.8 million, increasing the outstanding principal balance to \$15.5 million. In October 2002, \$856,900 in interest was collected, by the return of 85,690 shares of ARI Series A Preferred Stock. In June 2003, ARI sold a participating interest in \$5.8 million of the \$15.5 million balance to BCM, receiving 314,141 TCI shares from BCM (see NOTE 1. BASIS OF PRESENTATION.) In February 2004, \$2.3 million in interest was collected, accrued but unpaid interest of \$161,000 was added to the principal, the maturity date was extended to February 2007, and the interest rate was changed to 3.0% over the prime rate, currently at 8.75%. All principal and interest are due at maturity. Ronald E. Kimbrough, Acting Principal Executive Officer, Executive Vice President and Chief Financial Officer of ARI until May 31, 2004, was a 10.0% shareholder of One Realco until July 31, 2004. Mr. Kimbrough did not participate in the day-to-day operations or management of One Realco.

Investments in Real Estate Companies

Real estate entities. ARI's investment in real estate entities includes the equity securities of a publicly traded real estate company, IORI, and interests in real estate joint venture partnerships.

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The Board of Directors authorized the expenditure of up to an aggregate of \$50.0 million to acquire, in open market purchases, shares of IORI, excluding private purchase transactions which were separately authorized. Through December 31, 2004, ARI had expended an aggregate of \$10.0 million to acquire shares of IORI, in open market purchases, in accordance with these authorizations. As of December 31, 2004, ARI and its subsidiaries, other than TCI, owned no shares of common stock of IORI but TCI continued to own 345,728 IORI shares (approximately 24.0% of the outstanding IORI shares). ARI may make additional investments in the equity securities of IORI to the extent its liquidity permits.

The following summary description of IORI is based on information publicly reported by IORI in its Form 10-K Annual Report to the Commission for the fiscal year ended December 31, 2004.

Pertinent information regarding ARI's investment in the equity securities of the IORI at December 31, 2004, is summarized below (dollars in thousands):

| <u>Investee</u> | <u>Percentage of ARI's Ownership at December 31, 2004</u> | <u>Carrying Value of Investment at December 31, 2004</u> | <u>Equivalent Investee Book Value at December 31, 2004</u> | <u>Market Value of Investment at December 31, 2004</u> |
|-----------------|---|--|--|--|
| IORI | 19.73% | \$ 5,765 | \$ 10,545 | \$ 5,532 |

IORI owns real estate, some of which has been held for many years. Because of depreciation, IORI may earn substantial amounts in periods in which it sells real estate and will probably incur losses in periods in which it does not. ARI's reported income or loss attributable to IORI will differ materially from its cash flow attributable to it.

IORI is a Nevada corporation, which was originally organized on December 14, 1984, as a California business trust and commenced operations on April 10, 1985. IORI's business is investing in real estate through direct equity investments and partnerships. At December 31, 2004, IORI had total assets of \$91.2 million and owned six apartments, one office building, one shopping center, one industrial warehouse, and one parcel of unimproved land, all within the State of Texas. In 2004, IORI sold two apartments, two office buildings and a parcel of unimproved land for a total of \$24.5 million, receiving net cash of \$4.8 million after paying off \$15.8 million in mortgage debt and the payment of various closing costs. IORI recognized gains of \$5.6 million on the sales, of which ARI's equity share was \$1.1 million. In 2003, IORI sold three office buildings and a parcel of unimproved land for a total of \$55.7 million, receiving net cash of \$10.1 million after paying off \$9.5 million in mortgage debt and the payment of various closing costs. IORI recognized gains of \$3.0 million on the sales, of which ARI's equity share was \$715,000.

ARI received no dividends from IORI in 2004.

ITEM 3. LEGAL PROCEEDINGS

Innovo Realty, Inc. On August 10, 2004, American Realty Investors, Inc. (ARI), Investors, Inc. (TCI) and Income Opportunity Realty Investors, Inc. (IOT) 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, Hubert Guez, Third*

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Millennium Partners LLC, Third Millennium Partners, Inc., Third Millennium Group LLC and Sunridge Management Group, Inc., Defendants. Plaintiffs' Complaint alleges that Joseph Mizrachi, a former director of 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 controlled by, Joseph Mizrachi. Plaintiffs' Complaint alleges that the overall transaction required the establishment of a sinking fund by

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the Defendants and the 22 limited partnerships as a trust for the benefit of certain preferred shareholders of Innovo Group, Inc. and the payment of certain proceeds to the Plaintiffs. Plaintiffs assert that payments have not been made pursuant to the agreement of the parties. Plaintiffs allege that Defendants' conduct constituted a common business enterprise, alleges breach of contract and derivative claims on behalf of Innovo Group, Inc. against Joseph Mizrachi and others, and requests declaratory relief involving the Plaintiffs' rights in the partnerships, an accounting of proceeds, and the creation of a constructive trust. Plaintiffs' Complaint also alleges that Joseph Mizrachi engaged in fraud, negligent misrepresentation and/or breach of fiduciary duty and seeks unspecified damages, attorneys' fees, the establishment of a constructive trust and other relief.

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. (TCI) in the United States District Court for the Northern District of Texas, Dallas Division, against American Realty Investors, Inc. (ARI), Basic Capital Management, Inc. (BCM), Prime Income Asset Management, Inc. (PIAMI), Prime Income Asset Management LLC (Prime), Income Opportunity Realty Investors, Inc. (IOT), United Housing Foundation, Inc. (United), Regis Realty, Inc. (Regis), TCI, TCI's current directors and officers and others. Sunset's Complaint was instituted as Case No. 3:04-CV-02162-B styled *Sunset Management LLC, Derivatively on Behalf of Transcontinental Realty Investors, Inc. v. American Realty Investors, Inc., et al.* Sunset's Complaint alleges (i) Sunset is the owner of 10 shares of Common Stock of TCI and Sunset is the pledgee and beneficial owner of 3,673,115 shares of Common Stock of TCI, (ii) Sunset is a single-member limited liability company, (iii) all of the Defendants have in their various capacities breached fiduciary duties to TCI, and (iv) unjust enrichment of the various Defendants. Sunset's Complaint seeks an injunction prohibiting TCI from entering into any related-party transactions that are not fair to TCI and approved by disinterested directors and/or the stockholders of TCI with full knowledge of the common interest of the directors and/or officers, unspecified damages, attorneys' fees and costs. Individual directors and officers of TCI do not believe their interests are adverse to TCI in this matter. All Defendants believe the action is not properly brought as a derivative action on behalf of TCI, as Sunset's interests are adverse to the interests of TCI. The current action brought by Sunset contains many of the same allegations raised by Sunset in four other cases which, as rulings have occurred, have resulted in a denial of Sunset's requested relief. The Defendants intend to vigorously defend the action, and 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 exception for stockholder derivative actions, and that Sunset cannot fairly and adequately represent the interests of other stockholders. On January 4, 2005, the Defendants also filed a Motion to Stay Discovery and For Protective Order based on the concept that the Motion to Dismiss should dispose of the matter. No hearing has been held or order issued by the Court on either Motion through March 30, 2005. Separately, one of the individual Defendants filed on January 4, 2005 a Motion to Disqualify Sunset's Counsel.

On December 23, 2004, Sunset filed another Complaint in the United States District Court for the Northern District of Texas, Dallas Division, against ARI, BCM, EQK Holdings, Inc. (EQK) and American Realty Trust, Inc. (ART). EQK and ART are subsidiaries of ARI. Sunset's Complaint was instituted as Case No. 3:04-CV-2710-K styled *Sunset Management LLC, Plaintiff v. American Realty Investors, Inc., Basic Capital Management, Inc., EQK Holdings, Inc. and American Realty Trust, Inc.*, alleging (i) that on September 17, 2001, Sunset lent BCM, EQK, ART and ART Williamsburg, Inc. \$30,000,000, and in connection with such loan, BCM, EQK and ART pledged 3,673,115 shares of TCI stock to Sunset; 2,129,701 TCI shares pledged to Sunset by EQK; 920,507 TCI shares pledged to Sunset by BCM, and 622,907 shares pledged to Sunset by ART, (ii) that each of the stock pledge agreements specifically provides that the borrower will not without the written consent of Sunset, sell, dispose of, transfer directly or indirectly, or further encumber the Pledged Securities, (iii) some or all of the shares pledged by BCM and ART had been transferred to one or more subsidiaries of ARI in violation of the stock pledge agreements, (iv) BCM and ART have allegedly breached the stock pledge agreements by transferring certain shares of TCI, (v) that ARI and EQK have allegedly tortuously interfered with existing contractual relationships among BCM, ART and Sunset. Sunset's Complaint seeks specific performance under the stock pledge agreements, and that the Court enter an Order (a) requiring ART to reacquire at least 534,307

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pledged shares it allegedly transferred to EQK, (b) requiring BCM to reacquire at least 920,507 pledged shares it allegedly transferred to EQK, (c) requiring EQK to transfer 534,307 pledged shares back to ART, and (d) requiring EQK 920,507 pledged shares back to BCM. On February 2, 2005, the Defendants in this case filed a Motion to Dismiss or in the Alternative to Stay Action Pending the Resolution of Prior Proceedings in a sister federal court based upon dependency of an adversary proceeding in the United States Bankruptcy Court for the Eastern District of Texas, Sherman Division (Plano, Texas), styled *American Realty Trust, Inc. v. Sunset Management LLC*, Adversary Proceeding No. 03-4256 (E.D. Texas), which is described in the following paragraphs as the Texas Litigation. No hearing has been held or Order issued by the Court on such Motion through March 30, 2005.

The current Sunset Complaint is the fifth in a continuing series of actions involving Sunset, certain subsidiaries of ARI and ARI resulting from a loan in September 2001 to BCM and three subsidiaries of ARI in the original amount of \$30 million (\$19.5 million of which bore interest at 24% per annum, while the remaining \$10.5 million of which bore interest at 20%). In September 2002, \$15 million in principal was repaid leaving a \$15 million aggregate balance, which Sunset orally agreed to extend the maturity date and accept substitute collateral, an arrangement which Sunset did not honor, resulting in the original litigation filed in Texas State Court during October 2002 as Cause No. 02-09433-I in the 162nd Judicial District Court of Dallas County, Texas styled *American Realty Trust, Inc., ART Williamsburg, Inc., Basic Capital Management, Inc. and EQK Holdings, Inc. v. Sunset Management LLC* (the Texas Litigation). The Texas Litigation alleged breach of contract, misrepresentation, breach of duty of good faith and fair dealing and slander of title by Sunset and sought certain declaratory relief against Sunset, as well as temporary and permanent anti-suit injunction against Sunset.

During January 2003, without notice to the Plaintiffs in the Texas Litigation, Sunset institute an action in Federal District Court in Las Vegas, Nevada against Commonwealth Land Title (Commonwealth) seeking disposition of certain shares of Common Stock of TCI held by Commonwealth as Pledge Holder. On January 31, 2003, after a Temporary Restraining Order was issued in the Texas Litigation against Sunset, Sunset instituted a separate lawsuit in Nevada State Court styled *Sunset Management LLC v. American Realty Trust, Inc., et al.*, Cause No. A462587 pending in District Court of Clark County, Nevada (the Nevada Litigation). On February 12, 2003, the Nevada State Court held a hearing on Sunset s request for emergency relief and denied all of Sunset s requested relief and indicated that a stay of the Nevada Litigation may be appropriate, which stay of litigation (including claims against TCI) was granted on May 2, 2003. Notwithstanding the stay of the Nevada Litigation, Sunset has attempted to re-litigate the underlying issues already determined in the Texas Litigation and the Nevada Litigation through cross-claims and counterclaims in the Texas Litigation and renewed motions for injunctions and the appointment of a receiver in the Nevada Litigation. During September 2003, the Texas Litigation was removed to Bankruptcy Court for the Northern District of Texas and subsequently transferred to the Eastern District of Texas. Sunset and the Plaintiffs have filed cross-motions for partial summary judgment in the Bankruptcy Court which had been briefed but remain pending at this time. The parties have also filed an Agreed Motion to Withdraw the reference and have the case transferred to a United States District Judge for trial, which has been denied without prejudice pending resolution of pre-trial motions, including the motions for summary judgment.

On February 10, 2004, Sunset filed yet another lawsuit in Nevada styled *Sunset Management LLC v. Transcontinental Realty Investors, Inc.*, Case No. CV04-00345 in the Superior Court of Washoe County, seeking to compel a new election of directors, alleging that Sunset was improperly denied voting rights with respect to certain pledged shares at the 2003 stockholders meeting of TCI. TCI responded to that action by informing the Nevada Court that the issue of the validity and effectiveness of proxies purportedly held by Sunset in connection with the loan was already pending before the Bankruptcy Court. On May 12, 2004, the Nevada District Court denied Sunset s motion to compel and election of corporate directors because of the dispute pending in the Texas Bankruptcy Court concerning the status of the loan. Subsequently, the Nevada District Court denied two motions for reconsideration filed by Sunset. Sunset is currently appealing the rulings of the Washoe County District Court.

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The ownership of property and provision of services to the public as tenants entails an inherent risk of liability. Although the Company and its subsidiaries are involved in various items of litigation incidental to and in the ordinary course of its business, 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 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

Not applicable.

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ARI's Common Stock is traded on the New York Stock Exchange using the symbol ARL. The following table sets forth the high and low sales prices as reported in the consolidated reporting system of the New York Stock Exchange.

| <u>Quarter Ended</u> | <u>High</u> | <u>Low</u> |
|---|-------------|------------|
| March 31, 2005 (through March 24, 2005) | \$ 9.99 | \$ 8.90 |
| March 31, 2004 | 11.25 | 7.58 |
| June 30, 2004 | 9.80 | 6.99 |
| September 30, 2004 | 9.17 | 8.20 |
| December 31, 2004 | 11.60 | 7.54 |
| March 31, 2003 | 10.65 | 7.50 |
| June 30, 2003 | 13.10 | 8.30 |
| September 30, 2003 | 12.25 | 10.00 |
| December 31, 2003 | 12.55 | 8.95 |

As of March 24, 2005, the closing market price of ARI's Common Stock on the New York Stock Exchange was \$9.35 per share.

As of March 24, 2005, ARI's Common Stock was held by approximately 2,900 stockholders of record.

During the second quarter of 1999, the Board of Directors established the policy that dividend declarations on ARI's Common Stock would be determined on an annual basis following the end of each year. In accordance with that policy, the Board determined not to pay any dividends in 2004. Future distributions to Common stockholders will be dependent upon ARI's realized income, financial condition, capital requirements and other factors deemed relevant by the Board.

15,000,000 shares of Series A 10.0% Cumulative Convertible Preferred Stock are authorized under ARI's Amended Articles of Incorporation, with a par value of \$2.00 per share and a liquidation preference of \$10.00 per share plus accrued and unpaid dividends. Dividends are payable at the annual rate of \$1.00 per share, or \$.25 per share quarterly, to stockholders of record on the last day of each March, June, September, and December, when and as declared by the Board of Directors. The Series A Preferred Stock may be converted into Common Stock at 90.0% of the average daily closing price of ARI's Common Stock for the prior 20 trading days. At December 31, 2004, 3,469,350 shares of Series A Preferred Stock were outstanding and 869,808 shares were reserved for issuance as future consideration in various business transactions. Of the outstanding shares, 300,000 shares are owned by ART Edina, Inc., and 600,000 shares are owned by ART Hotel Equities, Inc., wholly-owned subsidiaries of ARI. Dividends are not paid on the shares owned by ARI subsidiaries.

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231,750 shares of Series C Cumulative Convertible Preferred Stock are authorized under ARI's Amended Articles of Incorporation, with a par value of \$2.00 per share and liquidation preference of \$100.00 per share plus accrued and unpaid dividends. The Series C Preferred Stock bears a quarterly dividend of \$2.50 per share to stockholders of record on the last day of March, June, September and December when and as declared by the Board of Directors. The Series C Preferred Stock is reserved for conversion of the Class A limited partner units of ART Palm, L.P. (Art Palm). At December 31, 2003, 10,188,750 Class A units were outstanding. The Class A units may be exchanged for Series C Preferred Stock at the rate of 100 Class A units for each share of Series C Preferred Stock. At June 30, 2003, shares of Series C Preferred Stock could be converted into 57,500 shares of ARI Common Stock. On or after December 31, 2005, additional shares of Series C Preferred Stock may be converted into 16,250 shares of ARI Common Stock. On or after December 31, 2006, all remaining outstanding

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shares of Series C Preferred Stock may be converted into ARI Common Stock. All conversions of Series C Preferred Stock into ARI Common Stock will be at 90.0% of the average daily closing price of ARI's Common Stock for the prior 20 trading days. In January 2001, 2.5 million Class A limited partner units of ART Palm were redeemed for \$2.5 million in cash. In December 2001, 7.2 million Class A limited partner units of ART Palm were redeemed for \$5.8 million, including \$2.5 million in cash. ARI gave a note payable for the remaining \$3.3 million. The note was paid in full in January 2003, including accrued but unpaid interest. In July 2002, 1.6 million Class A limited partner units of ART Palm were redeemed for \$1.6 million in cash. In August 2003, 1.6 million Class A limited partner units of ART Palm were redeemed for \$1.6 million in cash. In June 2004, 2.6 million Class A limited partner units were redeemed for \$2.6 million in cash. In December 2004, 750,000 Class A limited partner units were redeemed for \$750,000 in cash. At December 31, 2004, no Series C Preferred Stock was outstanding.

91,000 shares of Series D 9.50% Cumulative Preferred Stock are authorized under ARI's Amended Articles of Incorporation, with a par value of \$2.00 per share, and a liquidation preference of \$20.00 per share. Dividends are payable at the annual rate of \$1.90 per year or \$.475 per quarter to stockholders of record on the last day of each March, June, September and December when and as declared by the Board of Directors. The Series D Preferred Stock is reserved for the conversion of the Class A limited partner units of Ocean Beach Partners, L.P. The Class A units may be exchanged for Series D Preferred Stock at the rate of 20 Class A units for each share of Series D Preferred Stock. No more than one-third of the Class A units could be exchanged prior to May 31, 2001. Between June 1, 2001 and May 31, 2006, all unexchanged Class A units are exchangeable. At December 31, 2004, no Series D Preferred Stock was outstanding.

500,000 shares of Series E 6.0% Cumulative Preferred Stock are authorized under ARI's Amended Articles of Incorporation, with a par value \$2.00 per share and a liquidation preference of \$10.00 per share. Dividends are payable at the annual rate of \$.60 per share or \$.15 per quarter to stockholders of record on the last day of each March, June, September and December when and as declared by the Board of Directors. At December 31, 2004, 50,000 shares of Series E Preferred Stock were outstanding.

The following table sets forth information regarding purchases made by ARI of shares of ARI Common Stock on a monthly basis during the fourth quarter of 2004:

| <u>Period</u> | <u>(a) Total Number of Shares Purchased</u> | <u>(b) Average Price Paid per Share</u> | <u>(c) Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs⁽¹⁾</u> | <u>(d) Maximum Number of Shares that May Yet Be Purchased Under the Plans or Programs⁽¹⁾</u> |
|---------------|---|---|---|---|
| October 2004 | | \$ | | 465,393 |
| November 2004 | | | | 465,393 |
| December 2004 | 335,900 | 11.25 | 335,900 | 129,493 |
| Total | 335,900 | \$ 11.25 | 335,900 | |

(1) The repurchase program was announced in September 2000. 1,000,000 shares may be repurchased through the program. The program has no expiration date.

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| | For the Years Ended December 31, | | | | |
|---|---|--------------|-------------|------------|------------|
| | 2004 | 2003 | 2002 | 2001 | 2000 |
| | Restated ⁽¹⁾ (dollars in thousands, except per share) | | | | |
| EARNINGS DATA | | | | | |
| Operating income | \$ 42,746 | \$ 34,772 | \$ 11,922 | \$ 14,081 | \$ 29,620 |
| Gain on land sales | 11,781 | 43,831 | 16,727 | 7,883 | 29,001 |
| Pizza parlor gross margin | 7,812 | 7,006 | 6,750 | 6,278 | 5,784 |
| Income from operations | 62,339 | 85,609 | 35,399 | 28,242 | 64,405 |
| Equity in loss of investees | (41) | (4,441) | (20,914) | (13,352) | (4,581) |
| Loss on sale of investments in equity investees | | | (286) | (387) | (8,744) |
| Equity in gain on sale of real estate by equity investees | | | | 22,542 | 18,571 |
| Other income | 22,526 | 24,640 | 8,590 | 2,448 | 2,039 |
| Other expenses | 143,115 | 123,354 | 78,897 | 91,806 | 126,255 |
| Gain on sale of real estate | | | | 77,816 | 67,727 |
| Net income (loss) from continuing operations | (58,291) | (17,546) | (56,108) | 25,503 | 13,162 |
| Net income (loss) from discontinued operations | 91,485 | 29,409 | 47,644 | (8,149) | (10,483) |
| Net income (loss) | 33,194 | 11,863 | (8,464) | 17,354 | 2,679 |
| Preferred dividend requirement | (2,601) | (2,351) | (2,401) | (2,485) | (2,327) |
| Income (loss) applicable to Common shares | \$ 30,593 | \$ 9,512 | \$ (10,865) | \$ 14,869 | \$ 352 |
| PER SHARE DATA | | | | | |
| Net income (loss) from continuing operations | \$ (5.76) | \$ (1.85) | \$ (5.15) | \$ 1.96 | \$ 1.04 |
| Net income (loss) from discontinued operations | 8.66 | 2.73 | 4.19 | (.69) | (1.01) |
| Net income (loss) applicable to Common shares | \$ 2.90 | \$.88 | \$ (.96) | \$ 1.27 | \$.03 |
| Weighted average shares outstanding | 10,559,571 | 10,789,352 | 11,375,127 | 11,714,374 | 10,399,890 |
| BALANCE SHEET DATA | | | | | |
| Real estate, net | \$ 983,422 | \$ 1,054,735 | \$ 466,042 | \$ 590,488 | \$ 653,744 |
| Notes and interest receivable, net | 72,661 | 70,595 | 82,133 | 30,382 | 13,831 |
| Total assets | 1,190,843 | 1,240,880 | 711,330 | 761,048 | 787,015 |
| Notes and interest payable | 939,921 | 986,769 | 475,433 | 564,298 | 616,331 |
| Margin borrowings | 18,663 | 21,194 | 8,558 | 28,040 | 13,485 |
| Stockholders' equity | 103,009 | 76,871 | 79,527 | 88,169 | 73,402 |
| Book value per share | \$ 9.04 | \$ 6.75 | \$ 6.99 | \$ 7.75 | \$ 6.21 |

(1) The 2004 Restatement adjustments affecting 2003 are set forth in the following table:

| | 2003 | |
|--|---------------------------|----------------|
| | As Previously Reported | As Restated |
| | (dollars in thousands) | |
| Net income (loss) | \$ 8,321 | \$ 9,512 |
| Net income (loss) per Common Share | \$.77 | \$.88 |
| Financial Position Data (at December 31): | | |
| Total Assets | \$ 1,240,181 | \$ 1,240,880 |
| Stockholders' Equity | \$ 75,680 | \$ 76,871 |

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The 2004 Restatement adjustments affecting 2003 are adjustments with respect to net income (loss), as described in ITEM 8. CONSOLIDATED FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA. NOTE 24. RESTATEMENT OF 2003 FINANCIAL STATEMENTS.

ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Introduction

ARI was organized in 1999. In August 2000, ARI acquired American Realty Trust, Inc. (ART) and National Realty, L.P. (NRLP), ART was organized in 1961 to provide investors with a professionally managed, diversified portfolio of real estate and mortgage loan investments selected to provide opportunities for capital appreciation as well as current income. ART owns a portfolio of real estate and mortgage loan investments. NRLP was organized in 1987, and subsequently acquired all of the assets and assumed all of the liabilities of 35 public and private limited partnerships. NRLP also owns a portfolio of real estate and mortgage loan investments.

Critical Accounting Policies

Critical accounting policies are those that are both important to the presentation of ARI's financial condition and results of operations and require management's most difficult, complex or subjective judgments. ARI'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. ARI'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. ARI's estimates are subject to revision as market conditions and ARI's assessments of them change. In the third quarter of 2004, ARI recognized asset impairments of \$3.4 million. In the fourth quarter of 2004, ARI recognized asset impairments of \$7.1 million.

ARI'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 ARI's assessment of its ability to meet its lease or interest obligations. ARI'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.

ARI's management periodically discusses criteria for estimates and disclosures of its estimates with the Audit Committee of its Board of Directors.

Table of Contents**Index to Financial Statements****Obligations and Commitments**

ARI has contractual obligations and commitments primarily with regards to the payment of mortgages.

The following table aggregates ARI's expected contractual obligations and commitments subsequent to December 31, 2004. (dollars in thousands)

| <u>Contractual Obligations</u> | <u>Payments Due by Period</u> | | | | |
|---|-------------------------------|-----------------------------|-------------------|-------------------|------------------------------|
| | <u>Total</u> | <u>Less than 1 year</u> | <u>1-3 years</u> | <u>3-5 years</u> | <u>More than 5 years</u> |
| Long-Term Debt Obligations ⁽¹⁾ | \$ 931,663 | \$ 236,274 | \$ 246,100 | \$ 103,204 | \$ 346,085 |
| Capital Lease Obligations | | | | | |
| Operating Lease Obligations | 11,015 | 2,234 | 3,673 | 2,621 | 2,487 |
| Purchase Obligations | | | | | |
| Other Long-Term Liabilities Reflected on the Registrant's Balance Sheet under GAAP | 2,171 | 2,171 | | | |
| Total | \$ 944,849 | \$ 240,679 | \$ 249,773 | \$ 105,925 | \$ 348,572 |

(1) ARI's long-term debt may contain financial covenants that, if certain thresholds are not met, could allow the lender to accelerate principal payments or cause the note to become due immediately.

Other long-term liabilities represent ARI's intentions to purchase the interests of general and limited purchases of partnerships formed to construct residential properties.

Liquidity and Capital Resources

General. Cash and cash equivalents at December 31, 2004 totaled \$22.4 million, compared with \$9.5 million at December 31, 2003. ARI's principal sources of cash have been and will continue to be from property operations, proceeds from property sales, and the collection of mortgage notes receivable, borrowings and, to a lesser extent, distributions from partnerships. Management anticipates that ARI's cash at December 31, 2004, along with cash that will be generated in 2005 from property operations, will not be sufficient to meet all of ARI's cash requirements. Management intends to selectively sell income producing real estate or land, refinance or extend real estate debt and seek additional borrowings against real estate to meet its cash requirements. Historically, management has been successful at extending its current maturity obligations. Management also anticipates funding ongoing real estate construction projects and the acquisition of new real estate from cash generated by property sales, debt refinancings or extensions, and additional borrowings.

Notes payable totaling \$236.3 million are scheduled to mature during 2005. During the first quarter of 2005, ARI either extended, refinanced, paid down, paid off or received commitments from lenders to extend or refinance \$108.9 million of the debt scheduled to mature in 2005. See NOTE 2. REAL ESTATE, NOTE 8. NOTES AND INTEREST PAYABLE and NOTE 23. SUBSEQUENT EVENTS.

ARI reported net income of \$33.2 million for 2004, which included the following non-cash charges and credits: gain on sale of real estate of \$111.0 million, depreciation and amortization of real estate held for investment and intangible assets of \$30.4 million, amortization of deferred borrowing costs of \$10.5 million, provision for asset impairment of \$10.5 million, gain on settlement of debt of \$10.6 million, provision for loan losses of \$2.8 million, discount on sale of notes receivable of \$389,000 and gain on foreign currency transactions of \$3.8 million. Net cash used in operating activities was \$40.7 million. Interest receivable decreased by \$1.3 million due to a collection of notes receivable, other assets increased by \$3.5 million primarily due to increased affiliate receivables, interest payable increased by \$2.6 million primarily due to unpaid interest on disputed notes payable, and a decrease in minority interest primarily due to allocation of loss to minority owners.

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Net cash provided by investing activities of \$54.3 million was primarily due to proceeds from sale of real estate of \$273.4 million, proceeds from the sale of notes receivable of \$8.3 million, and collection of notes receivable of \$11.6 million. These inflows were offset by real estate improvements of \$165.2 million, investments in real estate entities of \$3.9 million, acquisition of real estate of \$57.8 million, earnest money deposits of \$4.8 million, and funding of notes receivable of \$6.8 million.

Net cash used in financing activities of \$659,000 was primarily comprised of proceeds for the funding or refinancing of notes payable of \$382.3 million and net advances from affiliates of \$14.2 million; offset by payouts of \$380.6 million to paydown existing notes payable, \$9.0 million for financing costs, \$5.2 million to repurchase common stock, \$1.6 million in dividends paid, and net margin payments of \$736,000.

If ARI continues to dispose of operating properties, a further decline in cash from property operations would be expected.

In 2004, ARI purchased a total of 408.7 acres of land in Denton, Ft. Worth, Farmers Branch, Irving, Lubbock, and Dallas, Texas and Kent, Ohio, in separate transactions for a total of \$19.7 million. ARI paid \$5.1 million in cash, including closing costs. ARI acquired three apartments and land for ten apartments for a total of \$34.4 million. ARI paid \$6.4 million in cash, including closing costs.

In 2004, ARI sold a total of 573.4 acres of land in Collin County, Ft Worth, Houston, Plano, Dallas, Tarrant County, and Lewisville, Texas and Kent, Ohio in 14 separate transactions for a total of \$40.1 million. ARI received net cash of \$16.5 million, after paying off or paying down \$11.8 million in mortgage debt secured by such land parcels. ARI also sold seven apartments, four industrial warehouses, four shopping centers, 11 office buildings, and an athletic club for a total of \$277.4 million. ARI received net cash of \$89.8 million, after the payoff or assumption by the purchaser of mortgage debt totaling \$145.2 million and after providing purchase money financing of \$34.4 million.

ARI expects that funds from existing cash resources, aggressive sales of land and selected income producing property sales, refinancing of real estate, and borrowings against its real estate will be sufficient to meet the cash requirements associated with ARI's current and anticipated level of operations, maturing debt obligations and existing commitments. To the extent that ARI's liquidity permits or financing sources are available, ARI will make investments in real estate, primarily in improved and unimproved land, will continue making investments in real estate entities and marketable equity securities, and will develop and construct income-producing properties.

ARI expects that it will be necessary for it to sell \$47.7 million, \$52.6 million and \$8.1 million of its land holdings during each of the next three years to satisfy the debt on the land as it matures. If ARI is unable to sell at least the minimum amount of land to satisfy the land debt obligations as they mature, ARI intends to extend such debt or sell other of its assets, specifically income producing properties, to pay the debt.

Stock Loans Payable. ARI has margin arrangements with various brokerage firms and financial institutions, which provide for borrowings of up to 50.0% of the market value of marketable equity securities. The borrowings under the margin arrangements are secured by the equity securities and bear interest rates ranging from 6.75% to 24.0%. Margin borrowings totaled \$18.7 million (approximately 20.8% of market value) at December 31, 2004, compared to \$21.2 million at December 31, 2003. See NOTE 8. MARGIN BORROWINGS.

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Equity Investments. During the fourth quarter of 1988, ARI began purchasing shares of IORI and TCI, both of which had the same advisor as ARI until June 30, 2003. It is anticipated that additional equity securities of IORI and TCI may be acquired in the future through open market and negotiated transactions to the extent ARI's liquidity permits. See ITEM 1. BUSINESS for discussion of the tender offer for shares of TCI and IORI common stock by ARI and the current ownership of TCI and IORI by ARI.

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Equity securities of IORI and TCI held by ARI may be deemed restricted securities under Rule 144 of the Securities Act of 1933 (Securities Act). Accordingly, ARI may be unable to sell such equity securities other than in a registered public offering or pursuant to an exemption under the Securities Act for a one-year period after they are acquired. Such restrictions may reduce ARI s ability to realize the full fair market value of such investments if ARI attempted to dispose of such securities in a short period of time.

ARI s cash flow from these investments is dependent on the ability of IORI to make distributions. In December 2000, the Board of IORI suspended the payment of quarterly dividends. ARI received no distributions from IORI in 2004, and ARI anticipates receiving no distributions from IORI in 2005.

In 2004, ARI paid dividends to its Preferred stockholders totaling \$1.6 million.

Management reviews the carrying values of ARI s properties and mortgage notes receivable 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 cash flow from the property (undiscounted and without interest) is less than the carrying amount of the property. For notes receivable, impairment is considered to exist if it is probable that all amounts due under the terms of the note will not be collected. If impairment is found to exist, a provision for loss is recorded by a charge against earnings to the extent that the investment in the note exceeds management s estimate of the fair value of the collateral securing such note. The mortgage note receivable review includes an evaluation of the collateral property securing each note. The property review generally includes: (1) selective property inspections, (2) a review of the property s current rents compared to market rents, (3) a review of the property s expenses, (4) a review of maintenance requirements, (5) a review of the property s cash flow, (6) discussions with the manager of the property, and (7) a review of properties in the surrounding area.

Commitments

ARI will rely on externally generated funds, including aggressive land sales, selected sales of income producing properties, refinancing of properties and, to the extent necessary, borrowings to meet these commitments.

Results of Operations

2004 Compared to 2003. ARI reported net income of \$33.2 million in 2004 compared to net income of \$11.9 million in 2003. ARI s net income in 2004 included gains on the sales of real estate of \$108.8 million compared to gains on the sales of real estate of \$92.6 million in 2003. The primary factors contributing to ARI s net income are discussed in the following paragraphs.

ARI began consolidating TCI s operations effective March 31, 2003. (See ITEM 1. BUSINESS.) The consolidation is the principal factor for the increase during 2004 in the following areas: rents, property operations expense, interest expense, depreciation and amortization, general and administrative expense, advisory fees, and gain on sale of real estate. For these items, 2004 results are also presented without the effect of the consolidation of TCI s operations for the first three months of 2004.

| | 2004 | | 2003 |
|------------------------------|-------------------|-------------------|-------------------|
| | With TCI | Without 1Q TCI | |
| Rents (dollars in thousands) | | | |
| Commercial | \$ 49,931 | \$ 43,000 | \$ 42,928 |
| Apartments | 76,186 | 62,957 | 54,733 |
| Hotels | 38,303 | 36,824 | 35,725 |
| Land | 610 | 468 | 615 |
| Other | 342 | 342 | 1,841 |
| | <u>\$ 165,372</u> | <u>\$ 143,591</u> | <u>\$ 135,842</u> |

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The increase in apartment rents, without the effect of the consolidation of TCI's operations, was primarily attributable to completed construction. The increase in hotel rents was primarily attributable to increased occupancy. The decrease in other rents was primarily attributable to the sale of ARI's interest in Realty Advisors Korea, Ltd. as of June 30, 2003. Total rents are expected to increase in 2005, as a result of completed apartment construction.

| | 2004 | | 2003 |
|---|------------|----------------|------------|
| | With TCI | Without IQ TCI | |
| Property Operations Expenses (dollars in thousands) | | | |
| Commercial | \$ 35,372 | \$ 31,128 | \$ 28,002 |
| Apartments | 50,519 | 42,433 | 39,809 |
| Hotels | 28,857 | 27,449 | 27,198 |
| Land | 7,115 | 6,722 | 5,671 |
| Other | 763 | 763 | 390 |
| | \$ 122,626 | \$ 108,495 | \$ 101,070 |

The increase in commercial operations expense was primarily attributable to increased management fees. The increase in apartment operations expense was primarily attributable to property replacements and completed apartment construction. The increase in hotel operations expense was primarily attributable to increased personnel costs and an increase in repairs and replacement expenses. Property operations expenses are expected to increase in 2005, as a result of completed apartment construction.

Pizza parlor sales and cost of sales increased to \$34.5 million and \$26.7 million in 2004 from \$33.1 million and \$26.1 million in 2003. The increases were primarily attributable to same-store sales increases of 6.4% in 2004 from 2003 levels.

Interest income decreased to \$5.3 million in 2004 from \$9.2 million income in 2003. The decrease was primarily attributable to the collection of \$41.2 million of notes receivable in 2003 and 2004.

Equity in loss of investees improved to \$(41,000) in 2004, from \$(4.4) million in 2003. Prior to March 31, 2003, ARI's equity in loss of investees included equity in TCI's operations. See NOTE 5. INVESTMENTS IN EQUITY INVESTEES.

Gain on foreign currency transaction was \$3.8 million in 2004. Gain or loss on foreign currency transaction is the result of Hotel Akademia converting long-term debt, which is denominated in Euros, into the functional currency, the Polish Zloty. The Euro weakened against the Zloty during 2004, which has resulted in ARI recognizing this gain.

Gain on settlement of debt was \$10.6 million in 2004, compared to \$7.2 million in 2003. The 2004 gain resulted from negotiated settlements regarding mortgage loans on an office building in Farmers Branch, Texas (\$8.4 million) and land properties in Texas (\$2.2 million). The 2003

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gain resulted from a favorable ruling in a lender dispute regarding the mortgage loans on three office buildings in New Orleans, Louisiana (\$4.4 million) and from the sale through foreclosure of a hotel in Kansas City, Missouri (\$2.8 million).

Gain on condemnation award was \$4.8 million in 2003, resulting from the settlement of a dispute regarding a land parcel in Dallas, Texas.

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Other income was \$2.7 million in 2004 compared to \$3.4 million in 2003. In 2004, ARI recognized \$2.3 million from the sale of leasehold interests in California.

| | 2004 | | 2003 |
|--|------------------|------------------|------------------|
| | With TCI | Without 1Q TCI | |
| Interest Expense (dollars in thousands) | | | |
| Commercial | \$ 13,665 | \$ 11,491 | \$ 12,249 |
| Apartments | 26,050 | 21,268 | 16,150 |
| Hotels | 5,916 | 5,881 | 5,072 |
| Land | 12,966 | 12,345 | 17,479 |
| MRI | 1,488 | 1,488 | 1,127 |
| Other | 7,554 | 7,554 | 6,523 |
| | \$ 67,639 | \$ 60,027 | \$ 58,600 |

The increase in apartment interest expense was primarily attributable to increased loan balances due to completed apartment construction. The decrease in land interest expense was primarily attributable to reduced principal balances payable and reduced interest rates on land mortgages.

| | 2004 | | 2003 |
|---|------------------|------------------|--------------------|
| | With TCI | Without 1Q TCI | |
| Depreciation and Amortization (dollars in thousands) | | | |
| | | | As Restated |
| Commercial | \$ 11,700 | \$ 9,150 | \$ 8,407 |
| Apartments | 8,631 | 7,070 | 4,213 |
| Hotels | 3,995 | 3,658 | 4,976 |
| MRI | 950 | 950 | 1,484 |
| Other | 56 | 45 | 34 |
| | \$ 25,332 | \$ 20,873 | \$ 19,114 |

The increase in apartment depreciation and amortization was primarily attributable to completed construction. The decrease in hotel depreciation and amortization was primarily attributable to the recognition, in 2003, of depreciation from the date of purchase for improvements at one hotel that had been placed in service in 1997.

Discount on sale of notes receivable was \$389,000 in 2004, compared to \$2.2 million in 2003. This represents the discount from the face amount given by ARI to purchasers of notes receivable. See NOTE 3. NOTES AND INTEREST RECEIVABLE.

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General and administrative expenses decreased to \$18.7 million in 2004 from \$22.1 million in 2003. The expenses in 2003 include \$3.1 million of one-time reimbursements to BCM for legal fees.

Advisory fees increased to \$10.7 million in 2004 from \$9.3 million in 2003. In 2003, ARI received an operating expense refund of \$1.3 million.

Provision for asset impairment increased to \$8.0 million in 2004, from \$7.7 million in 2003. In 2004, an office building in Farmers Branch, Texas, an office building in New Orleans, Louisiana, and 1.0 acre of land in Farmers Branch, Texas (exchanged for additional land in the first quarter of 2005) were reduced to their net realizable value.

Minority interest increased to \$7.3 million in 2004 from \$771,000 in 2003. Minority interest is the earnings attributable to owners, other than ARI, of certain controlled entities. Minority interest in 2004 and 2003 was

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attributable, in part, to the preferred return for limited partner units of Ocean Beach Partners, L.P., Edina Park Plaza Associates, L.P., Hawthorne Lakes Associates, L.P., and ART Palm, L.P. The increase is primarily attributable to reduced minority participation in ARI partnerships and to the increase in minority interest expense related to TCI's operations.

In 2004 and 2003 gains on sale of real estate totaling \$108.8 million and \$92.6 million were recognized. See Note 2. REAL ESTATE.

Net income from discontinued operations was \$91.5 million in 2004 compared to \$29.4 million in 2003. The net income relates to 23 properties and leasehold interests in oil and gas properties that ARI sold in 2002, 32 properties that ARI sold in 2003, and 27 properties that ARI sold in 2004, and three properties ARI sold in 2005. The following table summarizes revenue and expense information for the properties sold.

| | <u>2004</u> | <u>2003</u> |
|---|------------------|------------------|
| Revenue | | |
| Rental | \$ 30,414 | \$ 51,810 |
| Property operations | 18,161 | 30,757 |
| | <u>12,253</u> | <u>21,053</u> |
| Expenses | | |
| Interest | 12,368 | 21,025 |
| Depreciation | 5,108 | 8,105 |
| | <u>17,476</u> | <u>29,130</u> |
| Net loss from discontinued operations | (5,223) | (8,077) |
| Gain on sale of real estate | 96,994 | 48,806 |
| Write-down of assets held for sale | (2,498) | (12,036) |
| Equity in gain on sale of real estate by equity investees | 2,212 | 716 |
| | <u>\$ 91,485</u> | <u>\$ 29,409</u> |

2003 Compared to 2002. ARI reported net income of \$11.9 million in 2003 compared to a net loss of \$8.5 million in 2002. ARI's net income in 2003 included gains on the sale of real estate of \$92.6 million compared to gains on the sale of real estate of \$48.4 million in 2002. The primary factors contributing to ARI's net income are discussed in the following paragraphs.

ARI began consolidating TCI's operations effective March 31, 2003. (See ITEM 1. BUSINESS.) The consolidation is the principal factor for the increase during 2003 in the following areas: rents, property operations expense, interest expense, depreciation and amortization, general and administrative expense, advisory fees, and gain on sale of real estate. For these items, 2003 results are also presented without the effect of the consolidation of TCI's operations.

2003

2002

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| | <u>With TCI</u> | <u>Without TCI</u> | |
|------------------------------|-------------------|--------------------|------------------|
| Rents (dollars in thousands) | | | |
| Commercial | \$ 42,928 | \$ 16,370 | \$ 16,106 |
| Apartments | 54,733 | 20,678 | 20,129 |
| Hotels | 35,725 | 28,666 | 27,675 |
| Land | 615 | 46 | 575 |
| Other | 1,841 | 1,841 | 246 |
| | <u>\$ 135,842</u> | <u>\$ 67,601</u> | <u>\$ 64,731</u> |

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The increase in hotel rents was primarily attributable to increased occupancy.

| | 2003 | | 2002 |
|---|------------|-------------|-----------|
| | With TCI | Without TCI | |
| Property Operations Expenses (dollars in thousands) | | | |
| Commercial | \$ 28,002 | \$ 12,027 | \$ 12,076 |
| Apartments | 39,809 | 15,657 | 13,226 |
| Hotels | 27,198 | 22,115 | 20,977 |
| Land | 5,671 | 4,041 | 6,002 |
| Other | 390 | 390 | 528 |
| | \$ 101,070 | \$ 54,230 | \$ 52,809 |

The increase in apartment operations expense, without the effect of the consolidation of TCI's operations, was primarily attributable to the acquisition of one apartment complex and the construction of one apartment complex in 2002 and one apartment complex in 2003. The increase in hotel operations expense was primarily attributable to increased personnel costs and an increase in repairs and replacement expenses. The decrease in land operations expense was primarily attributable to lower property taxes due to land sales.

Pizza parlor sales and cost of sales increased to \$33.1 million and \$26.1 million in 2003 from \$32.0 million and \$25.3 million in 2002. The increases were primarily attributable to same-store sales increases of 4.6% in 2003 from 2002 levels.

Interest income increased to \$9.2 million in 2003 from \$3.1 million income in 2002. The increase was primarily attributable to interest earned by RAK during ARI's ownership, interest received by ARI upon the sale of RAK to Realty Advisors, and notes receivable from property sales late in 2002 and early in 2003.

Equity in loss of investees improved to \$(4.4) million in 2003, from \$(20.9) million in 2002. The improvement was primarily attributable to the consolidation of TCI's operations by ARI effective March 31, 2003, following ARI's acquisition of more than 50.0% of TCI's common stock. Prior to March 31, 2003, and in 2002, ARI's equity in loss of investees included equity in TCI's operations. See NOTE 5. INVESTMENTS IN EQUITY INVESTEES.

Loss on sale of investments in equity investees was \$(286,000) in 2002, recognizing the loss on the sale of Villas Continental Apartments.

Gain on settlement of debt was \$7.2 million in 2003. The gain resulted from a favorable ruling in a lender dispute regarding the mortgage loans on three office buildings in New Orleans, Louisiana (\$4.4 million) and from the sale through foreclosure of a hotel in Kansas City, Missouri (\$2.8 million).

Gain on condemnation award was \$4.8 million in 2003, resulting from the settlement of a dispute regarding a land parcel in Dallas, Texas.

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Other income decreased to \$3.4 million in 2003 from \$5.4 million in 2002. The decrease was primarily due to \$2.2 million received in 2002 in settlement of a lawsuit against a brokerage firm for improper sales in 2000 of TCI common stock owned by ARI and held by the brokerage firm, and \$1.4 million received in 2002 as partial settlement of a lawsuit against a lender for improperly attempting to seize, in 1996, a mortgage note receivable due to ARI. ARI sold the note to BCM in 1999, with the provision that any settlement received in excess of the amount paid by BCM, plus accrued interest, would be returned to ARI.

| | 2003 | | 2002 |
|--|------------------|------------------|------------------|
| | With TCI | Without TCI | |
| Interest Expense (dollars in thousands) | | | |
| Commercial | \$ 12,249 | \$ 5,566 | \$ 5,031 |
| Apartments | 16,150 | 6,636 | 7,212 |
| Hotels | 5,072 | 3,455 | 3,822 |
| Land | 17,479 | 14,397 | 19,763 |
| MRI | 1,127 | 1,127 | 840 |
| Other | 6,523 | 6,523 | 11,351 |
| | \$ 58,600 | \$ 37,704 | \$ 48,019 |

The decrease in land and other interest expense, without the effect of the consolidation of TCI's operations, was primarily attributable to reduced balances payable on stock loans and land mortgages. In 2002, ARI recognized a \$912,000 loss on an interest rate swap contract. See NOTE 21.

DERIVATIVE FINANCIAL INSTRUMENTS.

| | 2003 (as restated) | | 2002 |
|---|--------------------|-----------------|-----------------|
| | With TCI | Without TCI | |
| Depreciation and Amortization (dollars in thousands) | | | |
| Commercial | \$ 8,407 | \$ 1,820 | \$ 1,870 |
| Apartments | 4,213 | 1,447 | 1,449 |
| Hotels | 4,976 | 3,590 | 1,920 |
| MRI | 1,484 | 1,484 | 1,268 |
| Other | 34 | | 39 |
| | \$ 19,114 | \$ 8,341 | \$ 6,546 |

The increase in hotel depreciation and amortization, without the effect of the consolidation of TCI's operations, was primarily attributable to the recognition of depreciation from the date of purchase for improvements at one hotel that had been placed in service in 1997.

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Discount on sale of notes receivable was \$2.2 million in 2003. This represents the discount from the face amount given by ARI to purchasers of notes receivable. See NOTE 3. NOTES RECEIVABLE.

General and administrative expenses increased to \$22.1 million in 2003 from \$12.5 million in 2002. The expenses in 2003 include \$3.1 million of one-time reimbursements to BCM for legal fees. Without the effect of the consolidation, general and administrative expenses increased to \$14.6 million, which included \$1.4 million of the legal fee reimbursement to BCM.

Advisory fees increased to \$9.3 million in 2003 from \$5.9 million in 2002. Without the effect of the consolidation, advisory fees increased to \$6.0 million.

Provision for asset impairment increased to \$7.7 million in 2003, from \$3.7 million in 2002. In 2003, the carrying value of an office building in Farmers Branch, Texas, was reduced to its net realizable value. In 2002,

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the carrying value of an 89.3 acre tract of land in Palm Desert, California (sold in the first quarter of 2003) was reduced to its net realizable value.

Loss on foreign currency transaction was \$3.3 million in 2003. Loss on foreign currency transaction is the result of Hotel Akademia converting long-term debt, which is denominated in Euros, into the functional currency, the Polish Zloty. The Euro strengthened against the Zloty during 2003, which has resulted in ARI recognizing this charge.

Minority interest decreased to \$771,000 in 2003 from \$1.3 million in 2002. Minority interest is the earnings attributable to owners, other than ARI, of certain controlled entities. Minority interest in 2003 and 2002 was attributable, in part, to the preferred return for limited partner units of Ocean Beach Partners, L.P., Valley Ranch, L.P., Edina Park Plaza Associates, L.P., Hawthorne Lakes Associates, L.P., ART Florida Portfolio I, ART Florida Portfolio II, ART Florida Portfolio III and ART Palm, L.P. The decrease is primarily attributable to reduced minority participation in ARI partnerships and to the consolidation of TCI's operations by ARI effective March 31, 2003, following ARI's acquisition of more than 50.0% of TCI's common shares.

In 2003 and 2002, gains on sale of real estate totaling \$92.6 million and \$48.4 million were recognized.

Net income from discontinued operations was \$29.4 million in 2003 compared to \$47.6 million in 2002. The net income relates to 23 properties and leasehold interests in oil and gas properties that ARI sold during 2002, 32 properties that ARI sold in 2003, 27 properties that ARI sold in 2004, and three properties ARI sold in 2005. The following table summarizes revenue and expense information for the properties sold.

| | <u>2003</u> | <u>2002</u> |
|---|------------------|------------------|
| Revenue | | |
| Rental | \$ 51,810 | \$ 46,158 |
| Property operations | 30,757 | 28,297 |
| | <u>21,053</u> | <u>17,861</u> |
| Expenses | | |
| Interest | 21,025 | 17,814 |
| Depreciation | 8,105 | 7,699 |
| | <u>29,130</u> | <u>25,513</u> |
| Net loss from discontinued operations | (8,077) | (7,652) |
| Gain on sale of real estate | 48,806 | 31,706 |
| Write-down of assets held for sale | (12,036) | (479) |
| Equity in gain on sale of real estate by equity investees | 716 | 24,069 |
| | <u>\$ 29,409</u> | <u>\$ 47,644</u> |

Related Party Transactions

Historically, ARI, TCI, IORI, BCM and Prime 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 ARI as could have been obtained from unrelated parties.

Operating Relationships

In October 2003, ARI entered into a lease with Prime for space at the One Hickory Centre Office Building. The lease was for 59,115 sq. ft. (approximately 59.0% of the building), has a term of three years, and provided for annual base rent of \$1.3 million, or \$21.50 per sq. ft. Effective May 1, 2004, the lease was amended to 54,404 sq. ft. (approximately 56.0% of the building), with an annual base rent of \$1.2 million, or \$21.50 per sq. ft.

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ARI received rents of \$69,000 in 2004 from BCM for BCM's lease at Addison Hanger. BCM owns a corporate jet that is housed at the hanger and ARI has available space at the hanger.

In 2004, ARI paid BCM, Prime, their affiliates and a related party \$10.7 million in advisory fees, \$1.9 million in net income fees, \$1.9 million in loan arrangement fees, \$578,000 in property acquisition fees, \$8.4 million in real estate brokerage commissions, \$5.6 million in construction supervision fees and \$6.7 million in property and construction management fees and leasing commissions, net of property management fees paid to subcontractors, other than affiliates of BCM. In addition, as provided in the Advisory Agreement, BCM and Prime received cost reimbursements of \$4.6 million.

Partnership Transactions

BCM has entered into put agreements with certain holders of the Class A limited partner units of Ocean Beach Partners, L.P. The Class A units are convertible into Series D Cumulative Preferred Stock of ARI. The put price of the Series D Preferred Stock is \$20.00 per share plus accrued but unpaid dividends.

BCM has entered into put agreements with the holders of the Class A units of ART Palm, L.P. Such Class A units are convertible into Series C Cumulative Convertible Preferred Stock of ARI. The put price for the Class A units is \$1.00 per unit and the put price for either the Series C Preferred Stock or ARI's Common Stock is 90.0% of the average daily closing price of ARI's Common Stock for the prior 20 trading days. The put agreement calls for ARI to repurchase the outstanding Class A units as follows: December 31, 2005 875,000 units; and December 31, 2006 5,938,750 units.

Advances and Loans

From time-to-time, ARI and its affiliates have made advances to each other, which have not had specific repayment terms, do not bear interest, are unsecured and have been reflected in ARI's financial statements as other assets or other liabilities. At December 31, 2004, after accounting for affiliate purchases and sales, amounts still owed by ARI were \$260,000 and \$1.2 million to IORI and Regis I, respectively. Also at December 31, 2004, ARI was owed \$13.6 million and \$1.4 million by BCM, Prime and Regis I, respectively.

Activity in 2004 included:

In January 2004, ARI issued 200,000 shares of Series A 10.0% Cumulative Convertible Preferred Stock to Prime, ARI's advisor. In February 2004, 50,000 additional shares were issued to Prime. ARI's affiliate receivable was increased by \$2.5 million.

In February 2004, ARI obtained an unsecured loan of \$5.0 million. The proceeds of \$5.0 million were received by an affiliate of ARI, increasing ARI's affiliate receivable.

In February 2004, ARI obtained financing of \$7.5 million on the Katy land tract. The funds, along with additional cash of \$6.3 million, were sent to an affiliate. Subsequently, the affiliate paid off the existing loan balance on an ARI property.

In March 2001, ARI funded \$13.6 million of a \$15.0 million unsecured line of credit to One Realco. A wholly-owned subsidiary of One Realco owns approximately 2.2% of the outstanding shares of ARI's Common Stock. One Realco periodically borrows money to meet its cash obligations. The line of credit bore interest at 12.0% per annum. All principal and interest were due at maturity in February 2002. The line of credit is guaranteed by BCM. In June 2001, \$810,000 in principal and interest was collected. In December 2001, \$825,000 in principal and interest was collected. In February 2002, the line of credit was increased to \$18.0 million, accrued but unpaid interest of \$217,000 was added to the principal, and the maturity date was extended to February 2004. In March 2002, ARI funded an additional \$1.8 million, increasing the outstanding principal

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balance to \$15.5 million. In October 2002, \$856,900 in interest was collected, by the return of 85,690 shares of ARI Series A Preferred Stock. In June 2003, ARI sold a participating interest in \$5.8 million of the \$15.5 million balance to BCM; receiving 314,141 TCI shares from BCM (see NOTE 1. BASIS OF PRESENTATION.) In February 2004, \$2.3 million in interest was collected, accrued but unpaid interest of \$161,000 was added to the principal, the maturity date was extended to February 2007, and the interest rate was changed to 3.0% over the prime rate, currently at 8.75%. All principal and interest are due at maturity. Ronald E. Kimbrough, Acting Principal Executive Officer, Executive Vice President and Chief Financial Officer of ARI until May 31, 2004, was a 10.0% shareholder of One Realco until July 31, 2004. Mr. Kimbrough did not participate in the day-to-day operations or management of One Realco.

In March 2004, ARI obtained financing of \$11.5 million on a hotel property. The proceeds of \$11.0 million were received by an affiliate, increasing ARI's affiliate receivable.

In April 2004, \$825,000 was advanced under a security loan arrangement with a financial institution. The proceeds were paid to an affiliate, increasing ARI's affiliate receivable.

In July 2004, ARI obtained a loan of \$3.2 million secured by a contract for sale of the Waters Edge III Apartments. The proceeds of \$3.2 million were received by an affiliate, increasing ARI's affiliate receivable.

In October 2004, ARI advanced \$3.3 million to the Class A Limited Partners of Edina Park Plaza Associates, Limited Partnership, of which ARI is the general partner. The loans bear interest at 10.0% per annum and mature in September 2017. Interest due to ARI will be deducted from the quarterly return owed by ARI to the Class A Limited Partners, eliminating the quarterly payments. The outstanding principal is due at maturity.

In October 1999, ARI funded a \$4.7 million loan to Realty Advisors. The loan, to provide funds for acquisitions or working capital needs, was secured by all of the outstanding shares of common stock of American Reserve Life Insurance Company. The loan bore interest at 10.25% per annum, and matured in November 2001. In January 2000, \$100,000 was collected. In November 2001, the maturity date was extended to November 2004. The collateral was changed to a pledge of 850,000 shares of ARI Common Stock owned by BCM. The interest rate was changed to 2.0% over the prime rate, currently 7.75% per annum, and the accrued but unpaid interest of \$1.0 million was added to the principal. The new principal balance is \$5.6 million. In September 2003, \$0.7 million in accrued interest was collected. In August 2004, \$0.3 million in accrued interest was collected. In November 2004, the maturity date was extended to November 2006. All principal and accrued interest are due at maturity.

Property Transactions

Activity in 2004 included:

In December 2003, ARI sold seven properties to subsidiaries of Unified Housing Foundation, Inc. (UHF), a Texas Non-Profit 501(c)3 Corporation. ARI sold 39.3 acres of Pioneer Crossing land for \$3.9 million, 10.7 acres of Marine Creek land for \$1.5 million, the Limestone at Vista Ridge Apartments for \$19.0 million, the Cliffs of El Dorado Apartments for \$13.4 million, the Limestone Canyon Apartments for \$18.0 million, the Sendero Ridge Apartments for \$29.4 million, and Tivoli Apartments for \$16.1 million. All of the transactions included the

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assumption of debt and notes receivable to ARI for the remainder of the purchase price. Ted Stokely, Chairman of the Board of ARI, is the General Manager of UHF. Richard Humphrey, who is employed by Regis Realty I, LLC, an affiliate, is President of UHF. Due to UHF being considered a related party to ARI and ARI having continued involvement and control of these entities, these transactions have not been recorded as sales. Instead, these transactions will be accounted for on the deposit method, and the properties and corresponding debt will continue to be consolidated by ARI. All of these transactions were approved by ARI's Board of Directors. Mr. Stokely abstained from voting on all of these transactions. The loans on Limestone Canyon apartments and Limestone at Vista Ridge apartments were approved by their prospective lenders for

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transfer to the purchasing entities. ARI has guaranteed the loans on both of these transfers. Also, Marine Creek land and the Cliffs of El Dorado apartments were recognized as sales during 2004. See NOTE 2. REAL ESTATE. Management is currently seeking lender approval on the transfer of the notes associated with the Tivoli apartments and Sendero Ridge apartments.

In December 2003, ARI sold a tract of Marine Creek land to a subsidiary of United Housing Foundation, Inc. (UHF) for \$1.5 million, receiving cash and a note receivable. This sale was not recognized as a sale at that time because UHF is a related party and ARI has continuing involvement and control. In February 2004, Marine Creek was refinanced by UHF, which paid in full ARI's note payable on the land. ARI recorded the sale of the land and received a note receivable of \$270,000, which was the difference between the sales price and the amount of ARI's note payable. The note bears interest at 6.0%, requires quarterly payments from available surplus cash and matures in December 2007. See Note 9. RELATED PARTY TRANSACTIONS.

In May 2004, ARI purchased the Treehouse Apartments from an affiliate, with a net purchase price of \$7.5 million after assumption of debt and a note receivable, less cash received of \$0.5 million. The note receivable was from the sale of the Cliffs of El Dorado Apartments to a related party in 2003. At that time, the sale of the Cliffs of El Dorado was not recorded as a sale for accounting purposes. ARI recorded the sale of the Cliffs of El Dorado in May 2004, due to payment received for the Cliffs of El Dorado note receivable.

In September 2004, ARI sold Limestone Canyon II land to a subsidiary of UHF for \$720,000 in the form of a seller note receivable. Due to no cash received and common control, ARI has elected to continue consolidating this tract of land until the requirements for a sale have been met. No sale was recognized and no note receivable has been recorded.

In April 2002, ARI and TCI sold 21 apartment properties to partnerships controlled by Metra Capital, LLC (Metra). Innovo Group, Inc. (Innovo) is a limited partner in the partnerships that purchased the properties. Joseph Mizrachi, then a director of ARI, controlled approximately 11.67% of the outstanding common stock of Innovo. Management determined to treat the sales as financing transactions, and ARI and TCI continue to report the assets and the new debt incurred by Metra on their financial statements. The partnership agreements for each of these partnerships state that the Metra Partners, as defined, receive cash flow distributions at least quarterly in an amount sufficient to provide them with a 15.0% cumulative compounded annual rate of return on their invested capital, as well as a cumulative compounded annual amount of 0.50% of the average outstanding balance of the mortgage indebtedness secured by any of these properties. These distributions to the Metra Partners have priority over distributions to any other partners. At December 31, 2004, 16 of the properties remained on ARI's balance sheet, and ARI's other liabilities included \$1.4 million owed to the Metra Partners related to cash received by ARI upon the sale of these apartments in April 2002.

Environmental Matters

Under various federal, state and local environmental laws, ordinances and regulations, ARI 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 ARI's business, assets or results of operations.

Inflation

The effects of inflation on ARI's operations are not quantifiable. Revenues from property operations tend to fluctuate proportionately with inflationary increases and decreases in housing costs. Fluctuations in the rate of

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inflation also affect the sales values of properties and the ultimate gains 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.

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ARI's future operations, cash flow and fair values of financial instruments are partially dependent upon the then existing market interest rates and market equity prices. Market risk is the changes in the market rates and prices and the affect of the changes on the future operations. Market risk is managed by matching a property's anticipated net operating income to an appropriate financing.

The following table contains only those exposures that existed at December 31, 2004. Anticipation of exposures of risk on positions that could possibly arise was not considered. ARI's ultimate interest rate risk and its effect on operations will depend on future capital market exposures, which cannot be anticipated with a probable assurance level. Dollars in thousands.

| | <u>2005</u> | <u>2006</u> | <u>2007</u> | <u>2008</u> | <u>2009</u> | <u>Thereafter</u> | <u>Total</u> |
|---|-------------|-------------|-------------|-------------|-------------|-------------------|--------------|
| Assets | | | | | | | |
| Trading Instruments - Equity Price Risk | | | | | | | |
| Marketable securities at market value | | | | | | | \$ 6,670 |
| Notes receivable | | | | | | | |
| Variable interest rate - fair value | | | | | | | \$ 23,408 |
| Instrument's maturities | \$ 2,776 | \$ 5,633 | \$ 14,717 | \$ | \$ | \$ | \$ 23,126 |
| Instrument's amortization | | | | | | | |
| Interest | 1,672 | 1,395 | 182 | | | | 3,249 |
| Average rate | 7.3% | 8.3% | 2.0% | | | | |
| Fixed interest rate - fair value | | | | | | | \$ 52,075 |
| Instrument's maturities | \$ 27,849 | \$ 7,740 | \$ 2,570 | \$ 2,626 | \$ 125 | \$ 9,098 | \$ 50,008 |
| Instrument's amortization | 51 | 60 | 67 | 47 | | | 225 |
| Interest | 3,599 | 1,940 | 1,347 | 1,045 | 1,021 | 5,293 | 14,245 |
| Average rate | 8.5% | 11.3% | 11.3% | 11.3% | 11.3% | | |
| Liabilities | | | | | | | |
| Notes payable | | | | | | | |
| Variable interest rate - fair value | | | | | | | \$ 135,256 |
| Instrument's maturities | \$ 96,009 | \$ 44,258 | \$ 30,454 | \$ | \$ 6,637 | \$ 17,936 | \$ 195,294 |
| Instrument's amortization | 3,864 | 3,830 | 1,427 | 630 | 575 | 9,804 | 20,130 |
| Interest | 9,494 | 5,866 | 3,134 | 2,080 | 1,739 | 14,046 | 36,359 |
| Average rate | 5.1% | 4.4% | 4.7% | 7.0% | 7.0% | | |
| Fixed interest rate - fair value | | | | | | | \$ 690,115 |
| Instrument's maturities | \$ 126,960 | \$ 75,576 | \$ 72,880 | \$ 54,239 | \$ 26,162 | \$ 88,852 | \$ 444,669 |
| Instrument's amortization | 9,441 | 9,048 | 8,627 | 7,809 | 7,152 | 229,493 | 271,570 |
| Interest | 42,503 | 40,218 | 33,351 | 27,825 | 24,813 | 343,130 | 511,840 |
| Average rate | 7.2% | 7.9% | 8.2% | 8.5% | 8.9% | | |

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ITEM 8. CONSOLIDATED FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

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| <u>Consolidated Statements of Operations Years Ended December 31, 2004, 2003 and 2002</u> | 54 |
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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 Consolidated Financial Statements or the notes thereto.

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

Board of Directors of

American Realty Investors, Inc.

Dallas, Texas

We have audited the accompanying consolidated balance sheet of American Realty Investors, Inc. and Subsidiaries as of December 31, 2004, and the related consolidated statements of operations, stockholders' equity, and cash flows for the year ended December 31, 2004. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

As described in Note 22, American 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.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of American Realty Investors, Inc. as of December 31, 2004, and the results of its operations and its cash flows for the year ended December 31, 2004, in conformity with U.S. generally accepted accounting principles.

Our audits were made for the purpose of forming an opinion on the basic consolidated financial statements taken as a whole. Schedules III and IV are presented for the purpose of complying with the Securities and Exchange Commission's rules and is not a required part of the basic consolidated financial statements. These schedules have been subjected to the auditing procedures applied in the audits of the basic consolidated financial statements and, in our opinion, fairly states, in all material respects, the financial data required to be set forth therein in relation to the basic consolidated financial statements taken as a whole.

Farmer, Fuqua & Huff, PC

Plano, Texas

March 30, 2005

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

Board of Directors of

American Realty Investors, Inc.

We have audited the accompanying consolidated balance sheets of American Realty Investors, Inc. and Subsidiaries as of December 31, 2003 and the related consolidated statements of operations, stockholders' equity, other comprehensive income (loss) and cash flows for each of the two years in the period ended December 31, 2003. We have also audited the schedules listed in the accompanying index. These financial statements and 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.

As described in Note 22, American Realty Investors, Inc.'s management has indicated its intent to sell both land and operating properties and refinance or extend debt coming due, to meet its liquidity needs.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of American Realty Investors, Inc. and Subsidiaries as of December 31, 2003 and the consolidated results of their operations and their cash flows for each of the two years in the period ended December 31, 2003, in conformity with accounting principles generally accepted in the United States of America.

Also, in our opinion, the schedules present fairly, in all material respects, the information set forth therein.

BDO SEIDMAN, LLP

Dallas, Texas

April 15, 2004

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AMERICAN REALTY INVESTORS, INC.

CONSOLIDATED BALANCE SHEETS

| | December 31, | |
|---|--|--------------|
| | 2004 | 2003 |
| | As Restated (dollars in thousands, except per share) | |
| Assets | | |
| Real estate held for investment | \$ 877,677 | \$ 931,014 |
| Less accumulated depreciation | (157,138) | (168,069) |
| | 720,539 | 762,945 |
| Real estate held for sale, net of depreciation | 192,533 | 211,942 |
| Real estate subject to sales contract (Note 8) | 70,350 | 79,848 |
| Notes and interest receivable | | |
| Performing (\$43,605 in 2004 and \$37,697 in 2003 from affiliates) | 67,894 | 64,296 |
| Non-performing | 6,632 | 10,932 |
| | 74,526 | 75,228 |
| Less allowance for estimated losses | (1,865) | (4,633) |
| | 72,661 | 70,595 |
| Pizza parlor equipment | 13,747 | 12,237 |
| Less accumulated depreciation | (6,608) | (5,385) |
| | 7,139 | 6,852 |
| Marketable equity securities, at market value | 6,670 | 5,020 |
| Cash and cash equivalents | 22,401 | 9,543 |
| Investments in equity investees | 8,212 | 4,987 |
| Goodwill, net of accumulated amortization (\$1,763 in 2004 and 2003) | 11,858 | 11,858 |
| Other intangibles, net of accumulated amortization (\$871 in 2004 and \$822 in 2003) | 1,480 | 1,529 |
| Other assets (\$27,704 in 2004 and \$8,098 in 2003 from affiliate) | 77,000 | 75,761 |
| | \$ 1,190,843 | \$ 1,240,880 |
| Liabilities and Stockholders Equity | | |
| Liabilities | | |
| Notes and interest payable (\$36,298 in 2004 and \$34,775 in 2003 to affiliate) | \$ 722,985 | \$ 819,143 |
| Liabilities related to assets held for sale | 156,959 | 100,154 |
| Liabilities subject to sales contract (Note 8) | 59,977 | 67,472 |
| Margin borrowings | 18,663 | 21,194 |
| Accounts payable and other liabilities (\$2,557 in 2004 and \$2,934 in 2003 to affiliates) | 71,357 | 96,360 |
| | 1,029,941 | 1,104,323 |
| Minority interest | 57,893 | 59,686 |
| Stockholders equity | | |
| Preferred Stock, \$2.00 par value, authorized 50,000,000 shares, issued and outstanding Series A, 3,469,350 shares in 2004 and 3,225,370 shares in 2003 (liquidation preference \$34,694), including 900,000 shares in 2004 and 2003 held by subsidiaries | 5,139 | 4,651 |

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| | | |
|--|---------------------|---------------------|
| Series E, 50,000 shares in 2004 and 2003 (liquidation preference \$500) | 100 | 100 |
| Common Stock, \$.01 par value, authorized 100,000,000 shares; issued 11,392,272 in 2004 and 2003 | 114 | 114 |
| Treasury stock, at cost, 1,243,272 shares in 2004 and 746,972 shares in 2003 | (15,146) | (9,924) |
| Paid-in capital | 91,789 | 92,464 |
| Retained earnings (accumulated deficit) | 22,561 | (10,635) |
| Accumulated other comprehensive income (loss) | (1,548) | 101 |
| | <u>103,009</u> | <u>76,871</u> |
| | <u>\$ 1,190,843</u> | <u>\$ 1,240,880</u> |

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

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AMERICAN REALTY INVESTORS, INC.

CONSOLIDATED STATEMENTS OF OPERATIONS

| | Years Ended December 31, | | |
|--|---|------------|-----------|
| | 2004 | 2003 | 2002 |
| | As Restated (dollars in thousands, except per share) | | |
| Property revenue | | | |
| Rents (\$1,223 in 2004 and \$1,102 in 2003 from affiliates) | \$ 165,372 | \$ 135,842 | \$ 64,731 |
| Property operations expenses (\$5,182 in 2004, \$4,273 in 2003, and \$4,325 in 2002 to affiliates) | 122,626 | 101,070 | 52,809 |
| Operating income | 42,746 | 34,772 | 11,922 |
| Land operations | | | |
| Sales | 40,052 | 68,003 | 127,750 |
| Cost of sales | 27,690 | 40,603 | 75,718 |
| Deferral of gains on current period sales | 581 | 3,493 | 36,135 |
| Recognition of previously deferred gains | | 19,924 | 830 |
| Gain on land sales | 11,781 | 43,831 | 16,727 |
| Pizza parlor operations | | | |
| Sales | 34,525 | 33,057 | 32,036 |
| Cost of sales | 26,713 | 26,051 | 25,286 |
| Gross margin | 7,812 | 7,006 | 6,750 |
| Income from operations | 62,339 | 85,609 | 35,399 |
| Other income | | | |
| Interest income (\$3,258 in 2004, \$4,035 in 2003, and \$2,515 in 2002 from affiliates) | 5,347 | 9,222 | 3,145 |
| Equity in loss of investees | (41) | (4,441) | (20,914) |
| Gain on foreign currency transactions | 3,766 | | |
| Gain on settlement of debt | 10,649 | 7,210 | |
| Gain on condemnation award | | 4,800 | |
| Loss on sale of investments in equity investees | | | (286) |
| Other (\$300 in 2002 from affiliates) | 2,764 | 3,408 | 5,445 |
| | 22,485 | 20,199 | (12,610) |
| Other expenses | | | |
| Interest (\$2,825 in 2004, \$833 in 2003, and \$1,703 in 2002 to affiliates) | 67,639 | 58,600 | 48,019 |
| Depreciation and amortization | 25,332 | 19,114 | 6,546 |
| Discount on sale of notes receivable | 389 | 2,220 | |
| General and administrative (\$2,470 in 2004, \$8,282 in 2003, and \$2,546 in 2002 to affiliates) | 18,743 | 22,124 | 12,479 |
| Advisory fee to affiliate | 10,728 | 9,345 | 5,899 |
| Net income fee to affiliate | 1,933 | | |
| Litigation settlement | 5,848 | 15 | 916 |
| Provision for asset impairment | 8,001 | 7,698 | 3,692 |
| Provision for loan losses | (2,768) | 158 | |
| Loss on foreign currency transactions | | 3,309 | |
| Minority interest | 7,270 | 771 | 1,346 |
| | 143,115 | 123,354 | 78,897 |

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| | | | |
|---|-------------------|-------------------|-------------------|
| Net income (loss) from continuing operations | (58,291) | (17,546) | (56,108) |
| Discontinued operations (Note 20): | | | |
| Loss from operations | (5,223) | (8,077) | (7,652) |
| Gain on sale of real estate | 96,994 | 48,806 | 31,706 |
| Write-down of assets held for sale | (2,498) | (12,036) | (479) |
| Equity in gain on sale of real estate by equity investees | 2,212 | 716 | 24,069 |
| | <u> </u> | <u> </u> | <u> </u> |
| Net income (loss) from discontinued operations | 91,485 | 29,409 | 47,644 |
| Net income (loss) | 33,194 | 11,863 | (8,464) |
| Preferred dividend requirement | (2,601) | (2,351) | (2,401) |
| | <u> </u> | <u> </u> | <u> </u> |
| Net income (loss) applicable to Common shares | \$ 30,593 | \$ 9,512 | \$ (10,865) |
| | <u> </u> | <u> </u> | <u> </u> |
| Earnings per share basic and diluted | | | |
| Net income (loss) from continuing operations | \$ (5.76) | \$ (1.85) | \$ (5.15) |
| Discontinued operations | 8.66 | 2.73 | 4.19 |
| | <u> </u> | <u> </u> | <u> </u> |
| Net income (loss) applicable to Common shares | \$ 2.90 | \$.88 | \$ (.96) |
| | <u> </u> | <u> </u> | <u> </u> |
| Weighted average Common shares used in computing earnings per share | 10,559,571 | 10,789,352 | 11,375,127 |
| | <u> </u> | <u> </u> | <u> </u> |

Convertible Preferred Stock (2,569,350, 2,325,370, and 2,326,858 shares) and options to purchase 76,750, 98,250, and 105,750 shares of ARI's Common Stock were excluded from the computation of diluted earnings per share for 2004, 2003, and 2002, respectively, because the effect of their inclusion would be antidilutive.

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

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AMERICAN REALTY INVESTORS, INC.

CONSOLIDATED STATEMENTS OF STOCKHOLDERS EQUITY

| | Series A Preferred Stock | Series E Preferred Stock | Common Stock | Treasury Stock | Paid-in Capital | Retained Earnings/ (Accumulated Deficit) | Accumulated Other Comprehensive Income (Loss) | Stockholders Equity |
|--|--------------------------------|--------------------------------|-----------------|-------------------|--------------------|---|---|------------------------|
| (dollars in thousands, except per share) | | | | | | | | |
| Balance, January 1, 2002 | \$ 4,850 | \$ 100 | \$ 114 | \$ | \$ 97,140 | \$ (14,035) | \$ | \$ 88,169 |
| Comprehensive income: | | | | | | | | |
| Unrealized gain on foreign currency translation | | | | | | | 3,204 | 3,204 |
| Net loss | | | | | | (8,464) | | (8,464) |
| | | | | | | | | (5,260) |
| Series A Preferred Stock cash dividend (\$1.00 per share) | | | | | (2,371) | | | (2,371) |
| Series E Preferred Stock cash dividend (\$0.60 per share) | | | | | (30) | | | (30) |
| Repurchase of Series A Preferred Stock | (196) | | | | (784) | | | (980) |
| Common Stock dividends (pre-merger) | | | | | (25) | | | (25) |
| Other | | | | | 24 | | | 24 |
| Balance, December 31, 2002 | 4,654 | 100 | 114 | | 93,954 | (22,499) | 3,204 | 79,527 |
| Comprehensive income: | | | | | | | | |
| Unrealized gain on foreign currency translation | | | | | | | 14 | 14 |
| Recognition of previously unrealized gain, upon the sale of foreign operations | | | | | | | (3,117) | (3,117) |
| Net income (as restated) | | | | | | 11,863 | | 11,863 |
| | | | | | | | | 8,760 |
| Issuance of Common Stock | | | | | 195 | | | 195 |
| Repurchase of Series A Preferred Stock | (3) | | | | (12) | 1 | | (14) |
| Common shares held by acquired company | | | | (9,924) | | | | (9,924) |
| Exchange of investments with affiliates | | | | | 678 | | | 678 |
| Series A Preferred Stock cash dividend (\$1.00 per share) | | | | | (2,321) | | | (2,321) |
| Series E Preferred Stock cash dividend (\$0.60 per share) | | | | | (30) | | | (30) |
| Balance, December 31, 2003 (as Restated) | 4,651 | 100 | 114 | (9,924) | 92,464 | (10,635) | 101 | 76,871 |
| Comprehensive income: | | | | | | | | |
| Unrealized loss on foreign currency translation | | | | | | | (3,229) | (3,229) |
| Unrealized gain on marketable securities | | | | | | | 1,580 | 1,580 |
| Net income | | | | | | 33,194 | | 33,194 |

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| | | | | | | | | |
|---|-----------------|---------------|---------------|--------------------|------------------|------------------|-------------------|-------------------|
| | | | | | | | | 31,545 |
| Repurchase of Common Stock | | | (5,222) | | | | | (5,222) |
| Common Stock Dividends (pre-merger) | | | | (26) | | | | (26) |
| Repurchase of Series A Preferred Stock | (12) | | | (48) | | 2 | | (58) |
| Issuance of Series A Preferred Stock | 500 | | | 2,000 | | | | 2,500 |
| Series A Preferred Stock cash dividend (\$1.00 per share) | | | | (2,571) | | | | (2,571) |
| Series E Preferred Stock cash dividend (\$0.60 per share) | | | | (30) | | | | (30) |
| Balance, December 31, 2004 | \$ 5,139 | \$ 100 | \$ 114 | \$ (15,146) | \$ 91,789 | \$ 22,561 | \$ (1,548) | \$ 103,009 |

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

Table of Contents**Index to Financial Statements****AMERICAN REALTY INVESTORS, INC.****CONSOLIDATED STATEMENTS OF CASH FLOWS**

| | For Years Ended December 31, | | |
|---|-------------------------------------|--------------------|-------------------------------|
| | 2004 | 2003 | 2002 |
| | | | (As Restated) |
| | | | (dollars in thousands) |
| Cash Flows From Operating Activities | | | |
| Net income (loss) | \$ 33,194 | \$ 11,863 | \$ (8,464) |
| Adjustments to reconcile net income (loss) to net cash used in operating activities | | | |
| Gain on sale of real estate | (110,987) | (93,353) | (48,433) |
| Depreciation and amortization | 30,440 | 27,216 | 14,245 |
| Amortization of deferred borrowing costs | 10,488 | 10,540 | 8,930 |
| Provision for asset impairment | 10,499 | 19,892 | 4,171 |
| Discount on sale of notes receivable | 389 | 2,324 | |
| Provision for loan losses | (2,768) | 158 | |
| Gain on settlement of debt | (10,649) | (7,210) | |
| Gain on condemnation award | | (4,800) | |
| Equity in (income) loss of investees | 41 | 4,441 | (2,869) |
| (Gain) loss on foreign currency transactions | (3,766) | 3,306 | |
| (Increase) decrease in accrued interest receivable | 1,318 | (3,992) | (1,586) |
| (Increase) decrease in other assets | (3,548) | 7,177 | (14,481) |
| Increase (decrease) in accrued interest payable | 2,582 | 1,723 | 2,437 |
| Increase (decrease) in accounts payable and other liabilities (includes \$14,864 in 2004, \$36,160 in 2003, and \$(14,117) in 2002 with affiliates) | 199 | 7,581 | (5,361) |
| Decrease in minority interest | 1,819 | (2,621) | (1,282) |
| | <u> </u> | <u> </u> | <u> </u> |
| Net cash used in operating activities | <u>\$ (40,749)</u> | <u>\$ (15,755)</u> | <u>\$ (52,693)</u> |
| Cash Flows From Investing Activities | | | |
| Collections on notes receivable (\$718 in 2004, \$2,535 in 2003 and \$776 in 2002 from affiliates) | \$ 11,626 | \$ 29,622 | \$ 7,416 |
| Proceeds from sale of notes receivable | 8,264 | 33,866 | 7,641 |
| Notes receivable funded | (6,848) | (3,593) | (2,169) |
| Proceeds from sale of real estate | 273,393 | 163,097 | 102,772 |
| Purchase of marketable equity securities | | (1,640) | |
| Proceeds from sale of marketable equity securities | | 179 | 1,291 |
| Acquisitions of real estate | (57,877) | (15,313) | (1,359) |
| Real estate improvements | (165,154) | (50,997) | (34,336) |
| Pizza parlor equipment purchased | (1,527) | (1,615) | (2,869) |
| Proceeds from sale of pizza parlor equipment | 94 | 438 | 1,498 |
| Earnest money deposits | (4,825) | (8,594) | 331 |
| Distribution from (to) equity investees | 1,007 | (648) | |
| Settlement of interest rate swap contract | | (31) | (284) |
| Investment in real estate entities, net of cash acquired | (3,887) | (25,677) | (3,976) |
| | <u> </u> | <u> </u> | <u> </u> |

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| | | | |
|---|-----------|------------|-----------|
| Net cash provided by investing activities | \$ 54,266 | \$ 119,094 | \$ 75,956 |
|---|-----------|------------|-----------|

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

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AMERICAN REALTY INVESTORS, INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS (Continued)

| | For Years Ended December 31, | | |
|--|---|------------------|-----------------|
| | 2004 | 2003 | 2002 |
| | (As Restated) (dollars in thousands) | | |
| Cash Flows From Financing Activities | | | |
| Proceeds from notes payable | \$ 382,259 | \$ 178,523 | \$ 103,701 |
| Margin borrowings (payments), net | (736) | 11,886 | (19,548) |
| Payments on notes payable | (380,579) | (285,307) | (133,959) |
| Deferred borrowing costs | (8,994) | (7,450) | (7,170) |
| Net advances from affiliates | 14,189 | 2,485 | 43,813 |
| Dividends paid | (1,566) | (2,351) | (2,401) |
| Repurchase of Preferred Stock | (10) | (14) | |
| Repurchase of Common Stock | (5,222) | | |
| Stock sale profits received from affiliate | | | 24 |
| Net cash used in financing activities | (659) | (102,228) | (15,540) |
| Net increase (decrease) in cash and cash equivalents | 12,858 | 1,111 | 7,723 |
| Cash and cash equivalents, beginning of year | 9,543 | 8,432 | 709 |
| Cash and cash equivalents, end of year | \$ 22,401 | \$ 9,543 | \$ 8,432 |
| Supplemental Disclosures of Cash Flow Information | | | |
| Cash paid for interest | \$ 66,411 | \$ 80,867 | \$ 54,400 |
| Schedule of noncash investing and financing activities | | | |
| Notes payable from acquisition of real estate | \$ 5,027 | \$ 29,151 | \$ |
| Notes payable assumed by buyer upon sale of real estate | 34,357 | 45,321 | 80,729 |
| Carrying value of real estate exchanged for other real estate | | | 7,224 |
| Redemption of Series A Preferred Stock | | | 980 |
| Purchase accounting adjustment of net assets acquired | 8,434 | 58,558 | |
| Notes receivable from sale of real estate | 24,167 | 59,440 | 59,578 |
| Cancellation of Series F Preferred Stock | | | 3,969 |
| Note receivable from sale of leasehold interests | | | 1,300 |
| Acquisition of property to satisfy debt | | | 19,789 |
| Disposal of property to satisfy debt | | 4,760 | 41,050 |
| Exchange of interest in note receivable for stock | | 7,688 | |
| Note receivable from exchange of stock with affiliate | | 526 | |
| Notes payable proceeds collected by affiliate for property financing | 21,297 | 1,500 | |
| Sale of note and interest receivable to satisfy debt | | 13,435 | |
| Funds collected by affiliate on sale of real estate | | 6,239 | |
| Write-off goodwill upon sale of subsidiary | | 2,116 | |
| Sale of investment to reduce affiliate debt | | 6,000 | |
| Unrealized foreign currency translation gain | | 14 | 3,204 |

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| | | | |
|--|--------|--------|-------|
| Unrealized gain on marketable securities | 1,580 | | |
| Unrealized foreign currency translation loss | 3,229 | | |
| Issuance of Common Stock | | 195 | |
| Issuance of Series A Preferred Stock | 2,500 | | |
| Note Payable paid by affiliate | 10,823 | | |
| Subsidiary shares of parent Common Stock | | 9,924 | |
| Exchange of investments with affiliate | | 678 | |
| Asset impairment writedown | 10,499 | 19,892 | 4,171 |

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

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AMERICAN REALTY INVESTORS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

The accompanying Consolidated Financial Statements of American Realty Investors, Inc. and consolidated subsidiaries have been 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. These, along with the remainder of the Notes to Consolidated Financial Statements, are an integral part of the 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 and accompanying footnotes are in thousands, except per share amounts.

Certain balances for 2002 and 2003 have been reclassified to conform to the 2004 presentation.

NOTE 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Organization and business. In November 1999, American Realty Investors, Inc. (ARI), a Nevada corporation, was formed, and in August 2000, ARI acquired American Realty Trust, Inc. (ART), a Georgia corporation and National Realty, L.P. (NRLP), a Delaware partnership that primarily invests in real estate and real estate-related entities and purchases and originates mortgage loans.

The acquisition of ART and NRLP by ARI was completed on August 2, 2000. NRLP unit holders, except for ART, received one share of ARI Common Stock for each unit of NRLP held. ART stockholders received .91 shares of ARI Common Stock for each share of ART Common Stock held. Each share of ART Preferred Stock was converted into one share of Preferred Stock of ARI, having substantially the same rights as ART's Preferred Stock. The ART shares of Common Stock ceased trading on the New York Stock Exchange on August 2, 2000. The NRLP units of limited partner interest ceased trading on the American Stock Exchange on August 2, 2000. ARI Common Stock commenced trading on the New York Stock Exchange on August 3, 2000.

On October 23, 2001, ARI, Transcontinental Realty Investors, Inc. (TCI), and Income Opportunity Realty Investors, Inc. (IORI) jointly announced a preliminary agreement with the plaintiff's legal counsel of the derivative action entitled *Olive et al. V. National Income Realty Trust, et al.* for complete settlement of all disputes in the lawsuit (the Olive Litigation). In February 2002, the court granted final approval of the proposed settlement (the Olive Settlement). Under the Olive Settlement, 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 shares of IORI and TCI not currently owned by ARI. On November 15, 2002, ARI commenced the tender offer for the IORI and TCI shares. The tender offer was completed on March 19, 2003. ARI paid \$19.00 cash per IORI share and \$17.50 cash per TCI share for the stock held by non-affiliated stockholders. Pursuant to the tender offer, ARI acquired 265,036 IORI shares and 1,213,226 TCI shares. The completion of the tender offer fulfills the obligations under the Olive Settlement and the Olive Litigation has been dismissed with prejudice.

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After the tender offer, ARI owned 64.8% of the outstanding shares of TCI and 62.5% of the outstanding shares of IORI (46.9% owned directly by ARI and 15.6% through TCI's ownership of IORI shares). ARI began consolidation of TCI's and IORI's accounts and operations effective March 31, 2003. The effect of consolidating TCI's and IORI's operations from the completion of the tender offer through March 31, 2003 was determined to be immaterial. Through June 30, 2003, ARI had the same advisor as TCI and IORI, and TCI and IORI had the same board of directors. At December 31, 2004, ARI and TCI have the same Board of Directors, and a director of ARI (Ted Stokely) also serves as a director of IORI.

On June 2, 2003, ARI exchanged all of its 674,971 IORI shares with Basic Capital Management, Inc. (BCM), receiving 650,000 TCI shares from BCM. In addition, BCM has executed a promissory note in favor

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AMERICAN REALTY INVESTORS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

of ARI in the amount of \$526,000 (see NOTE 3. NOTES AND INTEREST RECEIVABLE). After the exchange, ARI owned 72.9% of the outstanding shares of TCI. On June 30, 2003, ARI sold a participating interest in \$5.8 million of its \$15.5 million line of credit receivable from One Realco Corporation (One Realco) to BCM, receiving 314,141 TCI shares from BCM (see NOTE 3. NOTES RECEIVABLE). After the transaction, ARI owned 76.8% of the outstanding shares of TCI. In December 2003, ARI purchased 88,600 TCI shares in market transactions and 204,633 TCI shares in transactions with related parties for a total of \$1.4 million. At December 31, 2004, ARI owned 82.2% of the outstanding shares of TCI. ARI no longer directly owns any IORI shares. At December 31, 2004, ARI owned 19.7% of IORI through TCI s ownership of IORI shares. ARI ceased consolidation of IORI s accounts and operations effective June 2, 2003.

The following pro forma information reflects the results of operations for ARI as though the consolidation of TCI s operations had begun on January 1, 2003.

| | <u>2003</u> |
|--------------------------------|-------------|
| Revenue, as reported | \$ 236,902 |
| Revenue, pro forma | 253,007 |
| Net income (loss), as reported | 11,863 |
| Net income (loss), pro forma | 11,108 |
| Earnings per share: | |
| Basic and diluted, as reported | \$.88 |
| Basic and diluted, pro forma | \$.81 |

On June 30, 2003, ARI sold its 71.4% interest in Realty Advisors Korea, Ltd. (RAK) to Realty Advisors, Inc. (Realty Advisors), a related party, for \$6.0 million, reducing ARI s affiliate debt. Realty Advisors also paid ARI \$600,000, representing 10.0% interest on the \$6.0 million price paid by ARI to purchase the 71.4% interest in RAK in 2002.

Effective July 1, 2003, Prime Asset Management, Inc. (PAMI) became the advisor to ARI and TCI. PAMI is owned by Realty Advisors (79.0%) and Syntek West, Inc. (Syntek West) (21.0%), related parties. Syntek West is owned by Gene Phillips. Effective August 18, 2003, PAMI changed its name to Prime Income Asset Management, Inc. (PIAMI). On October 1, 2003, Prime Income Asset Management, LLC (Prime), which is 100% owned by PIAMI, replaced PIAMI as the advisor to ARI and TCI.

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

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Accounting estimates. In the preparation of these 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 expense for the year then ended. Actual results could differ materially from these estimates.

Non-performing notes receivable. ARI considers a note receivable to be non-performing when the maturity date has passed without principal repayment and the borrower is not making interest payments. Any new note receivable that results from a modification or extension of a note considered non-performing will also be considered non-performing, without regard to the borrower's adherence to payment terms.

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AMERICAN REALTY INVESTORS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Interest recognition on notes receivable. Interest income is not recognized on notes receivable that have been delinquent for 60 days or more. In addition, accrued but unpaid interest income is only recognized to the extent that the net realizable value of the underlying collateral exceeds the carrying value of the receivable.

Allowance for estimated losses. A valuation allowance is provided for estimated losses on notes receivable considered to be impaired. Impairment is considered to exist when it is probable that all amounts due under the terms of the note will not be collected. Valuation allowances are provided for estimated losses on notes receivable to the extent that the investment in the note exceeds management's estimate of fair value of the collateral securing such note.

Recent Accounting pronouncements. SFAS No. 151 In November 2004, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 151, Inventory Costs, an Amendment of ARB No. 43, Chapter 4 (SFAS No. 151). SFAS No. 151 amends ARB 43, Chapter 4, to clarify that abnormal amounts of idle facility expense, freight, handling costs and wasted materials (spoilage) be recognized as current period charges. It also requires that allocation of fixed production overheads to the costs of conversion be based on the normal capacity of the production facilities. SFAS No. 151 is effective for inventory costs incurred during fiscal years beginning after June 15, 2005. The adoption of SFAS No. 151 is not expected to have a material impact on the consolidated financial position or results of operations of ARI.

SFAS No. 152 In December 2004, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 152, Accounting for Real Estate Time-Sharing Transactions (SFAS No. 152). SFAS No. 152 amends FASB Statement No. 66, Accounting for Sales of Real Estate, to reference the financial accounting and reporting guidance for real estate time-sharing transactions that is provided in AICPA Statement of Position 04-2, Accounting for Real Estate Time-Sharing Transactions (SOP 04-2). This Statement also amends FASB Statement No. 67, Accounting for Costs and Initial Rental Operations of Real Estate Projects, to state that the guidance for (a) incidental operations and (b) costs incurred to sell real estate projects does not apply to real estate time-sharing transactions. The accounting for those operations and costs is subject to the guidance in SOP 04-2.

SFAS No. 152 is effective for financial statements for fiscal years beginning after June 15, 2005, and is to be reported as a cumulative effect of a change in accounting principle. The adoption of SFAS No. 145 is not expected to have a material impact on the consolidated financial position or results of operations of ARI.

SFAS No. 123 In December 2004, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 123, Share-Based Payment, revised (SFAS No. 123R). SFAS No. 123R addresses the accounting for share-based payments to employees, including grants of employee stock options. Under the new standard, companies will no longer be able to account for share-based compensation transactions using the intrinsic method in accordance with APB Opinion No. 25, Accounting for Stock Issued to Employees. Instead, companies will be required to account for such transactions using a fair-value method and recognize the expense in the consolidated statement of income. SFAS No. 123R will be effective for periods beginning after June 15, 2005 and allows, but does not require, companies to restate the full fiscal year of 2005 to reflect the impact of expensing share-based payments under SFAS No. 123R. The Company has not yet determined which

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fair-value method and transitional provision it will follow. The adoption of SFAS No. 123R is not expected to have a material impact on the Company's consolidated financial position or results of operations. See Stock-Based Employee Compensation for the pro forma impact on net income and net income per share from calculating stock-based compensation costs under the fair value alternative of SFAS No. 123.

SFAS No. 153 In December 2004, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 153, Exchanges of Non-monetary Assets, An Amendment of APB Opinion

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AMERICAN REALTY INVESTORS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

No. 29 (SFAS No. 153). The guidance in APB Opinion No. 29, Accounting for Non-monetary Transactions, is based on the principle that exchanges of non-monetary assets should be measured based on the fair value of the assets exchanged. The guidance in APB Opinion No. 29, however, included certain exceptions to that principle. SFAS No. 153 amends APB Opinion No. 29 to eliminate the exception for non-monetary exchanges of similar productive assets and replaces it with a general exception for exchanges of non-monetary assets that do not have commercial substance. A non-monetary exchange has commercial substance if the future cash flows of the entity are expected to change significantly as a result of the exchange. SFAS No. 153 is effective for non-monetary asset exchanges in fiscal periods beginning after June 15, 2005. The adoption of SFAS No. 153 is not expected to have a material impact on the consolidated financial position or results of operations of ARI.

Real estate held for investment and depreciation. Real estate held for investment is carried at cost. Statement of Financial Accounting Standards No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets (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 less cost to sell 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 five to 40 years.

Real estate held for sale. Foreclosed real estate is initially recorded at new cost, defined as the lower of original cost or fair value minus estimated costs of sale. SFAS No. 144 also requires that properties held for sale be reported at the lower of carrying amount or fair value less costs of sale. If a reduction in a held for sale property's carrying amount to fair value less costs of sale is required, a provision for loss is recognized by a charge against earnings. Subsequent revisions, either upward or downward, to a held for sale property's estimated fair value less costs of sale are recorded as an adjustment to the property's carrying amount, but not in excess of the property's carrying amount when originally classified as held for sale. A corresponding charge against or credit to earnings is recognized. Properties held for sale are not depreciated.

Investments in equity investees. ARI may be considered to have the ability to exercise significant influence over the operating and investment policies of certain of its investees. Those investees are accounted for using the equity method. Under the equity method, an initial investment, recorded at cost, is increased by a proportionate share of the investee's operating income and any additional investment and decreased by a proportionate share of the investee's operating losses and distributions received.

Present value premiums/discounts. Present value premiums and discounts are provided on notes receivable or payable that have interest rates that differ substantially from prevailing market rates and such premiums and discounts are amortized by the interest method over the lives of the related notes. The factors considered in determining a market rate for notes receivable include the borrower's credit standing, nature of the collateral and payment terms of the note.

Foreign Currency Translation. Foreign currency denominated assets and liabilities of subsidiaries with local functional currencies are translated to United States dollars at year-end exchange rates. The effects of translation are recorded in the cumulative translation component of

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shareholders' equity. Subsidiaries with a United States dollar functional currency remeasure monetary assets and liabilities at year-end exchange rates and non-monetary assets and liabilities at historical exchange rates. The effects of re-measurement are included in income. Exchange gains and losses arising from transactions denominated in foreign currencies are translated at average exchange rates. The effects of these exchange adjustments are included in income and amounted to a gain of \$3.8 million in 2004 and a loss of \$3.3 million in 2003.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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), as amended by SFAS No. 144. Until the requirements of SFAS No. 66 for full profit recognition have been met, transactions are accounted for using either the deposit, the installment, the cost recovery, or the financing method, whichever is appropriate.

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 its notes receivable, marketable equity securities and notes payable. For performing notes receivable, the fair value was estimated by discounting future cash flows using current interest rates for similar loans. For non-performing notes receivable, the estimated fair value of ARI's interest in the collateral property was used. For marketable equity securities, fair value was based on the year-end closing market price of each security. For notes payable, the fair value was estimated using current 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 to be cash equivalents.

Earnings (loss) 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.

Stock-based employee compensation. Accounting Principles Board Opinion No. 25 Accounting for Stock Issued to Employees, and related interpretations are utilized by management in accounting for the option plans. All share options issued have exercise prices equal to the market price of the shares at the dates of grant. Accordingly, no compensation cost has been recognized for the option plans. Had compensation cost for the option plans been determined based on the fair value at the grant dates consistent with the method of Statement of Financial Accounting Standards No. 123, Accounting for Stock-Based Compensation, net income (loss) and net income (loss) per share would have been the pro forma amounts indicated below.

| | <u>2004</u> | <u>2003</u> | <u>2002</u> |
|--------------------------------|--|-------------|-------------|
| | (dollars in thousands, except per share amounts) | | |
| Net income (loss), as reported | \$ 30,593 | \$ 9,512 | \$ (10,865) |

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Deduct: Total stock-based employee compensation expense determined under fair value based methods for all awards, net of related tax effects

| | | | |
|--------------------------------|-------------------|-------------------|-------------------|
| | 22 | 21 | 114 |
| | <u> </u> | <u> </u> | <u> </u> |
| Pro forma net income (loss) | \$ 30,571 | \$ 9,491 | \$ (10,979) |
| | <u> </u> | <u> </u> | <u> </u> |
| Net income (loss) per share | | | |
| Basic and diluted, as reported | \$ 2.90 | \$.88 | \$ (.96) |
| Basic and diluted, pro forma | \$ 2.90 | \$.88 | \$ (.97) |

The fair value of each option is estimated on the date of grant using the Black-Scholes option-pricing model with the following weighted average assumptions:

| | | | |
|---------------------------|-------------|-------------|-------------|
| | <u>2004</u> | <u>2003</u> | <u>2002</u> |
| Dividend yield | | | |
| Expected volatility | 64% | 65% | 69% |
| Risk-free interest rate | 4.55% | 4.04% | 3.95% |
| Expected lives (in years) | 10 | 10 | 10 |
| Forfeitures | 10% | 10% | 10% |

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The weighted average fair value per share of options granted in 2004 was \$7.22.

NOTE 2. REAL ESTATE

In 2004, ARI purchased the following properties:

| <u>Property</u> | <u>Location</u> | <u>Units/Acres</u> | <u>Purchase Price</u> | <u>Net Cash Paid/ (Received)</u> | <u>Debt Incurred</u> | <u>Interest Rate</u> | <u>Maturity Date</u> |
|--|--------------------|--------------------|-----------------------|----------------------------------|----------------------|----------------------|----------------------|
| Apartments | | | | | | | |
| 288 City Park ⁽¹⁾ | Houston, TX | 240 Units | \$ 3,056 | \$ 612 | \$ 2,444 | 5.95% | 04/45 |
| Blue Lake Villas II ⁽¹⁾ | Waxahachie, TX | 70 Units | 729 | (164) | 729 | 5.80 | 04/45 |
| Bridges on Kinsey ⁽¹⁾ | Tyler, TX | 232 Units | 2,291 | 596 | 1,687 | 5.74 | 08/45 |
| Dakota Arms ⁽¹⁾ | Lubbock, TX | 208 Units | 2,472 | 681 | 1,791 | 5.85 | 06/45 |
| Laguna Vista ⁽¹⁾ | Farmers Branch, TX | 206 Units | 2,424 | 902 | 1,522 | 5.50 | 09/46 |
| Lake Forest ⁽¹⁾ | Houston, TX | 240 Units | 2,316 | (470) | 2,316 | 5.60 | 03/45 |
| Parc at Maumelle ⁽¹⁾ | Maumelle, AR | 240 Units | 3,120 | 916 | 2,204 | 5.37 | 07/46 |
| Treehouse ⁽³⁾ | Irving, TX | 160 Units | 7,519 | (498) | 5,027 ⁽⁴⁾ | 5.00 | 08/13 |
| Vistas of Vance Jackson ⁽¹⁾ | San Antonio, TX | 240 Units | 3,550 | 771 | 2,779 | 5.78 | 06/45 |
| Wildflower Villas ⁽¹⁾ | Temple, TX | 220 Units | 2,045 | 79 | 1,996 | 5.99 | 10/45 |
| Land | | | | | | | |
| Cooks Lane | Ft. Worth, TX | 21.9 Acres | 1,000 | 1,034 | | | |
| Denton-Coonrod | Denton, TX | 13.9 Acres | 1,644 | 1,046 | 840 | 6.25 | 11/06 |
| DeSoto | DeSoto, TX | 202.0 Acres | 2,516 | 1,364 | 1,265 | 6.25 | 11/06 |
| Granbury Station | Ft. Worth, TX | 15.7 Acres | 923 | 236 | 738 | 7.00 | 09/07 |
| Ladue | Farmers Branch, TX | 8.0 Acres | 1,743 | 659 | 1,206 | 6.65 ⁽²⁾ | 06/06 |
| Las Colinas | Irving, TX | 45.5 Acres | 4,802 | 1,674 | 3,121 | 7.00 | 12/06 |
| Las Colinas ⁽⁵⁾ | Irving, TX | 268.0 Acres | 4,687 | 159 | | | |
| Lubbock | Lubbock, TX | 2.9 Acres | 224 | 224 | | | |
| Meloy Road | Kent, OH | 54.2 Acres | 4,900 | 343 | 4,900 | 5.00 ⁽²⁾ | 01/06 |
| Railroad | Dallas, TX | 0.3 Acres | 708 | 704 | | | |
| Rogers | Rogers, AR | 20.1 Acres | 1,390 | 619 | 1,130 | 10.50 | 04/05 |
| West End | Dallas, TX | 0.2 Acres | 71 | 71 | | | |

(1) Initial construction loan funding to purchase land and begin apartment construction. Does not represent actual units purchased.

(2) Variable interest rate.

(3) Purchased from IORI, a related party, for assumption of debt and a note receivable, less \$498 in cash received.

(4) Assumed debt of seller.

(5) Obtained in exchange for 13.0 acres of Las Colinas land.

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In 2003, ARI purchased the following properties:

| <u>Property</u> | <u>Location</u> | <u>Units/Acres</u> | <u>Purchase Price</u> | <u>Net Cash Paid</u> | <u>Debt Incurred</u> | <u>Interest Rate</u> | <u>Maturity Date</u> |
|-------------------------------|--------------------|--------------------|-----------------------|----------------------|----------------------|----------------------|----------------------|
| Apartments | | | | | | | |
| Breakwater Bay ⁽¹⁾ | Beaumont, TX | 176 Units | \$ 1,979 | \$ 383 | \$ 1,554 | 5.50% | 08/44 |
| Capitol Hill ⁽¹⁾ | Little Rock, AR | 156 Units | 1,904 | 615 | 1,289 | 5.50 | 10/44 |
| Longwood | Long Beach, MS | 200 Units | 6,349 | 334 | 6,349 ⁽²⁾ | 7.60 | 04/12 |
| Land | | | | | | | |
| Pulaski | Pulaski County, AR | 21.9 Acres | 2,000 | 695 | 1,400 | 6.50% | 05/05 |
| Sheffield Village | Grand Prairie, TX | 13.9 Acres | 1,500 | 464 | 975 | 5.50 ⁽³⁾ | 09/04 |
| Travelers ⁽⁴⁾ | Farmers Branch, TX | 202.0 Acres | 25,000 | 1,947 | 22,802 | 5.49 | 10/06 |

- (1) Initial construction loan funding to purchase land and begin apartment construction. Does not represent actual units purchased.
- (2) Assumed debt of seller.
- (3) Variable interest rate.
- (4) Purchased from IORI.

In February 1990, ARI sold the Bridgeview Plaza Shopping Center, located in LaCrosse, Wisconsin, providing purchase money financing of \$5.0 million in the form of a wrap mortgage. In 1996, the first lienholder

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called a default under the ARI wrap note, and directed future payments be made directly to them. ARI began legal proceedings against the first lienholder. In December 1999, ARI sold the note to BCM at its carrying value of \$489,000, retaining the right to receive any amounts collected by BCM in excess of the amount paid, plus accrued interest. In 2002, ARI prevailed in its litigation and ARI's lien on the property was restored. The borrower continued in default, and ARI foreclosed on the property in March 2003. The property was subsequently sold to TCI. See NOTE 9. RELATED PARTY TRANSACTIONS.

In 2004, ARI sold the following properties:

| <u>Property</u> | <u>Location</u> | <u>Units /Sq.Ft./ Acres</u> | <u>Sales Price</u> | <u>Net Cash Received/ (Paid)</u> | <u>Debt Discharged</u> | <u>Gain/ (Loss) on Sale</u> |
|------------------------------------|--------------------|---------------------------------|------------------------|--|----------------------------|-------------------------------------|
| Apartments | | | | | | |
| Cliffs of El Dorado ⁽⁵⁾ | McKinney, TX | 208 Units | \$ 13,442 | \$ 10 | \$ 10,323 ⁽¹⁾ | \$ |
| Falcon House | Ft. Walton, FL | 82 Units | 3,330 | 1,178 | 1,950 ⁽¹⁾ | 1,209 |
| In the Pines | Gainesville, FL | 242 Units | 11,300 | 3,247 | 5,201 | 5,517 |
| La Mirada | Jacksonville, FL | 320 Units | 10,500 | 2,576 | 7,098 | 7,576 |
| Park Avenue | Tallahassee, FL | 121 Units | 6,225 | 926 | 4,320 ⁽¹⁾ | 3,922 |
| Sandstone | Mesa, AZ | 238 Units | 8,650 | 2,920 | 5,531 | 1,688 |
| Tiberon Trails | Merrillville, IN | 376 Units | 10,325 | 2,869 | 6,189 ⁽¹⁾ | 49 |
| Industrial Warehouses | | | | | | |
| Kelly (Cash Road) | Dallas, TX | 97,150 Sq. Ft. | 1,500 | 1,077 | 422 | 454 |
| Kelly (Pinewood) | Dallas, TX | 100,000 Sq. Ft. | 1,650 | 65 | 65 | 153 |
| Ogden Industrial | Ogden, UT | 107,112 Sq. Ft. | 2,600 | 668 | 668 | 1,474 |
| Texstar Warehouse | Arlington, TX | 97,846 Sq. Ft. | 2,400 | | | ⁽³⁾ |
| Land | | | | | | |
| Allen | Collin County, TX | 492.5 Acres | 19,962 | 7,956 | 4,088 | 7,915 ⁽²⁾ |
| Marine Creek | Ft. Worth, TX | 10.7 Acres | 1,488 | 1,198 | 991 | ⁽⁷⁾ |
| Mason Goodrich | Houston, TX | 5.7 Acres | 686 | 45 | 588 | 379 |
| Mason Goodrich | Houston, TX | 8.0 Acres | 1,045 | 251 | 200 | 617 |
| Mason Goodrich | Houston, TX | 4.0 Acres | 523 | 33 | 436 | 306 |
| Mason Goodrich | Houston, TX | 2.4 Acres | 250 | 15 | 200 | 115 |
| Mason Goodrich | Houston, TX | 5.0 Acres | 515 | 466 | | 254 |
| Mason Goodrich | Houston, TX | 12.0 Acres | 1,492 | 1,338 | | 854 |
| Meloy Road | Kent, OH | 1.3 Acres | 135 | | 135 | 11 |
| Rasor | Plano, TX | 24.5 Acres | 2,600 | 2,600 | 1,260 | 220 |
| Red Cross | Dallas, TX | 2.9 Acres | 8,500 | 2,842 | 4,450 | |
| Vineyards | Tarrant County, TX | 1.6 Acres | 1,307 | (275) | 548 | 677 |
| Vineyards II | Tarrant County, TX | 1.5 Acres | 1,239 | (261) | 200 | 551 |
| Vista Ridge | Lewisville, TX | 1.3 Acres | 310 | 259 | | 131 |
| Office Buildings | | | | | | |
| 4135 Bellline | Addison, TX | 90,000 Sq. Ft. | 4,900 | 2,472 | 2,009 | 337 |
| Ambulatory Surgery Center | Sterling, VA | 33,832 Sq. Ft. | 8,675 | 5,448 | 2,899 | 784 |
| Atrium | Palm Beach, FL | 74,603 Sq. Ft. | 5,775 | 1,842 | 3,772 | 708 |
| Brandeis ⁽⁶⁾ | Omaha, NE | 319,234 Sq. Ft. | | | | (92) |
| Centura Tower ⁽⁴⁾ | Farmers Branch, TX | 410,901 Sq. Ft. | 84,075 | 36,350 | 49,878 | 38,154 |

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| | | | | | | |
|--|-------------------|-----------------|--------|-------|----------------------|----------------|
| Corporate Pointe | Chantilly, VA | 65,918 Sq. Ft. | 9,000 | 5,025 | 3,585 | 5,533 |
| Countryside Harmon | Sterling, VA | 72,062 Sq. Ft. | 9,150 | 4,608 | 3,865 | 1,931 |
| Countryside Mimado | Sterling, VA | 35,127 Sq. Ft. | 4,000 | 102 | 941 | 72 |
| Countryside Retail | Sterling, VA | 133,422 Sq. Ft. | 27,100 | 3,408 | 3,408 | 6,807 |
| One Steeplechase | Sterling, VA | 103,376 Sq. Ft. | 11,900 | 3,743 | 7,654 | 6,786 |
| Venture Center | Atlanta, GA | 38,272 Sq. Ft. | 4,000 | 997 | 2,550 | 1,381 |
| Shopping Centers | | | | | | |
| Collection | Denver, CO | 267,812 Sq. Ft. | 21,200 | 6,703 | 13,153 | 3,314 |
| K-Mart | Cary, NC | 92,033 Sq. Ft. | 3,200 | | 1,677 ⁽¹⁾ | ⁽³⁾ |
| Plaza on Bachman Creek | Dallas, TX | 80,278 Sq. Ft. | 7,850 | 1,808 | 5,358 | 4,073 |
| Sadler Square | Amelia Island, FL | 70,295 Sq. Ft. | 4,500 | 1,876 | 2,680 | 1,897 |
| Other | | | | | | |
| Signature Athletic Club ⁽²⁾ | Dallas, TX | N/A | 120 | (154) | 88 | (47) |

(1) Debt assumed by purchaser.

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- (2) Signature Athletic Club was sold for the assumption of capital leases by purchaser. Net cash paid is from prepaid dues and unearned revenues due purchaser.
- (3) Sold to BCM, a related party, for assumption of debt and a secured note receivable. See NOTE 3. NOTES AND INTEREST RECEIVABLE. Gain of \$1,157 (Texstar) and \$521 (K-Mart) deferred until sale to unrelated party.
- (4) ARI sold a 95% limited partnership interest, retaining a 1% general partner and 4% limited partner interest.
- (5) Sold to Unified Housing Foundation, Inc. (UHF), a related party, in 2003. See NOTE 9. RELATED PARTY TRANSACTIONS. Gain of \$2,542 deferred until sale to unrelated party.
- (6) Returned to lender. See NOTE 7. NOTES AND INTEREST PAYABLE.
- (7) Sold to UHF. Gain of \$581 deferred until sale to unrelated party.

In 2003, ARI sold the following properties:

| <u>Property</u> | <u>Location</u> | <u>Units/Rooms/ Acres/Sq.Ft.</u> | <u>Sales Price</u> | <u>Net Cash Received/ (Paid)</u> | <u>Debt Discharged</u> | <u>Gain/ (Loss) on Sale</u> |
|-----------------------------------|-------------------|--------------------------------------|------------------------|--|----------------------------|-------------------------------------|
| Apartments | | | | | | |
| Bay Anchor | Panama City, FL | 12 Units | \$ 369 | \$ | \$ 291 | \$ 174 |
| Confederate Point | Jacksonville, FL | 206 Units | 10,700 | 2,780 | 7,241 ⁽³⁾ | 8,373 |
| Georgetown | Panama City, FL | 44 Units | 1,175 | 323 | 789 ⁽³⁾ | 72 |
| Greenbriar | Tallahassee, FL | 50 Units | 1,700 | 594 | 976 ⁽³⁾ | 1,025 |
| Lake Château | Thomasville, GA | 98 Units | 1,600 | 460 | 1,033 | 147 |
| Landing & Marina | Pensacola, FL | 52 Units | 1,825 | 576 | 1,162 ⁽³⁾ | 492 |
| Lincoln Court | Dallas, TX | 55 Units | 3,038 | 1,834 | 1,208 | 1,895 |
| Marquis at Vista Ridge | Lewisville, TX | 288 Units | 17,700 | 2,175 | 15,518 ⁽³⁾ | ⁽²⁾ |
| Northside Villas | Tallahassee, FL | 81 Units | 5,575 | 1,806 | 2,784 | 915 |
| Pincrest | North Augusta, SC | 120 Units | 2,707 | 1,136 | 1,429 | (304) |
| Quail Creek | Lawrence, KS | 95 Units | 4,700 | 1,188 | 3,260 | 1,683 |
| Regency | Lincoln, NE | 106 Units | 4,880 | 838 | 3,179 | 2,815 |
| Rolling Hills | Tallahassee, FL | 134 Units | 5,061 | 1,361 | 2,785 | 1,182 |
| Seville | Tallahassee, FL | 62 Units | 2,795 | | 2,360 | 697 |
| Stone Oak | San Antonio, TX | 252 Units | 6,930 | 3,670 | 2,699 | 4,490 |
| Summerfield | Orlando, FL | 224 Units | 9,415 | 4,845 | 4,476 ⁽³⁾ | 4,268 |
| Treehouse | Irving, TX | 160 Units | 7,500 | | 5,083 ⁽³⁾ | 4,762 ⁽⁸⁾ |
| Willo Wick Gardens | North Augusta, SC | 104 Units | 2,707 | 255 | 1,943 | 1,140 |
| Hotels | | | | | | |
| Clarion KC Airport ⁽⁶⁾ | Kansas City, MO | 196 Rooms | 2,070 | | 4,888 ⁽⁶⁾ | |
| Grand Hotel Sofia | Sofia, Bulgaria | 136 Rooms | 24,750 | 6,258 | 4,209 ⁽³⁾ | (31) ⁽⁴⁾ |
| Industrial Warehouses | | | | | | |
| Kelly (108 th Street) | Dallas, TX | 20,871 Sq.Ft. | 675 | | 634 ⁽³⁾ | 357 |
| Kelly (301 Hilltop) | Dallas, TX | 76,946 Sq.Ft. | 1,800 | | 1,712 ⁽³⁾ | 639 |
| McLeod | Orlando, FL | 110,914 Sq.Ft. | 5,450 | 2,980 | 1,902 | 2,805 |
| Tricon | Atlanta, GA | 570,877 Sq.Ft. | 13,084 | 3,364 | 9,395 | 5,579 |
| Land | | | | | | |
| Eagle Crest | Dallas, TX | 20.0 Acres | 4,000 | | 4,000 ⁽⁸⁾ | ⁽⁸⁾ |
| Jeffries Ranch | Oceanside, CA | 82.4 Acres | 2,900 | 151 | | 1,474 |
| Katrina | Palm Desert, CA | 89.3 Acres | 8,550 | (410) | 2,840 | (40) |

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| | | | | | | |
|---------------------|--------------------|-------------|--------|---------------------|-------|--------|
| Keller | Tarrant County, TX | 30.0 Acres | 2,800 | 2,676 | | 2,063 |
| Mason Goodrich | Houston, TX | 8.0 Acres | 210 | (5) | | (149) |
| Mason Goodrich | Houston, TX | 1.6 Acres | 209 | 12 | 169 | 113 |
| Mason Goodrich | Houston, TX | 7.7 Acres | 900 | 36 | 764 | 466 |
| Mason Goodrich | Houston, TX | 2.8 Acres | 250 | 14 | 197 | 97 |
| Mason Goodrich | Houston, TX | 6.6 Acres | 1,350 | 84 | 1,124 | 964 |
| McKinney Corners II | Collin County, TX | 2.1 Acres | 300 | (60) | 285 | 208 |
| Nashville | Nashville, TN | 1.1 Acres | 201 | 9 | 170 | 135 |
| Nashville | Nashville, TN | 8.8 Acres | 235 | (11) | 217 | 114 |
| Palm Desert | Palm Desert, CA | 25.1 Acres | 2,600 | (88) ⁽⁹⁾ | | 797 |
| Pioneer Crossing | Austin, TX | 367.4 Acres | 22,500 | 4,948 | | 13,916 |
| Pioneer Crossing | Austin, TX | 33.4 Acres | 2,386 | (78) | | (11) |
| Pioneer Crossing | Austin, TX | 113.7 Acres | 1,839 | 718 | | (94) |
| Pioneer Crossing | Austin, TX | 196.6 Acres | 3,911 | 2,839 | | (285) |

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| <u>Property</u> | <u>Location</u> | <u>Units/Rooms/ Acres/Sq.Ft.</u> | <u>Sales Price</u> | <u>Net Cash Received/ (Paid)</u> | <u>Debt Discharged</u> | <u>Gain/ (Loss) on Sale</u> |
|--|--------------------|--------------------------------------|------------------------|--|----------------------------|---|
| Sendero Ranch | Ft. Worth, TX | 14.0 Acres | 300 | 292 | | (770) |
| Scout | Tarrant County, TX | 51.6 Acres | 2,788 | 485 | | 2,321 |
| Solco-Valley Ranch | Farmers Branch, TX | 6.1 Acres | 1,999 | (90) ⁽⁷⁾ | | 529 |
| State Highway 121/Watters Road ⁽¹⁰⁾ | Collin County, TX | 37.1 Acres | 2,188 | 1,197 | 912 | 1,410 |
| Vineyards II | Tarrant County, TX | 4.8 Acres | 2,617 | 225 | 1,570 | 14 |
| Vista Ridge | Lewisville, TX | 14.5 Acres | 2,250 | 713 | 1,343 | 622 |
| Office Buildings | | | | | | |
| 56 Expressway | Oklahoma City, OK | 54,649 Sq.Ft. | \$ 1,702 | \$ 103 | \$ 1,478 ⁽³⁾ | \$ 1,253 |
| Bonita Plaza | Bonita, CA | 47,777 Sq.Ft. | 8,034 | 1,698 | 5,944 | 2,798 |
| Encino Executive Plaza | Encino, CA | 177,211 Sq.Ft. | 37,040 | 1,947 | 33,145 ⁽³⁾ | (67) |
| Remington Tower | Tulsa, OK | 90,009 Sq.Ft. | 3,360 | (80) | 3,360 ⁽³⁾ | (579) |
| Shopping Centers | | | | | | |
| Bridgeview Plaza | LaCrosse, WI | 116,008 Sq.Ft. | 8,700 | | | (1) |
| Cullman | Cullman, AL | 92,466 Sq.Ft. | 2,000 | | 2,650 ⁽³⁾ | (1) |
| Oak Tree Village | Lubbock, TX | 45,623 Sq.Ft. | 3,366 | 1,527 | 1,328 | 820 |
| Parkway Centre | Dallas, TX | 28,374 Sq.Ft. | 4,000 | | 1,640 ⁽³⁾ | 2,470 ⁽⁸⁾ |
| Sheboygan | Sheboygan, WI | 74,532 Sq.Ft. | 1,225 | 669 | 569 | 181 |
| Westwood | Tallahassee, FL | 149,855 Sq.Ft. | 8,950 | 5,045 | 1,880 | 5,787 |

- (1) Sold to TCI to satisfy affiliate debt. Gain of \$8,700 (Bridgeview) and \$1,118 (Cullman) deferred until sale to unrelated party.
- (2) Sold to Housing for Senior of Lewisville, LLC, a related party. Gain of \$125 deferred until sale to unrelated party.
- (3) Debt assumed by purchaser.
- (4) Includes recognition of \$3,117 of accumulated foreign currency translation gains.
- (5) Cash of \$210 was received by BCM and applied to ARI's affiliate debt.
- (6) Sold at foreclosure auction. Impairment of \$3,343 and debt forgiveness of \$2,818 recognized.
- (7) Cash of \$1,999 was received by BCM and applied to ARI's affiliate debt.
- (8) Sold to IORI to satisfy affiliate debt. Gain of \$1,918 deferred until sale to unrelated party.
- (9) Cash of \$2,600 was received by Prime and applied to ARI's affiliate debt.
- (10) Approximately 20.0 acres of Watters Road land and 17.1 acres of State Highway 121 land were sold together in a single transaction.
- (11) Gain of \$1,776 deferred until collection of note receivable.

At December 31, 2004, ARI had the following properties under construction:

| <u>Property</u> | <u>Location</u> | <u>Units</u> | <u>Amount Expended</u> | <u>Additional Amount to Expend</u> | <u>Construction Loan Funding</u> |
|-----------------------|-----------------|--------------|----------------------------|--|--|
| Apartments | | | | | |
| Blue Lake Villas II | Waxahachie, TX | 76 Units | \$ 4,454 | \$ 217 | \$ 4,234 |
| Bluffs at Vista Ridge | Lewisville, TX | 272 Units | 17,239 | 3,347 | 15,500 |

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| | | | | | |
|---|--------------------|-----------|--------|--------|--------|
| Bridges on Kinsey | Tyler, TX | 232 Units | 11,572 | 4,509 | 14,477 |
| Dakota Arms | Lubbock, TX | 208 Units | 12,611 | 1,326 | 12,549 |
| Kingsland Ranch | Houston, TX | 398 Units | 24,573 | 1,081 | 23,000 |
| Laguna Vista | Farmers Branch, TX | 206 Units | 3,432 | 17,673 | 17,741 |
| Lake Forest | Houston, TX | 240 Units | 13,919 | 519 | 12,815 |
| Parc at Maumelle | Maumelle, AR | 240 Units | 4,502 | 14,196 | 16,829 |
| Stonebridge at City Park (formerly 288 City Park) | Houston, TX | 240 Units | 15,486 | 1,201 | 15,005 |
| Vistas of Vance Jackson | San Antonio, TX | 240 Units | 13,393 | 4,708 | 16,056 |
| Wildflower Villas | Temple, TX | 220 Units | 9,377 | 6,220 | 14,073 |

In 2004, ARI completed the 248 unit DeSoto Ranch Apartments in DeSoto, Texas, the 314 unit Verandas at Cityview Apartments in Fort Worth, Texas, the 216 unit Mariposa Villas (Echo Valley) in Dallas, Texas, the 176 unit Breakwater Bay Apartments in Beaumont, Texas, the 156 unit Capitol Hill Apartments in Little Rock, Arkansas and the 332 unit Vistas of Pinnacle Park Apartments in Dallas, Texas.

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AMERICAN REALTY INVESTORS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

NOTE 3. NOTES AND INTEREST RECEIVABLE

| | 2004 | | 2003 | |
|---|----------------------------|------------------|----------------------------|------------------|
| | Estimated Fair Value | Book Value | Estimated Fair Value | Book Value |
| Notes receivable | | | | |
| Performing (including \$42,423 in 2004 and \$35,054 in 2003 from affiliates) | \$ 68,728 | \$ 66,315 | \$ 60,064 | \$ 60,359 |
| Non-performing | 6,755 | 7,044 | 9,800 | 10,819 |
| | <u>\$ 75,483</u> | <u>73,359</u> | <u>\$ 69,864</u> | <u>71,178</u> |
| Interest receivable (including \$1,182 in 2004 and \$2,643 in 2003 from affiliates) | | 1,167 | | 4,050 |
| | | <u>\$ 74,526</u> | | <u>\$ 75,228</u> |

Interest income is recognized on non-performing notes receivable on a cash basis. For the years 2004, 2003, and 2002, unrecognized interest income on such non-performing notes receivable totaled \$961,000, \$583,000 and \$706,000, respectively.

Notes receivable at December 31, 2004, mature from 2003 to 2017 with interest rates ranging from 4.0% to 18.0% per annum and a weighted average rate of 7.3% per annum. Notes receivable are generally collateralized by real estate or interests in real estate and personal guarantees of the borrower and, unless noted otherwise, are so secured. A majority of the notes receivable provide for principal to be paid at maturity. Scheduled principal maturities of \$30.6 million are due in 2005.

In March 2004, ARI sold an 8.0 acre tract of its Mason Goodrich land parcel for \$1.0 million, receiving \$251,000 after payment of closing costs and providing purchase money financing of \$523,000. The secured loan bears interest at 10.0% per annum, requires monthly payments of accrued interest and matures in March 2006. All principal and accrued but unpaid interest is due at maturity.

In March 2004, ARI sold 492.5 acres in Collin County, Texas for \$20.0 million, receiving \$8.0 million after payment of debt and closing costs, and providing purchase money financing of \$7.2 million for a portion of the land on a contingent basis. The secured note bore interest at 7.0% per annum and matured in September 2004. The purchaser extended the note to December 2004 with a \$1.1 million extension payment in September 2004. In December 2004, the note was collected in full, including accrued but unpaid interest.

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In June 2003, ARI sold the 104 unit Willow Wick Apartments in North Augusta, South Carolina, for \$2.7 million and provided \$42,000 of the purchaser's closing costs as seller financing. The note bore interest at 5.0% per annum and required all interest and principal payments be paid at maturity in December 2003. This loan was extended until February 2004 and \$10,000 was received in March 2004. The note, including accrued and unpaid interest, was paid in June 2004. ARI discounted the note \$2,000 and recognized a loss of \$2,000.

In October 2004, TCI sold the In The Pines apartments to a third party and provided \$1.0 million of the purchase price as seller financing in the form of two notes. The first note bears interest at 7.0% per annum, requires monthly interest payments and matured in January 2005. The Purchaser extended this note to March 2005 by paying 1.0% of the outstanding principal balance as an extension fee and then extended the note an

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

additional 30 days to April 2005 by paying an extension fee of 0.5% of the outstanding principal balance. In the event of a default, the note is also secured by membership rights in the purchaser's entity. The second note is unsecured; bears interest at 8.5% per annum, requires monthly interest payments and matured in January 2005. The Purchaser extended this note to March 2005 by paying 1.0% of the outstanding principal balance as an extension fee and then extended the note an additional 30 days to April 2005 by paying an extension fee of 0.5% of the outstanding principal balance.

In November 2004, ARI sold a 1.6 acre tract of its Vineyards II land parcel for \$2.5 million, paying \$536,000 after mortgage paydowns, closing costs, and providing purchase money financing of \$2.0 million. In November 2004, the note was sold to an unrelated party for \$2.0 million plus accrued and unpaid interest.

In August 2001, ARI agreed to fund up to \$5.6 million secured by a second lien on an office building in Dallas, Texas. The note receivable bore interest at a variable rate (then 9.0% per annum), required monthly interest only payments and originally matured in January 2003. As of March 2004, ARI had funded a total of \$4.3 million. On January 22, 2003, ARI agreed to extend the maturity date until May 1, 2003. The collateral used to secure ARI's second lien was seized by the first lien holder. On March 11, 2004, ARI agreed to accept an assignment of claims in litigation as additional security for the note. In December 2004, ARI agreed to a Modification Agreement with the borrower, which was effective November 1, 2003. As of the modified effective date, accrued interest of \$582,000 was added to the principal balance of the note, the interest rate fixed at 9.0% per annum and all principal and interest is due November 2005. ARI also received Pledge and Security Agreements in various partnership interests belonging to the borrower and received various Assignments of Proceeds from sales in certain entities owned by the borrower. ARI reduced accrued interest and principal by \$1.5 million from the receipt of notes receivable assigned to ARI by borrower and by \$605,000 from cash received. ARI also received \$1.4 million in January 2005 that was applied to accrued interest and principal effective December 30, 2004. As a result of this modification, ARI has released \$1.4 million of allowance for loan losses to expense. The following notes were assigned to ARI as payment on the note:

\$678,000 from a partnership that owns an apartment building. This note is unsecured, bears no interest and has no maturity date. Distributions made from the partnership operations will be used to pay the principal on the note.

\$264,000 secured by a second lien on 13 acres of unimproved land. This note bears interest at 9.0% and matured in February 2003. ARI's parent company, ARI, is in negotiations to take title to the collateral, therefore, this note is considered performing and no allowance has been established.

\$466,000 secured by a second lien on 23.3 acres of unimproved land. This note bears interest at 4.0% and is payable upon demand.

\$125,000 secured by a 100% interest in an affiliated company that owns an apartment building. This note bears interest at 12.0%, only requires payments if surplus cash is available and matures in April 2009.

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In March 2002, ARI sold the 174,513 sq. ft. Hartford Office Building in Dallas, Texas, for \$4.0 million and provided the \$4.0 million purchase price as seller financing and an additional \$1.4 million line of credit for leasehold improvements in the form of a first lien mortgage note. The note bears interest at a variable interest rate, currently 7.0% per annum, requires monthly payments of accrued interest and matures in March 2007. As of March 2005, ARI has funded \$788,000 of the additional line of credit.

In July 2002, ARI entered into an agreement to fund up to \$300,000 under a revolving line of credit secured by 100% interest in a partnership of the borrower. The line of credit bears interest at 12.0% per annum, requires monthly payments of accrued interest, and matures in June 2005. ARI has funded the entire \$300,000.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

In October 2002, ARI sold its Varner Road land parcel for \$3.7 million, receiving \$0.7 million after payment of closing costs and providing purchase money financing of \$2.8 million. The loan bore interest at 9.0% per annum, matured in October 2004 and required quarterly interest payments. All principal and accrued but unpaid interest were due at maturity. In October 2004, the note was collected in full, including accrued but unpaid interest.

In September 2003, ARI sold a 367.4 acre tract of its Pioneer Crossing land parcel for \$22.5 million, receiving \$4.9 million after payment of closing costs and providing purchase money financing of \$16.9 million. The note bears interest at 8.0% per annum, matures in September 2006 and requires quarterly payments of accrued interest beginning in January 2004. All principal and accrued but unpaid interest are due at maturity. In November 2003, ARI sold an interest in \$8.0 million of the note for \$7.5 million, receiving \$7.2 million in cash after payment of closing costs and debt pay down. In February 2004, ARI sold an additional interest in \$6.6 million of the note for \$6.3 million, receiving \$6.3 million in cash after payment of closing costs.

In September 1999, in conjunction with the sale of two apartments in Austin, Texas, \$2.1 million in purchase money financing was provided, secured by limited partnership interests in two limited partnerships owned by the buyer. The financing bore interest at 16.0% per annum, required monthly payments of interest only at 6.0% per annum beginning in February 2000, required a \$200,000 principal pay down in December 1999, which was not received, and matured in August 2000. ARI had the option of obtaining the buyer's general and limited partnership interests in the collateral partnerships in full satisfaction of the financing. In March 2000, ARI agreed to forbear foreclosing on the collateral securing the note and released one of the partnership interests, in exchange for a payment of \$250,000 and executed deeds of trusts on certain properties owned by the buyer. In March 2000, the borrower made a \$1.1 million payment, upon receipt of which ARI returned the deeds of trust. The borrower executed a replacement promissory note for the remaining note balance of \$1.0 million, which was unsecured, non-interest bearing and matured in April 2003. In April 2004, a demand letter was sent to the debtor. ARI initiated legal action in June 2004.

In February 2003, ARI sold an 89.3 acre tract of its Katrina land parcel for \$8.5 million, paying \$410,000 after payment of closing costs and debt pay down and providing purchase money financing of \$5.6 million. The note bears interest at 8.0% per annum and matures three years after the recording of the Deed of Trust. Interest will begin accruing after improvements to the site have been completed by ARI. At March 2005, the improvements have begun. The future costs to ARI to complete the improvements, estimated to be \$2.5 million, were accrued in 2002. A principal payment of \$450,000 is due within ten days after a Tentative Parcel Map (the Map) is recorded. At March 2005, negotiations with the buyer to settle any further obligations are underway. Interest payments will be due on the first day of each calendar quarter, beginning with the first quarter following the completion of the site improvements.

In October 2003, ARI sold a 33.4 acre tract of its Pioneer Crossing land parcel for \$2.4 million, paying \$78,000 after payment of closing costs and providing purchase money financing of \$2.4 million. The note bears interest at 10.0% per annum, requires interest-only payments beginning in November 2007 and matures in October 2008.

In November 2003, ARI purchased a note receivable from an unrelated party for \$1.4 million, including accrued and unpaid interest. The note is secured by a first lien Deed of Trust on 13.0 acres of undeveloped land in Harris County, bears interest at the default rate of 18.0%, and matures

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in May 2003. The note is classified as non-performing. Air is negotiating with the borrower to obtain title to the property.

In December 2002, ARI sold a 238.0 acre tract of its Desert Wells land parcel for \$23.8 million, receiving \$321,000 after payment of closing costs and debt paydown and providing purchase money financing of \$21.4

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million. The first lien financing of \$17.8 million bore interest at 8.0% per annum, matured in December 2004 and required payments beginning in March 2003. In March 2003, the note was sold to an unrelated party for \$17.1 million plus accrued and unpaid interest. The buyer of the note has limited recourse against a 53 acre parcel of ARI's Katrina land, in event of default by the borrower. ARI recognized a previously deferred gain of \$15.0 million upon completion of the sale of the note. The second lien financing of \$3.6 million bore interest at 8.0% per annum and matured on March 31, 2003. All principal and interest were due at maturity. In February 2005, the note was exchanged for 23.0 acres of land in Palm Desert, California. See Note 23. SUBSEQUENT EVENTS. In July 2003, ARI advanced an additional \$357,000 to the borrower. The new note bore interest at 8.0% per annum and matured in July 2004. In November 2003, the note was collected in full, including accrued but unpaid interest.

Related Parties. In March 2001, ARI funded \$13.6 million of a \$15.0 million unsecured line of credit to One Realco. A wholly-owned subsidiary of One Realco owns approximately 2.2% of the outstanding shares of ARI's Common Stock. The line of credit bore interest at 12.0% per annum. All principal and interest were due at maturity in February 2002. The line of credit is guaranteed by BCM. In June 2001, \$810,000 in principal and interest was collected. In December 2001, \$825,000 in principal and interest was collected. In February 2002, the line of credit was increased to \$18.0 million, accrued but unpaid interest of \$217,000 was added to the principal, and the maturity date was extended to February 2004. In March 2002, ARI funded an additional \$1.8 million, increasing the outstanding principal balance to \$15.5 million. In October 2002, \$856,900 in interest was collected, by the return of 85,690 shares of ARI Series A Preferred Stock. In June 2003, ARI sold a participating interest in \$5.8 million of the \$15.5 million balance to BCM, receiving 314,141 TCI shares from BCM (see NOTE 1. BASIS OF PRESENTATION.) In February 2004, \$2.3 million in interest was collected, accrued but unpaid interest of \$161,000 was added to the principal, the maturity date was extended to February 2007, and the interest rate was changed to 3.0% over the prime rate, currently at 8.75%. All principal and interest are due at maturity. Ronald E. Kimbrough, Acting Principal Executive Officer, Executive Vice President and Chief Financial Officer of ARI until May 31, 2004, was a 10.0% shareholder of One Realco until July 31, 2004. Mr. Kimbrough did not participate in the day-to-day operations or management of One Realco.

In March 2004, ARI sold a K-Mart in Cary, North Carolina to BCM for \$3.2 million, including the assumption of debt. ARI also provided \$1.5 million of the purchase price as seller financing. The secured note bears interest at 2.0% over the prime rate, currently 7.75%, and matures in April 2005.

In March 2004, ARI sold the Texstar Warehouse in Arlington, Texas to BCM for \$2.4 million, including the assumption of debt. ARI also provided \$1.3 million of the purchase price as seller financing. The secured note bears interest at 2.0% over the prime rate, currently 7.75%, and matures in April 2005.

In December 2003, ARI sold a tract of Marine Creek land to a subsidiary of United Housing Foundation, Inc. (UHF) for \$1.5 million, receiving cash and a note receivable. This sale was not recognized as a sale at that time because UHF is a related party and ARI has continuing involvement and control. In February 2004, Marine Creek was refinanced by UHF, which paid in full ARI's note payable on the land. ARI recorded the sale of the land and received a note receivable of \$270,000, which was the difference between the sales price and the amount of ARI's note payable. The note bears interest at 6.0%, requires quarterly payments from available surplus cash and matures in December 2007. See Note 9. RELATED PARTY TRANSACTIONS.

In October 2004, ARI advanced \$3.3 million to the Class A Limited Partners of Edina Park Plaza Associates, Limited Partnership, of which ARI is the general partner. The loans bear interest at 10.0% per annum and mature in September 2017. Interest due to ARI will be deducted from the quarterly return owed by ARI to the Class A Limited Partners, eliminating the quarterly payments. The outstanding principal is due at maturity.

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In October 2004, ARI contemplated the sale of the common stock of TCI Lexington Corp, which owns the Lexington Center office building in Colorado Springs, Colorado, to One Realco Office Investors, Inc., a related party, for the assumption of debt of \$4.9 million, which was subject to lender approval, and a seller note of \$237,00. The assumption of debt by One Realco Office Investors, Inc. was not approved by the lender; therefore, ARI's Board of Directors rescinded their approval of the transaction. ARI extended the loan on the Lexington Center with the lender in December 2004.

In October 1999, ARI funded a \$4.7 million loan to Realty Advisors. The loan, to provide funds for acquisitions or working capital needs, was secured by all of the outstanding shares of common stock of American Reserve Life Insurance Company. The loan bore interest at 10.25% per annum and matured in November 2001. In January 2000, \$100,000 was collected. In November 2001, the maturity date was extended to November 2004. The collateral was changed to a pledge of 850,000 shares of ARI Common Stock owned by BCM. The interest rate was changed to 2.0% over the prime rate, currently 7.75% per annum, and the accrued but unpaid interest of \$1.0 million was added to the principal. The new principal balance is \$5.6 million. In September 2003, \$673,000 in accrued interest was collected. In August 2004, \$342,000 in accrued interest was collected. In November 2004, the maturity date was extended to November 2006. All principal and accrued interest are due at maturity.

In October 2003, ARI advanced \$1.6 million to the Class A Limited Partners of Encino Executive Plaza, Ltd., of which ARI is the general partner. The loans bear interest at 8.5% per annum and mature in June 2006. Interest due to ARI will be deducted from the quarterly return owed by ARI to the Class A Limited Partners, eliminating the quarterly payments. The outstanding principal is due at maturity.

NOTE 4. ALLOWANCE FOR ESTIMATED LOSSES

Activity in the allowance for estimated losses was as follows:

| | <u>2004</u> | <u>2003</u> | <u>2002</u> |
|---|-----------------|-----------------|-----------------|
| Balance January 1, | \$ 4,633 | \$ 3,077 | \$ 2,577 |
| TCI allowance added through consolidation | | 1,456 | |
| (Decrease) increase in provision | (2,768) | 100 | 500 |
| Balance December 31, | <u>\$ 1,865</u> | <u>\$ 4,633</u> | <u>\$ 3,077</u> |

NOTE 5. INVESTMENTS IN EQUITY INVESTEEES

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Before 2003, ARI's investment in real estate entities included equity securities of IORI and TCI, and interests in real estate joint venture partnerships. BCM, ARI's advisor until June 30, 2003, also served as advisor to IORI and TCI until June 30, 2003.

Through March 31, 2003, ARI accounted for its investment in IORI and TCI and the joint venture partnerships using the equity method. ARI began consolidation of TCI's and IORI's accounts and operations effective March 31, 2003. See NOTE 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES. The effect of consolidating TCI's and IORI's operations from the completion of the tender offer through March 31, 2003 was determined to be immaterial. On June 2, 2003, ARI exchanged all of its 674,971 IORI shares with BCM, receiving 650,000 TCI shares from BCM. In addition, BCM has executed a promissory note in favor of ARI in the amount of \$526,000 (see NOTE 3. NOTES RECEIVABLE). After the exchange, ARI owned 72.9% of the outstanding shares of TCI. On June 30, 2003, ARI sold a participating interest in \$5.8 million of its \$15.5 million line of credit receivable from One Realco to BCM, receiving 314,141 TCI shares from BCM (see NOTE 3. NOTES RECEIVABLE). After the transaction, ARI owned 76.8% of the outstanding shares of TCI. In

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

December 2003, ARI purchased 88,600 TCI shares in market transactions and 204,633 TCI shares in transactions with related parties for a total of \$1.4 million. At December 31, 2004, ARI owned 82.2% of the outstanding shares of TCI. ARI no longer directly owns any IORI shares. At December 31, 2004, ARI owned 19.7% of IORI through TCI's ownership of IORI shares. ARI ceased consolidation of IORI's accounts and operations effective June 2, 2003.

ARI is a non-controlling 30.0% general partner in Sacramento Nine (SAC 9), which owned an office building in Rancho Cordova, California. In December 2004, SAC 9 sold the office building for \$3.7 million, of which ARI received \$1.1 million after closing costs and fees. ARI recognized a gain on the sale of investment in SAC 9 of \$882,000 relating to this transaction.

In December 2004, ARI sold a 95% interest in Garden Centura, L.P. that owns the 410,901 sq. ft. Centura Tower office building located in Farmers Branch, Texas. ARI retained a non-controlling 1% general partner and 4% limited partner interest in Garden Centura, L.P. ARI will account for its investment in this partnership on the cost basis.

The investments in IORI and the joint venture partnerships are accounted for using the equity method as more fully described in NOTE 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES Investments in equity investees.

A significant portion of ARI's investment in IORI and TCI is pledged as collateral for borrowings. See NOTE 7. NOTES AND INTEREST PAYABLE and NOTE 8. MARGIN BORROWINGS.

Investments in equity investees consisted of the following:

| Investee | Percentage of Ownership At December 31, 2004 | Carrying Value of Investment At December 31, 2004 | Equivalent Investee Book Value At December 31, 2004 | Market Value of Investment at December 31, 2004 |
|----------|--|---|--|---|
| IORI | 19.73% | \$ 5,765 | \$ 10,545 | \$ 5,532 |
| Other | | 2,447 | | |
| | | \$ 8,212 | | |

Investee

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| | Percentage of Ownership At December 31, 2003 | Carrying Value of Investment At December 31, 2003 | Equivalent Investee Book Value At December 31, 2003 | Market Value of Investment at December 31, 2003 |
|-------|--|---|--|---|
| IORI | 19.20% | \$ 4,423 | \$ 9,381 | \$ 5,331 |
| Other | | 564 | | |
| | | \$ 4,987 | | |

Set forth below are summary financial data for equity investees:

| | 2004 | 2003 |
|------------------------------------|-----------|-----------|
| Property and notes receivable, net | \$ 86,279 | \$ 95,896 |
| Other assets | 4,662 | 5,248 |
| Notes payable | (44,571) | (60,825) |
| Other liabilities | (2,579) | (1,230) |
| Equity | \$ 43,791 | \$ 39,089 |

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| | <u>2004</u> | <u>2003</u> | <u>2002</u> |
|--|-----------------|-------------------|-----------------|
| Revenues | \$ 9,227 | \$ 35,306 | \$ 121,055 |
| Depreciation | (740) | (5,817) | (20,799) |
| Provision for losses | | (956) | (4,316) |
| Interest | (3,491) | (11,517) | (43,679) |
| Operating expenses | (4,888) | (26,287) | (93,760) |
| Income (loss) from continuing operations | 108 | (9,271) | (41,499) |
| Income (loss) from discontinued operations | (89) | (1,685) | (2,675) |
| Gain from sale of discontinued operations | 5,473 | 5,334 | 51,110 |
| Net income (loss) | <u>\$ 5,492</u> | <u>\$ (5,622)</u> | <u>\$ 6,936</u> |

ARI's equity share of:

| | <u>2004</u> | <u>2003</u> | <u>2002</u> |
|---|-----------------|-------------------|-----------------|
| Loss before gain from sale of discontinued operations | \$ (41) | \$ (4,441) | \$ (20,938) |
| Gain from sale of discontinued operations | 2,212 | 716 | 24,069 |
| Net income (loss) | <u>\$ 2,171</u> | <u>\$ (3,725)</u> | <u>\$ 3,131</u> |

The cash flow from IORI is dependent on the ability of IORI to make distributions. IORI ceased making quarterly distributions in the fourth quarter of 2000.

ARI initially acquired its investment in IORI and TCI in 1989.

NOTE 6. MARKETABLE EQUITY SECURITIES

Since 1994, ARI has purchased equity securities of entities other than those of the IORI and TCI to diversify and increase the liquidity of its margin accounts and its trading portfolio. Trading and available-for-sale portfolio securities are carried at market value. In 2004, ARI did not purchase or sell any marketable securities. At December 31, 2004, ARI recognized an unrealized increase in the market value of its trading portfolio securities of \$82,000. Also at December 31, 2004, ARI recorded an unrealized increase in the market value of its available-for-sale portfolio securities of \$1.6 million. In 2003, ARI purchased \$1.6 million and sold \$108,000 of marketable securities. At December 31, 2003, ARI recognized an unrealized increase in the market value of trading portfolio securities of \$7,000. In 2003, ARI realized \$66,000 in gains from the sale of trading portfolio securities. At December 31, 2002, ARI recognized an unrealized decline in the market value of trading portfolio

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securities of \$25,000. In 2002, ARI realized no gains or losses from the sale of trading portfolio securities and received no dividends. Unrealized and realized gains and losses on trading portfolio securities are included in other income in the accompanying Consolidated Statements of Operations. Unrealized gains and losses on available-for-sale portfolio securities are included in accumulated other comprehensive income in the accompanying Consolidated Balance Sheets.

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AMERICAN REALTY INVESTORS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

NOTE 7. NOTES AND INTEREST PAYABLE

Notes and interest payable consisted of the following:

| | 2004 | | 2003 | |
|--|-------------------------|-------------------|-------------------------|-------------------|
| | Estimated Fair Value | Book Value | Estimated Fair Value | Book Value |
| Notes payable | | | | |
| Mortgage loans | \$ 782,532 | \$ 881,335 | \$ 911,991 | \$ 926,034 |
| Borrowings from financial institutions | 12,715 | 14,030 | 19,104 | 15,414 |
| Notes payable to affiliates | 30,124 | 36,298 | 31,498 | 34,775 |
| | <u>\$ 825,371</u> | <u>931,663</u> | <u>\$ 962,593</u> | <u>976,223</u> |
| Interest payable | | 8,258 | | 10,546 |
| | | <u>\$ 939,921</u> | | <u>\$ 986,769</u> |

Scheduled principal payments on notes payable are due as follows:

| | |
|------------|-------------------|
| 2005 | \$ 236,274 |
| 2006 | 132,712 |
| 2007 | 113,398 |
| 2008 | 62,678 |
| 2009 | 40,526 |
| Thereafter | 346,085 |
| | <u>\$ 931,663</u> |

Stated interest rates on notes payable ranged from 4.0% to 14.8% per annum at December 31, 2004 and matured in varying installments between 2005 and 2046. At December 31, 2004, notes payable were collateralized by deeds of trust on real estate with a net carrying value of \$1,109.1 million.

Prior to February 2004, the Brandeis Office Building in Denver, Colorado was occupied by two tenants, one of which occupied a significant portion of the building. The larger tenant built its own building and moved out, resulting in the office building being at only approximately 20% occupancy. The loan matured in December 2003, and ARI proposed an extension of the maturity of the loan. The lender desired a sufficient pay down of the loan. In February 2004, the title to the Brandeis Office Building was transferred to the lender by agreement. Outstanding indebtedness and accrued interest at that time was \$8.8 million. ARI recorded a net impairment of \$4.4 million in the fourth quarter of 2003 for this transaction.

A subsidiary of ARI developed and constructed a commercial property in Texas, consisting of a 220,000 square foot building, with construction financing guaranteed by ARI. Several challenges occurred with respect to the construction of the property, involving work stoppages, completion of construction by the prime contractor, and actions of the prime contractor with respect to subcontractors. The construction loan matured and ARI proposed to the lender a month-to-month extension, but the lender desired an extension for a two-year period with fees and points which ARI considered to be excessive. During December 2003, ARI sold the property to a related party, which instituted a reorganization proceeding, in an effort to restructure the indebtedness on the property. In November 2004, ARI settled with the contractor, who was also the junior lender, and modified and extended its debt with the primary lender. ARI recognized an \$8.4 million gain on settlement of debt for these transactions.

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AMERICAN REALTY INVESTORS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

In March 2003, ARI received a loan for \$5.0 million that was secured by its investment in equity securities of Realty Korea CR-REIT Co., Ltd. No. 1. The loan was also secured by a second deed of trust on commercial properties in North Carolina and Texas. The loan bore interest at the prime rate plus 1.0%, required monthly interest only payments and matured in August 2004. In May 2003, the loan was paid in full.

In October 2003, ARI borrowed \$1.6 million from IORI, which was then advanced to the Class A Limited Partners of Encino Executive Plaza, Ltd. The loan bore interest at 2.0% per annum and matures in June 2006. All principal and interest are due at maturity. Effective January 1, 2004, the interest rate was changed to 5.49%.

In 2004, ARI financed/refinanced or obtained second mortgage financing on the following:

| <u>Property</u> | <u>Location</u> | <u>Units/Sq. Ft. Rooms/Acres</u> | <u>Debt Incurred</u> | <u>Debt Discharged</u> | <u>Net Cash Received/ (Paid)</u> | <u>Interest Rate</u> | <u>Maturity Date</u> |
|--------------------------------|--------------------|--------------------------------------|--------------------------|----------------------------|--|--------------------------|--------------------------|
| Apartments | | | | | | | |
| Mountain Plaza | El Paso, TX | 188 Units | \$ 5,184 | \$ 4,257 | \$ 370 | 5.16% | 12/34 |
| Treehouse | Irving, TX | 160 Units | 5,780 | 5,027 | 138 | 5.06 | 07/34 |
| Villager | Fort Walton, FL | 33 Units | 804 | 507 | 129 | 5.15 | 06/34 |
| Waters Edge III | Gulfport, MS | 238 Units | 3,250 | | (5) | 12.50 | 12/04(9) |
| Hotels | | | | | | | |
| City Suites | Chicago, IL | 45 Rooms | 3,640 | | 3,548 | 6.75(1) | 09/09 |
| Majestic Inn | San Francisco, CA | 57 Rooms | 2,000(8) | 5,138 | (1,238) | 5.75(1) | 10/05 |
| Williamsburg Hospitality House | Williamsburg, VA | 296 Rooms | 11,500 | 12,332 | (13,689)(3) | 7.00(1) | 03/05(10) |
| Willows | Chicago, IL | 52 Rooms | 3,500 | | 3,411 | 6.75(1) | 09/09 |
| Land | | | | | | | |
| Bonneau | Dallas County, TX | 8.4 Acres | 9,661(6) | 10,283(7) | 76 | 6.75(1) | 09/05 |
| Centura | Farmers Branch, TX | 8.8 Acres | 4,485 | 4,000 | (183) | 7.00(1) | 02/05(11) |
| Chase Oaks | Plano, TX | 5.8 Acres | (6) | | | | |
| Cooks Lane | Ft. Worth, TX | 23.2 Acres | 550 | | | 6.75 | 11/06 |
| Dalho | Farmers Branch, TX | 2.9 Acres | (6) | | | | |
| Dominion/Hollywood | Farmers Branch, TX | 66.1 Acres | 6,985 | 6,222 | (67) | 7.00(1) | 02/05(12) |
| HSM | Farmers Branch, TX | 6.2 Acres | (6) | | | | |
| JHL Connell | Carrollton, TX | 7.6 Acres | (6) | | | | |
| Katy | Harris County, TX | 130.6 Acres | 7,500 | | (75)(4) | 6.00(1) | 02/07 |
| Lacy Longhorn | Farmers Branch, TX | 17.1 Acres | 1,965 | 1,800 | 78 | 4.03(1) | 07/07 |
| Las Colinas | Las Colinas, TX | 1.5 Acres | (6) | | | | |
| Marine Creek | Ft. Worth, TX | 28.4 Acres | 1,785(3) | | 1,746 | 4.03(1) | 07/07 |
| Mason/Goodrich | Houston, TX | 39.4 Acres | 2,133 | 714 | 1,345 | 6.00(1) | 08/05 |
| Stagliano | Farmers Branch, TX | 3.2 Acres | (6) | | | | |
| Vista Ridge | Lewisville, TX | 64.9 Acres | (6) | | | | |
| Walker | Dallas County, TX | 132.6 Acres | 8,750 | 7,950 | 264 | 5.90(1) | 06/06 |
| Office Buildings | | | | | | | |
| 225 Baronne | New Orleans, LA | 416,834 Sq. Ft. | 500(8) | | | 5.75(1) | 10/05 |

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| | | | | | | | |
|--|--------------------|-----------------|-----------------------|--------|---------|---------------------|-------|
| 1010 Common | New Orleans, LA | 494,579 Sq. Ft. | 16,250 | 8,000 | 7,829 | 4.03 ⁽¹⁾ | 07/07 |
| Amoco | New Orleans, LA | 378,244 Sq. Ft. | 1,500 ⁽⁸⁾ | | | 5.75 ⁽¹⁾ | 10/05 |
| Centura Tower | Farmers Branch, TX | 410,901 Sq. Ft. | 34,000 ⁽²⁾ | 36,889 | (4,588) | 5.50 ⁽¹⁾ | 04/06 |
| Centura Tower | Farmers Branch, TX | 410,901 Sq. Ft. | 3,800 ⁽²⁾ | | 3,737 | 5.75 ⁽¹⁾ | 04/06 |
| Centura Tower | Farmers Branch, TX | 410,901 Sq. Ft. | 50,000 | 37,594 | 2,989 | 4.94 | 10/09 |
| Cooley | Farmers Branch, TX | 27,000 Sq. Ft. | 2,600 | 1,726 | 811 | 5.50 ⁽¹⁾ | 09/06 |
| Two Hickory Centre | Farmers Branch, TX | 96,127 Sq. Ft. | 7,500 | 7,500 | (164) | 3.60 ⁽¹⁾ | 05/06 |
| Warehouses | | | | | | | |
| Addison Hangers I & II ⁽¹³⁾ | Addison, TX | 52,650 Sq. Ft. | 4,500 | 2,592 | 1,635 | 10.00 | 09/14 |

- (1) Variable interest rate.
(2) Repaid with proceeds of subsequent \$50,000 loan.
(3) Cash of \$10,961 was received by an affiliate, increasing ARI's affiliate receivable.

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- (4) Cash of \$7,400 was received by an affiliate, increasing ARI's affiliate receivable.
- (5) Cash of \$3,250 was received by an affiliate, increasing ARI's affiliate receivable.
- (6) Single note, with all properties as collateral.
- (7) Debt forgiveness of \$2,268 recognized.
- (8) The Majestic Inn, 225 Baronne Office Building and Amoco Office Building are cross collateralized. The debt incurred on 225 Baronne and Amoco are 2nd lien loans.
- (9) Repaid in December 2004.
- (10) Maturity date extended to September 2005.
- (11) Repaid in February 2005.
- (12) Maturity date extended to February 2006.
- (13) The Addison Hangers were sold in September 2004 to a third party but were then leased back for 10 years on a triple net lease basis. This transaction has been recorded as a financing transaction for accounting purposes.

In July 2004, the stock securing a \$2.6 million security loan was released, following substitution of additional collateral (see NOTE 8. MARGIN BORROWINGS). Accordingly, this loan has been reclassified from Margin borrowings to Notes and interest payable in the Consolidated Balance Sheets.

In 2003, ARI financed/refinanced or obtained second mortgage financing on the following:

| <u>Property</u> | <u>Location</u> | <u>Units/Acres/ Sq. Ft.</u> | <u>Debt Incurred</u> | <u>Debt Discharged</u> | <u>Net Cash Received/ (Paid)</u> | <u>Interest Rate</u> | <u>Maturity Date</u> |
|------------------------------|--------------------|---------------------------------|--------------------------|----------------------------|--|--------------------------|--------------------------|
| Apartments | | | | | | | |
| Arlington Place | Pasadena, TX | 230 Units | \$ 1,500 | \$ | \$ (2) | 5.00% | 05/03 ⁽³⁾ |
| Plantation | Tulsa, OK | 138 Units | 2,320 | 1,924 | 173 | 5.60 | 06/29 |
| Tree House | Irving, TX | 160 Units | 5,100 | 2,518 | 2,132 | 5.00 ⁽¹⁾ | 08/13 |
| Windsor Tower | Ocala, FL | 64 Units | 2,000 | 1,989 | (104) | 4.75 | 08/08 |
| Industrial Warehouses | | | | | | | |
| Ogden Industrial | Ogden, UT | 107,112 Sq. Ft. | 1,800 | | 1,722 | 6.25 ⁽¹⁾ | 04/05 |
| Land | | | | | | | |
| Elm Fork | Denton County, TX | 101.0 Acres | 5,000 | 1,551 | 2,885 | 10.75 | 03/04 |
| Katrina | Palm Desert, CA | 52.0 Acres | 5,100 | 3,000 | 1,795 | 6.25 ⁽¹⁾ | 05/05 |
| Keller | Tarrant County, TX | 30.1 Acres | 2,016 ⁽⁴⁾ | 450 | 1,494 | 7.50 | 07/04 |
| Lacy Longhorn | Farmers Branch, TX | 17.1 Acres | ⁽⁴⁾ | | | | |
| Las Colinas | Las Colinas, TX | 13.0 Acres | ⁽⁴⁾ | | | | |
| Las Colinas | Las Colinas, TX | 55.7 Acres | 6,885 | 17,338 | (11,622) | 7.00 ⁽¹⁾ | 11/04 |
| Mason Goodrich | Houston, TX | 84.0 Acres | 3,750 | 757 | 2,850 | 6.25 ⁽¹⁾ | 06/04 |
| McKinney Corners II | Collin County, TX | 11.0 Acres | ⁽⁴⁾ | | | | |
| Nashville | Nashville, TN | 113.8 Acres | 6,059 | 807 | 4,725 | 14.00 | 03/04 |
| Nashville | Nashville, TN | 113.8 Acres | 941 | | 737 | 14.00 | 03/04 |
| Rasor | Plano, TX | 23.7 Acres | 1,260 | | 1,214 | 7.00 ⁽¹⁾ | 11/04 |
| Thompson | Farmers Branch, TX | 3.3 Acres | ⁽⁴⁾ | | | | |

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| | | | | | | | | |
|---------------------------|--------------------|-----------------|-----------------------|--------|-------|---------------------|-------|--|
| Tomlin | Farmers Branch, TX | 9.0 Acres | (4) | | | | | |
| Valwood | Dallas County, TX | 235.0 Acres | 8,100 | 5,400 | 1,745 | 7.00 ⁽¹⁾ | 11/06 | |
| Vineyards II | Tarrant County, TX | 18.6 Acres | 3,280 | 3,750 | (583) | 6.75 ⁽¹⁾ | 02/06 | |
| Office Buildings | | | | | | | | |
| 1010 Common | New Orleans, LA | 494,579 Sq. Ft. | 5,574 | 7,876 | 1,320 | 5.50 ⁽¹⁾ | 12/06 | |
| 225 Baronne | New Orleans, LA | 416,834 Sq. Ft. | 6,286 | 7,108 | | 5.50 ⁽¹⁾ | 12/06 | |
| Ambulatory Surgery Center | Sterling, VA | 33,832 Sq. Ft. | 3,425 | 6,269 | | 5.25 ⁽¹⁾ | 12/06 | |
| Amoco | New Orleans, LA | 378,244 Sq. Ft. | 10,140 | 14,408 | | 5.50 ⁽¹⁾ | 12/06 | |
| Countryside Retail Center | Sterling, VA | 133,422 Sq. Ft. | 17,342 | 16,102 | 101 | 5.25 ⁽¹⁾ | 12/06 | |
| Harmon | Sterling, VA | 72,062 Sq. Ft. | 8,869 | 7,569 | | 5.25 ⁽¹⁾ | 12/06 | |
| Mimado | Sterling, VA | 35,127 Sq. Ft. | 4,790 | 4,486 | | 5.25 ⁽¹⁾ | 12/06 | |
| One Hickory Centre | Farmers Branch, TX | 102,615 Sq. Ft. | 11,973 ⁽⁵⁾ | | | 5.49 | 10/06 | |

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AMERICAN REALTY INVESTORS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

| <u>Property</u> | <u>Location</u> | <u>Units/Acres/ Sq. Ft.</u> | <u>Debt Incurred</u> | <u>Debt Discharged</u> | <u>Net Cash Received/ (Paid)</u> | <u>Interest Rate</u> | <u>Maturity Date</u> |
|-------------------------|-----------------|---------------------------------|--------------------------|----------------------------|--|--------------------------|--------------------------|
| Shopping Centers | | | | | | | |
| Bridgeview | LaCrosse, WI | 116,008 Sq. Ft. | 6,500 | | 6,152 | 6.25 ⁽¹⁾ | 04/05 |
| Cullman | Cullman, AL | 92,433 Sq. Ft. | 1,700 | 2,650 | 1,048 | 6.25 ⁽¹⁾ | 04/05 |

- (1) Variable interest rate.
- (2) Cash of \$1,500 was received by BCM and applied to ARI's affiliate debt.
- (3) Paid in July 2003.
- (4) Single note, with all properties as collateral.
- (5) Payable to IORI. In April 2002, ARI sold the company that owned One Hickory Centre to TCI. The transaction was accounted for as a note payable. In October 2003, TCI sold One Hickory Centre to IORI for \$12.2 million, providing purchase money wraparound financing of \$12.0 million. Also in October 2003, IORI sold One Hickory Centre to ARI for \$12.2 million, providing purchase money wraparound financing of \$12.0 million. These additional transactions discharged the 2002 financing from TCI.

NOTE 8. MARGIN BORROWINGS

ARI has margin arrangements with various financial institutions and brokerage firms, which provide for borrowings of up to 50.0% of the market value of marketable equity securities. The borrowings under such margin arrangements are secured by the equity securities of IORI and TCI and ARI's trading portfolio securities and bear interest rates ranging from 6.75% to 24.0% per annum. Margin borrowings were \$18.7 million at December 31, 2004 and \$21.2 million at December 31, 2003, representing 20.8% and 22.2%, respectively, of the market values of the equity securities at those dates.

Sunset Management Loan. 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. (TCI) in the United States District Court for the Northern District of Texas, Dallas Division, against American Realty Investors, Inc. (ARI), Basic Capital Management, Inc. (BCM), Prime Income Asset Management, Inc. (PIAMI), Prime Income Asset Management LLC (Prime), Income Opportunity Realty Investors, Inc. (IORI), United Housing Foundation, Inc. (United), Regis Realty, Inc. (Regis), TCI, TCI's current directors and officers and others. Sunset's complaint was instituted as Case No. 3:04-CV-02162-B styled *Sunset Management, LLC, derivatively on behalf of Transcontinental Realty Investors, Inc. v. American Realty Investors, Inc., et al.* Sunset's complaint alleges (i) Sunset is the owner of ten shares of Common Stock of TCI, and Sunset is the pledgee and beneficial owner of 3,673,115 shares of Common Stock of TCI, (ii) Sunset is a single-member limited liability company, (iii) that all of the defendants have in their various capacities breached fiduciary duties to TCI and (iv) unjust enrichment of the various defendants. Sunset's complaint seeks an injunction prohibiting TCI from entering into any related-party transactions that are not fair to TCI and approved by disinterested directors and/or the stockholders with full knowledge of the common interest of the directors and/or officers, unspecified damages, attorneys' fees and costs. Individual directors and officers of TCI do not believe their interests are adverse to TCI in this matter. All defendants believe the action is not properly brought as a derivative action on behalf of TCI, as Sunset's interests are adverse to the interests of TCI. The current action brought by Sunset contains many of the same allegations raised by Sunset in four other cases, which, as rulings have occurred, have resulted in a denial of Sunset's requested relief.

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The Defendants intend to vigorously defend the action and have 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 exception for stockholder derivative actions, and that Sunset cannot fairly and adequately represent the interests of other stockholders.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

On December 23, 2004, Sunset filed another Complaint in the United States District Court for the Northern District of Texas, Dallas Division, against ARI, BCM, EQK Holdings, Inc. (EQK) and American Realty Trust, Inc. (ART). EQK and ART are subsidiaries of ARI. Sunset's Complaint was instituted as Case No. 3:04-CV-02710-K styled *Sunset Management LLC, Plaintiff v. American Realty Investors, Inc., Basic Capital Management, Inc., EQK Holdings, Inc. and American Realty Trust, Inc.*, alleging (i) that on September 17, 2001, Sunset lent BCM, EQK, ART and ART Williamsburg, Inc. \$30,000,000, and in connection with such loan, BCM, EQK and ART pledged 3,673,115 shares of TCI stock to Sunset; 2,129,701 TCI shares pledged to Sunset by EQK; 920,507 TCI shares pledged to Sunset by BCM, and 622,907 shares pledged to Sunset by ART, (ii) that each of the stock pledge agreements specifically provides that the borrower will not without the written consent of Sunset, sell, dispose of, transfer directly or indirectly, or further encumber the Pledged Securities, (iii) some or all of the shares pledged by BCM and ART had been transferred to one or more subsidiaries of ARI in violation of the stock pledge agreements, (iv) BCM and ART have allegedly breached the stock pledge agreements by transferring certain shares of TCI, (v) that ARI and EQK have allegedly tortuously interfered with existing contractual relationships among BCM, ART and Sunset. Sunset's Complaint seeks specific performance under the stock pledge agreements, and that the Court enter an Order (a) requiring ART to reacquire at least 534,307 pledged shares it allegedly transferred to EQK, (b) requiring BCM to reacquire at least 920,507 pledged shares it allegedly transferred to EQK, (c) requiring EQK to transfer 534,307 pledged shares back to ART, and (d) requiring EQK 920,507 pledged shares back to BCM. On February 2, 2005, the Defendants in this case filed a Motion to Dismiss or in the Alternative to Stay Action Pending the Resolution of Prior Proceedings in a sister federal court based upon dependency of an adversary proceeding in the United States Bankruptcy Court for the Eastern District of Texas, Sherman Division (Plano, Texas), styled *American Realty Trust, Inc. v. Sunset Management LLC*, Adversary Proceeding No. 03-4256 (E.D. Texas), which is described in the following paragraphs as the Texas Litigation. No hearing has been held or Order issued by the Court on such Motion through March 30, 2005.

The current Sunset complaint is the fifth in a continuing series of actions involving Sunset, certain subsidiaries of ARI, and ARI resulting from a loan in September 2001 to BCM and three subsidiaries of ARI in the original amount of \$30 million (\$19.5 million of which bore interest at 24.0% per annum, while the remaining \$10.5 million of which bore interest at 20.0% per annum). In September 2002, \$15 million in principal was repaid leaving a \$15 million balance, which Sunset orally agreed to extend the maturity date and accept substitute collateral, an arrangement which Sunset did not honor, resulting in original litigation filed in Texas state court during October 2002 styled *American Realty Trust, Inc. ART Williamsburg, Inc., Basic Capital Management, Inc. and EQK Holdings, Inc. v. Sunset Management, LLC, et al.*, Cause No. 02-09433-I in the 162nd Judicial District Court of Dallas County, Texas (the Texas Litigation). The Texas Litigation alleged breach of contract, misrepresentation, breach of duty of good faith and fair dealing and slander of title by Sunset and sought certain declaratory relief against Sunset, as well as a temporary and permanent anti-suit injunction against Sunset.

During January 2003, without notice to the plaintiffs in the Texas Litigation, Sunset instituted an action in federal district court in Las Vegas, Nevada against Commonwealth Land Title (Commonwealth) seeking disposition of certain shares of Common Stock of TCI held by Commonwealth as Pledge Holder. On January 31, 2003 after a Temporary Restraining Order was issued in the Texas Litigation, Sunset instituted a separate lawsuit in state court in Nevada styled *Sunset Management, LLC v. American Realty Trust, Inc., et al.*, Cause No. A462587 pending in District Court of Clark County, Nevada (the Nevada Litigation). On February 12, 2003, the Nevada state court held a hearing on Sunset's request for emergency relief and denied all Sunset's requested relief and indicated that a stay of the Nevada Litigation may be appropriate, which stay of litigation (including claims against TCI) was granted on May 2, 2003. Notwithstanding the stay of the Nevada Litigation, Sunset has continued to attempt to re-litigate the underlying fact issues already determined in the Texas Litigation and the Nevada Litigation through cross claims and counterclaims in the Texas Litigation and renewed motions for injunctions and

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

appointment of a receiver in the Nevada Litigation. During September 2003, the Texas Litigation was removed to the bankruptcy court for the Northern District of Texas and subsequently transferred to the Eastern District of Texas. Sunset and the Plaintiffs have filed cross-motions for partial summary judgment in the bankruptcy court, which have been briefed but remain pending at this time. The parties have also filed an agreed motion to withdraw the reference and have the case transferred to a United States District Judge for trial, which has been denied without prejudice pending the resolution of pretrial motions, including the motions for summary judgment.

On February 10, 2004, Sunset filed yet another lawsuit in Nevada styled *Sunset Management L.L.C. v. Transcontinental Realty Investors, Inc.*, Case No. CV04-00345 in the Superior Court of Washoe County, seeking to compel a new election of directors, alleging that Sunset was improperly denied voting rights with respect to certain pledged shares at the 2003 stockholders' meeting of TCI. TCI responded to that action by informing the Nevada Court that the issue of the validity and effectiveness of proxies purportedly held by Sunset in connection with the loan was already pending before the bankruptcy court. On May 12, 2004, the Nevada District Court denied Sunset's motion to compel an election of corporate directors because of the dispute pending in the Texas bankruptcy court concerning the status of the loan. Subsequently, the Nevada Court denied two motions for reconsideration filed by Sunset. Sunset is currently appealing the rulings of the Washoe District Court.

Security Loans. In September 2003, ARI obtained a security loan in the amount of \$12.5 million from a financial institution. The loan bears interest at 12.0% over the 30-day LIBOR rate, currently 14.8%, requires monthly payments of interest only and matured in September 2004. The loan is secured by 1,656,537 shares of TCI common stock held by ARI. In September 2004, the maturity date was extended to December 2004. In December 2004, the maturity date was extended to March 2005. In March 2005, the maturity date was extended to March 2006.

In September 2003, ARI obtained a security loan in the amount of \$1.0 million from a financial institution. The loan bears interest at 12.0% over the 30-day LIBOR rate, currently 14.8%, requires monthly payments of interest only and matured in September 2004. The loan is secured by 250,000 shares of IORI common stock held by ARI. In September 2004, the maturity date was extended to December 2004. In December 2004, the maturity date was extended to March 2005. In March 2005, the maturity date was extended to March 2006.

In October 2003, ARI obtained a security loan in the amount of \$2.6 million from a financial institution. The loan bears interest at 9.0% over the six-month LIBOR rate, currently 12.3% (not to exceed 10.5%), requires monthly interest payments, and matures in November 2004. In 2003, \$1.8 million was advanced to ARI. In April 2004, an additional \$0.8 million was advanced. The loan was partially secured by 825,666 shares of TCI common stock held by ARI. In July 2004, additional collateral provided by an affiliate of ARI was substituted for the TCI shares, and the shares were returned to ARI. Accordingly, this loan has been reclassified from Margin borrowings to Notes and interest payable in the Consolidated Balance Sheets.

In October 2001, ARI obtained a security loan in the amount of \$1.0 million from a financial institution. The loan bore interest at 1.0% over the prime rate, required monthly payments of interest only, and matured in October 2003. The loan was secured by 250,000 shares of ARI Common Stock held by BCM. In October 2003, the maturity date was extended to December 2003. In February 2004, ARI paid \$450,000 in principal, and the maturity date was extended to February 2005. In February 2005, the note was paid in full.

In August 2003, ARI obtained a security loan in the amount of 5.0 million from a financial institution in Bulgaria. The funds were used for earnest money for a potential property acquisition in Bulgaria. The loan bore interest at 4.33% over the six-month EURIBOR rate and matured in November 2003. Principal and accrued interest were due at maturity. The loan was secured by 825,666 shares of TCI common stock held by ARI. In October 2003, the earnest money was returned to ARI. In November 2003, the loan was repaid.

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NOTE 9. RELATED PARTY TRANSACTIONS

In October 2003, ARI obtained a security loan in the amount of \$2.6 million from a financial institution. In 2003, \$1.8 million was advanced. In April 2004, an additional \$825,000 was advanced. The proceeds were paid to an affiliate, increasing ARI's affiliate receivable.

In January 2004, ARI issued 200,000 shares of Series A 10.0% Cumulative Convertible Preferred Stock to Prime, ARI's advisor. In February 2004, 50,000 additional shares were issued to Prime. ARI's affiliate receivable was increased by \$2.5 million.

In February 2004, ARI obtained an unsecured loan of \$5.0 million. The proceeds of \$5.0 million were received by an affiliate, increasing ARI's affiliate receivable.

In February 2004, ARI obtained financing of \$7.5 million on the Katy land tract. The funds, along with additional cash of \$6.3 million, were sent to an affiliate. Subsequently, the affiliate paid off the existing loan balance on an ARI property.

In December 2003, ARI sold a tract of Marine Creek land to a subsidiary of United Housing Foundation, Inc. (UHF) for \$1.5 million, receiving cash and a note receivable. This sale was not recognized as a sale at that time because UHF is a related party and ARI has continuing involvement and control. In February 2004, Marine Creek was refinanced by UHF, which paid in full ARI's note payable on the land. ARI recorded the sale of the land and received a note receivable of \$270,000, which was the difference between the sales price and the amount of ARI's note payable. The note bears interest at 6.0%, requires quarterly payments from available surplus cash and matures in December 2007. See Note 9. RELATED PARTY TRANSACTIONS.

In March 2001, ARI funded \$13.6 million of a \$15.0 million unsecured line of credit to One Realco. A wholly-owned subsidiary of One Realco owns approximately 2.1% of the outstanding shares of ARI's Common Stock. The line of credit bore interest at 12.0% per annum. All principal and interest were due at maturity in February 2002. The line of credit is guaranteed by BCM. In June 2001, \$810,000 in principal and interest was collected. In December 2001, \$825,000 in principal and interest was collected. In February 2002, the line of credit was increased to \$18.0 million, accrued but unpaid interest of \$217,000 was added to the principal, and the maturity date was extended to February 2004. In March 2002, ARI funded an additional \$1.8 million, increasing the outstanding principal balance to \$15.5 million. In October 2002, \$856,900 in interest was collected, by the return of 85,690 shares of ARI Series A Preferred Stock. In June 2003, ARI sold a participating interest in \$5.8 million of the \$15.5 million balance to BCM, receiving 314,141 TCI shares from BCM (see NOTE 1. BASIS OF PRESENTATION.) In February 2004, \$2.3 million in interest was collected, accrued but unpaid interest of \$161,000 was added to the principal, the maturity date was extended to February 2007, and the interest rate was changed to 3.0% over the prime rate, currently at 8.75%. All principal and interest are due at maturity. Ronald E. Kimbrough, Acting Principal Executive Officer, Executive Vice President and Chief Financial Officer of ARI until May 31, 2004, was a 10.0% shareholder of One Realco until July 31, 2004. Mr. Kimbrough did not participate in the day-to-day operations or management of One Realco.

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In March 2004, ARI obtained financing of \$11.5 million on a hotel property. The proceeds of \$11.0 million were received by an affiliate, increasing ARI's affiliate receivable. In December 2004, the proceeds were paid to ARI.

In May 2004, ARI purchased the Treehouse Apartments from an affiliate, with a net purchase price of \$7.5 million after assumption of debt and a note receivable, less cash received of \$498,000. The note receivable was from the sale of the Cliffs of El Dorado Apartments to a related party in 2003. At that time, the sale of the Cliffs of El Dorado was not recorded as a sale for accounting purposes. ARI recorded the sale of the Cliffs of El Dorado in May 2004, due to payment received for the Cliffs of El Dorado note receivable.

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In July 2004, ARI obtained a loan of \$3.2 million secured by a contract for sale of the Waters Edge III Apartments. The proceeds of \$3.2 million were received by an affiliate, increasing ARI's affiliate receivable.

In August 2003, ARI sold three Chicago hotels to a related party for \$13.5 million, including the assumption of debt. Due to the sale to a related party to ARI and ARI having continued involvement and control of this entity, this transaction was not recorded as a sale. In September 2004, ARI purchased the three Chicago hotels from the related party for assumption of debt and cancellation of the seller notes.

In September 2004, ARI sold 10.0 acres of land to an affiliate for a purchase price of \$720,000 for a note receivable. Due to no cash received and common control, ARI has elected to continue consolidating this tract of land until the requirements for a sale have been met. No sale has been recognized and no note receivable has been recorded.

In October 1999, ARI funded a \$4.7 million loan to Realty Advisors. The loan, to provide funds for acquisitions or working capital needs, was secured by all of the outstanding shares of common stock of American Reserve Life Insurance Company. The loan bore interest at 10.25% per annum, and matured in November 2001. In January 2000, \$100,000 was collected. In November 2001, the maturity date was extended to November 2004. The collateral was changed to a pledge of 850,000 shares of ARI Common Stock owned by BCM. The interest rate was changed to 2.0% over the prime rate, currently 7.75% per annum, and the accrued but unpaid interest of \$1.0 million was added to the principal. The new principal balance is \$5.6 million. In September 2003, \$673,000 in accrued interest was collected. In August 2004, \$342,000 in accrued interest was collected. In November 2004, the maturity date was extended to November 2006. All principal and accrued interest are due at maturity.

In March 2003, ARI sold the Bridgeview Plaza and Cullman shopping centers to TCI for \$10.7 million to satisfy debt. TCI assumed debt of \$2.7 million on Cullman. TCI received \$5.1 million cash on the subsequent financing of the shopping centers.

In May 2003, ARI sold its Solco-Valley Ranch land parcel. The proceeds of \$2.0 million were received by BCM, reducing ARI's affiliate debt by \$2.0 million. (See NOTE 2. REAL ESTATE.)

On June 2, 2003, ARI exchanged all of its 674,971 IORI shares with BCM, receiving 650,000 TCI shares from BCM. In addition, BCM executed a promissory note in favor of ARI in the amount of \$526,000 (see NOTE 3. NOTES RECEIVABLE). On June 30, 2003, ARI sold a participating interest in \$5.8 million of its \$15.5 million line of credit receivable from One Realco to BCM, receiving 314,141 TCI shares from BCM. In December 2003, ARI purchased 204,633 TCI shares in transactions with related parties for a total of \$1.4 million.

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In June 2003, ARI received funds of \$757,000 from an affiliate, reducing the affiliate receivable. The funds paid down a note secured by undeveloped land in Harris County, Texas.

Effective July 1, 2003, PAMI became the advisor to ARI and TCI. PAMI is owned by Realty Advisors (80.0%) and Syntek West, (20.0%). Syntek West is owned by Gene Phillips. Effective August 18, 2003, PAMI changed its name to PIAMI. On October 1, 2003, Prime, which is 100% owned by PIAMI, replaced PIAMI as the advisor to ARI and TCI.

In July 2003, ARI sold its interest in Milano Restaurants International Corporation (MRI) to Gruppa Florentina, LLC (Gruppa), for \$18.5 million, receiving \$7.4 million in cash after debt assumption and providing purchase money financing of \$2.3 million (see NOTE 3. NOTES RECEIVABLE). ARI owns 20.0% of Gruppa, thereby retaining a 20.0% interest in MRI. ARI remains as the guarantor of \$8.7 million of assumed

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debt and is one of the guarantors of \$7.5 million in new debt obtained by Gruppa. Due to the debt guarantees and ARI's continuing ownership interest in MRI, management has determined that this should be accounted for as a financing transaction. In September 2003, ARI sold the note to Syntek West for \$2.3 million, plus accrued but unpaid interest, to reduce affiliate debt.

In July 2003, ARI paid \$3.1 million to BCM for a pro-rata portion of prior year's legal fees incurred by Gene Phillips. Mr. Phillips is a related party and advisor to ARI.

In September 2003, ARI sold its Palm Desert land parcel. The proceeds of \$2.6 million were received by an affiliate, reducing ARI's affiliate debt by \$2.6 million. (See NOTE 2. REAL ESTATE.)

In October 2003, ARI borrowed \$1.6 million from IORI, which was then advanced to the Class A Limited Partners of Encino Executive Plaza, Ltd. The loan bore interest at 2.0% per annum and matures in June 2006. All principal and interest are due at maturity. Effective January 1, 2004, the interest rate was changed to 5.49%.

In October 2003, ARI advanced \$1.6 million to the Class A Limited Partners of Encino Executive Plaza, Ltd., of which ARI is the general partner. The loans bear interest at 8.5% per annum and mature in June 2006. Interest due to ARI will be deducted from the quarterly return owed by ARI to the Class A Limited Partners, eliminating the quarterly payments. The outstanding principal is due at maturity.

In October 2003, ARI purchased the Travelers land from IORI for \$25.0 million, paying \$1.9 million in cash and giving a wrap note payable to IORI for \$22.8 million. The note bears interest at 5.49% per annum, requires monthly payments sufficient to pay the installments due on the underlying debt and matures in October 2006. The principal is due at maturity.

In November 2003, ARI sold its Scout land parcel for \$2.8 million, receiving \$485,000 in cash after paying closing costs and providing purchase money financing of \$2.1 million. The note bore interest at 6.25% per annum, required monthly payments of accrued interest beginning in December 2003 and matured in November 2006. All principal and accrued but unpaid interest were due at maturity. In December 2003, the note was sold to Realty Advisors, a related party, for \$2.1 million, plus accrued interest, to reduce ARI's affiliate debt.

In December 2003, ARI sold its Jeffries Ranch land parcel for \$2.9 million, receiving \$151,000 after payment of closing costs and providing purchase money financing of \$2.5 million. Also in December 2003, the note was sold to Realty Advisors for \$2.5 million, to reduce ARI's affiliate debt.

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In December 2003, ARI sold Treehouse Apartments and Parkway Centre to IORI for \$11.5 million, including the assumption of debt. This transaction increased ARI's affiliate receivable by \$4.8 million. (See NOTE 2. REAL ESTATE.)

In December 2003, ARI sold Eagle Crest land to IORI for \$4.0 million. This transaction decreased ARI's affiliate payable to IORI by \$4.0 million. (See NOTE 2. REAL ESTATE.)

In December 2003, ARI's Board of Directors approved the payment to Regis of a six percent (6.0%) construction management fee on all construction projects in process at December 31, 2003, to be applied to all construction costs incurred during 2003 on each project. The resulting calculation of \$4.1 million was treated as a reduction in the affiliate receivable balance from Prime.

In December 2003, ARI sold seven properties to subsidiaries of Unified Housing Foundation, Inc. (UHF), a Texas Non-Profit 501(c) 3 Corporation. ARI sold 39.3 acres of Pioneer Crossing land for \$3.9 million, 10.7

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acres of Marine Creek land for \$1.5 million, the Limestone at Vista Ridge Apartments for \$19.0 million, the Cliffs of El Dorado Apartments for \$13.4 million, the Limestone Canyon Apartments for \$18.0 million, the Sendero Ridge Apartments for \$29.4 million, and Tivoli Apartments for \$16.1 million. All of the transactions included the assumption of debt and notes receivable to ARI for the remainder of the purchase price. Ted Stokely, Chairman of the Board of ARI, is the General Manager of UHF. Richard Humphrey, who is employed by Regis Realty I, LLC, an affiliate, is President of UHF. Due to UHF being considered a related party to ARI and ARI having continued involvement and control of these entities, these transactions have not been recorded as sales. Instead, these transactions will be accounted for on the deposit method, and the properties and corresponding debt will continue to be consolidated by ARI. All of these transactions were approved by ARI's Board of Directors. Mr. Stokely abstained from voting on all of these transactions. The loans on Limestone Canyon apartments and Limestone at Vista Ridge apartments were approved by their prospective lenders for transfer to the purchasing entities. ARI has guaranteed the loans on both of these transfers. Also, Marine Creek land and the Cliffs of El Dorado apartments were recognized as sales during 2004. See NOTE 2. REAL ESTATE. Management is currently seeking lender approval on the transfer of the notes associated with the Tivoli apartments and Sendero Ridge apartments.

In December 2000, an unsecured loan with a remaining principal balance of \$1.8 million to Warwick of Summit, Inc. (Warwick) matured. The loan was made to provide funds to purchase, renovate and expand a shopping center property in Warwick, Rhode Island. All principal and interest were due at maturity. In February 2002, \$275,000 of interest was received. In March 2003, \$27,000 of principal and \$223,000 of interest was received. In April 2003, \$149,000 of principal and \$26,000 of interest was received. In July 2003, \$10,000 of interest was received. Richard D. Morgan, a Warwick shareholder, served as a director of ARI until October 2001. In December 2003, the note was sold to Prime for \$1.8 million, to reduce ARI's affiliate debt.

In December 2000, a loan with a principal balance of \$1.6 million to Bordeaux Investments Two, L.L.C. (Bordeaux), matured. The loan, to provide funds to purchase and renovate a shopping center property in Oklahoma City, Oklahoma, was secured by (1) a 100% interest in Bordeaux, which owns a shopping center in Oklahoma City, Oklahoma; (2) 100% of the stock of Bordeaux Investments One, Inc., which owns 6.5 acres of undeveloped land in Oklahoma City, Oklahoma; and (3) the personal guarantees of the Bordeaux members. Richard D. Morgan, a Bordeaux member until July 2003, served as a director of ARI until October 2001. In July 2003, the members of Bordeaux assigned 100% of the membership interest in Bordeaux to ARI in payment of the note. ARI recorded real estate assets of \$8.8 million and assumed \$7.2 million of mortgage debt and other liabilities on the shopping center and the undeveloped land. No gain or loss was recorded on this transaction. In December 2003, the shopping center was exchanged with Regis I, a related party, for three notes receivable: \$1.4 million from Harvest Hill; \$1.4 million from Harvest Hill I; and \$2.1 million from Harvest Hill III, related parties. All three notes bear interest at 12.0%, mature in October 2013, and require monthly payments of interest, to the extent surplus cash is available, beginning in November 2003. No payments have been received to date. Ted P. Stokely, Chairman of the Board and a Director of ARI, is the General Manager of Unified, a related party, which is the sole member of Harvest Hill, Harvest Hill I, and Harvest Hill III.

In March 2000, a loan with a remaining principal balance of \$2.6 million to Lordstown, L.P., matured. The loan, to provide funds to purchase for resale various parcels of land, is secured by a second lien on land in Ohio and Florida, by 100% of the general and limited partner interest in Partners Capital, Ltd., the limited partner of Lordstown, L.P., and a profits interest in subsequent land sales. A corporation controlled by Richard D. Morgan is the general partner of Lordstown, L.P. Mr. Morgan served as a director of ARI until October 2001. In December 2003, the note was exchanged with Regis I, a related party, for three notes receivable: \$1.4 million from Harvest Hill; \$1.4 million from Harvest Hill I; and \$2.1 million from Harvest Hill III, related parties. All three notes bear interest at 12.0%, mature in October 2013, and require monthly payments of interest, to the extent surplus cash is available, beginning in November 2003. No payments have been received to date. Ted P.

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Stokely, Chairman of the Board and a Director of ARI, is the General Manager of Unified, a related party, which is the sole member of Harvest Hill, Harvest Hill I, and Harvest Hill III.

In January 2002, IORI purchased 100% of the outstanding common shares of Rosedale Corporation (Rosedale), a wholly-owned subsidiary of ARI, for \$5.1 million. The purchase price was determined based upon the market value of the property exchanged, using a market rate multiple of net operating income. Rosedale owned the Rosedale Towers Office Building. ARI guaranteed that the asset would produce at least a 12.0% annual return on the purchase price for a period of three years from the purchase date. If the asset failed to produce the 12.0% return, ARI would pay IORI any shortfall. In addition, if the asset failed to produce the 12.0% return for a calendar year, IORI could require ARI to repurchase the shares of Rosedale for the purchase price. The business purpose of the transaction was for IORI to make an equity investment in Rosedale, anticipating a profitable return, and for ARI to receive cash for its equity investment. Management classified this related party transaction as a note payable to IORI. After IORI sold the Rosedale Towers Office Building to an unrelated buyer in December 2002, ARI owed \$2.1 million to IORI for remaining principal and 12.0% return. In April 2003, ARI repaid \$2.0 million in principal and accrued interest. In August 2003, ARI repaid the remaining principal and accrued interest.

In April 2002, TCI purchased all of the general and limited partnership interests in Garden Confederate Point, L.P. (Confederate Point) from ARI for \$1.9 million. The purchase price was determined based upon the market value of the property, using a market rate multiple of net operating income. Confederate Point owned the Confederate Point Apartments. ARI guaranteed that the asset would produce at least a 12.0% annual return on the purchase price for a period of three years from the purchase date. If the asset failed to produce the 12.0% return, ARI would pay TCI any shortfall. In addition, if the asset failed to produce the 12.0% return for a calendar year, TCI could require ARI to repurchase the partnership interests in Confederate Point for the purchase price. The business purpose of this transaction was for TCI to make an equity investment in Confederate Point, anticipating a profitable return, and to reduce ARI's affiliate debt. Management classified this related party transaction as a note payable to TCI. In November 2003, the property was sold to an unrelated buyer. ARI repaid the \$2.0 million in principal and accrued interest.

In April 2002, TCI purchased 100% of the common shares of ART One Hickory Corporation (One Hickory), a wholly-owned subsidiary of ARI, for \$4.5 million. The purchase price was determined based upon the market value of the property using a market rate multiple of net operating income. One Hickory owned the One Hickory Centre office building (One Hickory Centre.) ARI guaranteed that the asset would produce at least a 12.0% annual return on the purchase price for a period of three years from the purchase date. If the asset failed to produce the 12.0% return, ARI would pay TCI any shortfall. In addition, if the asset failed to produce the 12.0% return for a calendar year, TCI could require ARI to repurchase the shares of One Hickory for the purchase price. The business purpose of this transaction was for TCI to make an equity investment in One Hickory, anticipating a profitable return, and to reduce ARI's affiliate debt. Management classified this related party transaction as a note payable. In October 2003, TCI sold One Hickory Centre to IORI for \$12.2 million, providing purchase money wraparound financing of \$12.0 million. Also in October 2003, IORI sold One Hickory Centre to ARI for \$12.2 million, providing purchase money wraparound financing of \$12.0 million. These additional transactions discharged the 2002 financing from TCI.

In June 2002, ARI purchased all the general and limited partnership interests in Chalet North, L.P. (Chalet North) from BCM for \$3.0 million. Chalet North owns the Pinecrest Apartments (Pinecrest). The purchase price was determined based on the market value of the property exchanged, using a market rate multiple of net operating income. ARI assumed debt of \$1.4 million. ARI's receivable from BCM was reduced by

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\$1.6 million, and no cash was paid by ARI. The business purpose of the transaction was to reduce the affiliate payable owed by BCM to ARI. In June 2003, ARI sold Pinecrest to an unrelated buyer (See NOTE 2. REAL ESTATE).

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In June 2002, ARI purchased the Tiberon Trails Apartments from BCM for \$12.3 million. The purchase price was determined based on the market value of the property exchanged, using a market rate multiple of net operating income. ARI assumed debt of \$6.4 million. ARI's receivable from BCM was reduced by \$5.9 million, and no cash was paid by ARI. The business purpose of the transaction was to reduce the affiliate payable owed by BCM to ARI. In March 2004, ARI sold Tiberon Trails Apartments to an unrelated buyer (see NOTE 2. REAL ESTATE.)

On June 30, 2002, ARI obtained 71.4% interest in RAK from BCM for \$6.0 million. The business purpose of the transaction was to reduce the affiliate payable owed by BCM to ARI. ARI's receivable from BCM was reduced by \$6.0 million, and no cash was paid by ARI. At the date of acquisition, RAK's assets consisted of \$2.3 million in cash, \$3.0 million in deposits and marketable securities, and \$225,000 in other assets. RAK's net equity was \$5.5 million. ARI recorded \$1.9 million in goodwill as a result of this transaction. In June 2003, ARI sold its 71.4% interest in RAK to Realty Advisors and Syntek West for \$6.0 million, reducing ARI's affiliate debt. Realty Advisors also paid ARI \$600,000, representing 10.0% interest on ARI's investment.

In December 2002, ARI sold the Lakeshore Villas Apartments to Humble for \$22.0 million, paying \$764,000 after payment of closing costs and debt paydown and providing purchase money financing of \$8.4 million. One note had a principal amount of \$2.0 million. The loan was unsecured, and was guaranteed by Unified Housing Foundation, Inc. (Unified), a related party. The second note had a principal amount of \$6.4 million, and was secured by a pledge by Unified of 100% of the Member Interest in Humble. Both notes bore interest at 11.5% per annum, matured in December 2009 and required quarterly payments beginning in March 2003. Richard W. Humphrey, a Director of ARI until July 2003, is the President of Humble and the President and Treasurer of Unified. Ted P. Stokely, Chairman of the Board and a Director of ARI, is the General Manager of Unified. In December 2003, both notes were sold to IORI for \$8.4 million, plus accrued interest, to reduce ARI's affiliate debt.

During 2002, ARI's Board of Directors authorized ARI's Chief Financial Officer to advance funds either to or from ARI, through BCM (then the advisor to ARI), in an amount up to \$10.0 million and, subsequent to that, authorized ARI's Chief Financial Officer to make additional advances, 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 affiliate receivables (payables) as of December 31, 2004.

| | <u>BCM</u> | <u>PRIME</u> | <u>IORI</u> |
|---|------------|--------------|-------------|
| Balance, December 31, 2003 | \$ 1,998 | \$ 4,393 | \$ (627) |
| Cash transfers to affiliates | | 250,076 | |
| Cash transfers from affiliates | | (264,940) | |
| Advance through receipt of financing proceeds | | 19,777 | |
| Transfer of payable from BCM to Prime | (1,998) | 1,998 | |

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| | | | |
|---------------------------------|----|-----------|----------|
| Payables clearing through Prime | | 2,275 | 367 |
| | | | |
| Other additions | \$ | \$ 13,579 | \$ (260) |
| | | | |

Also at December 31, 2004, ARI owed \$1.1 million to affiliates related to cash received upon the sale of apartments to Metra, and an affiliate owed ARI \$1.4 million in accrued rent.

Returns on Metra Properties. In April 2002, ARI and TCI sold 21 apartment properties to partnerships controlled by Metra Capital, LLC (Metra). Innovo Group, Inc. (Innovo) is a limited partner in the

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partnerships that purchased the properties. Joseph Mizrachi, then a director of ARI, controlled approximately 11.67% of the outstanding common stock of Innovo. Management determined to treat the sales as financing transactions, and ARI and TCI continue to report the assets and the new debt incurred by Metra on their financial statements. The partnership agreements for each of these partnerships state that the Metra Partners, as defined, receive cash flow distributions at least quarterly in an amount sufficient to provide them with a 15.0% cumulative compounded annual rate of return on their invested capital, as well as a cumulative compounded annual amount of 0.50% of the average outstanding balance of the mortgage indebtedness secured by any of these properties. These distributions to the Metra Partners have priority over distributions to any other partners. At December 31, 2004, 16 of the properties remained on ARI's balance sheet, and ARI's other liabilities included \$1.7 million owed to the Metra Partners related to cash received by ARI upon the sale of these apartments in April 2002. As of December 2004, ARI and Metra were involved in a lawsuit concerning certain details of this transaction. See NOTE 22. COMMITMENTS, CONTINGENCIES, AND LIQUIDITY for additional details.

NOTE 10. DIVIDENDS

During the second quarter of 1999, ARI's Board of Directors established a policy that dividend declarations on Common Stock would be determined on an annual basis following the end of each year. No dividends on Common Stock were declared for 2002, 2003 or 2004. Future distributions to Common stockholders will be dependent upon ARI's income, financial condition, capital requirements and other factors deemed relevant by the Board.

NOTE 11. PREFERRED STOCK

There are 15,000,000 shares of Series A 10.0% Cumulative Convertible Preferred Stock authorized, with a par value of \$2.00 per share and liquidation preference of \$10.00 per share plus accrued and unpaid dividends. Dividends are payable at the annual rate of \$1.00 per share or \$.25 per share quarterly to stockholders of record on the last day of each March, June, September and December when and as declared by the Board of Directors. Since August 15, 2003, the Series A Preferred Stock may be converted into ARI Common Stock at 90.0% of the average daily closing price of ARI's Common Stock for the prior 20 trading days. At December 31, 2004, 3,469,350 shares of Series A Preferred Stock were outstanding and 869,808 shares were reserved for issuance as future consideration in various business transactions. Of the outstanding shares, 300,000 shares are owned by ART Edina, Inc., and 600,000 are owned by ART Hotel Equities, Inc., wholly-owned subsidiaries of ARI. Dividends are not paid on the shares owned by ARI subsidiaries.

There are 231,750 shares of Series C Cumulative Convertible Preferred Stock authorized, with a par value of \$2.00 per share and liquidation preference of \$100.00 per share plus accrued and unpaid dividends. The Series C Preferred Stock bears a quarterly dividend of \$2.25 per share through June 30, 2001 and \$2.50 per share thereafter, to stockholders of record on the last day of March, June, September and December when and as declared by the Board of Directors. The Series C Preferred Stock is reserved for conversion of the Class A limited partner units of ART Palm, L.P. (ART Palm). At December 31, 2003, 10,188,750 Class A units were outstanding. The Class A units may be exchanged for Series C Preferred Stock at the rate of 100 Class A units for each share of Series C Preferred Stock. At June 30, 2003, shares of Series C Preferred Stock could be converted into 57,500 shares of ARI Common Stock. On or after December 31, 2005, additional shares of Series C Preferred Stock may be converted into 16,250 shares of ARI Common Stock. On or after December 31, 2006, all remaining outstanding shares of Series C Preferred Stock may be converted into ARI Common Stock. All conversions of Series C Preferred Stock into ARI Common Stock will be at

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90.0% of the average daily closing price of ARI's Common Stock for the prior 20 trading days. In January 2001, 2.5 million Class A limited partner units of ART Palm were redeemed for \$2.5 million in cash. In December 2001, 7.2 million Class A limited partner units of ART Palm were redeemed for \$5.8 million, including \$2.5 million in cash. ARI gave a note payable for the remaining \$3.3 million. The note bore interest at 10.0% per annum, with a payment of

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\$1.9 million plus accrued but unpaid interest due in June 2002, and the remaining principal and accrued but unpaid interest due at maturity in December 2002. The note was paid in full in January 2003, including accrued but unpaid interest. In July 2002, 1.6 million Class A limited partner units of ART Palm were redeemed for \$1.6 million cash. In August 2003, 1.6 million Class A limited partner units of ART Palm were redeemed for \$1.6 million in cash. In June 2004, 2.6 million Class A limited partner units were redeemed for \$2.6 million in cash. In December 2004, 750,000 Class A limited partner units were redeemed for \$750,000 in cash. At December 31, 2004, no Series C Preferred Stock was outstanding.

There are 91,000 shares of Series D 9.50% Cumulative Preferred Stock authorized, with a par value of \$2.00 per share, and a liquidation preference of \$20.00 per share. Dividends are payable at the annual rate of \$1.90 per year or \$.475 per quarter to stockholders of record on the last day of each March, June, September and December when and as declared by the Board of Directors. The Series D Preferred Stock is reserved for the conversion of the Class A limited partner units of Ocean Beach Partners, L.P. The Class A units may be exchanged for Series D Preferred Stock at the rate of 20 Class A units for each share of Series D Preferred Stock. No more than one-third of the Class A units could be exchanged prior to May 31, 2001. Between June 1, 2001 and May 31, 2006, all unexchanged Class A units are exchangeable. At December 31, 2004, no Series D Preferred Stock was outstanding.

There are 500,000 shares of Series E 6.0% Cumulative Preferred Stock authorized, with a par value \$2.00 per share and a liquidation preference of \$10.00 per share. Dividends are payable at the annual rate of \$.60 per share or \$.15 per quarter to stockholders of record on the last day of each March, June, September and December when and as declared by the Board of Directors. At December 31, 2004, 50,000 shares of Series E Preferred Stock were outstanding.

There were 10,000 shares of Series I 8.0% Cumulative Preferred Stock authorized, with a par value of \$2.00 per share and a liquidation preference of \$1,000.00 per share. Dividends were payable at the annual rate of \$80.00 per share or \$20.00 per quarter to stockholders of record on the last day of each March, June, September and December when and as declared by the Board of Directors. In February 2003, 10,000 shares were issued to ART Morgan, Inc., a wholly-owned subsidiary of ARI. In September 2003, the shares were returned to ARI and were canceled. In October 2003, Series I Cumulative Preferred Stock was eliminated.

NOTE 12. STOCK OPTIONS

In January 1998, stockholders approved the 1997 Stock Option Plan (the "Option Plan"). Under the Option Plan, options have been granted to certain ARI officers and key employees of BCM and its affiliates. The Option Plan provides for options to purchase up to 300,000 shares of Common Stock. All grants are determined by the Option Committee of the Board of Directors. Options granted pursuant to the Option Plan are exercisable, based upon vesting of 20.0% per year, beginning one year after the date of grant and expire the earlier of three months after termination of employment or ten years from the date of grant. At December 31, 2004, 68,250 options were exercisable at an exercise price of \$16.35 per Common share, and 2,500 shares were exercisable at an exercise price of \$18.53 per Common share.

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In January 1999, stockholders approved the Director's Stock Option Plan (the Director's Plan) which provides for options to purchase up to 40,000 shares of Common Stock. Options granted pursuant to the Director's Plan are immediately exercisable and expire on the earlier of the first anniversary of the date on which a Director ceases to be a Director or ten years from the date of grant. Each Independent Director was granted an option to purchase 1,000 Common shares at an exercise price of \$17.71 per Common share on January 11, 1999, the date stockholders approved the plan. On January 1, 2000, 2001, 2002, 2003, 2004 and 2005, each Independent Director was granted an option to purchase 1,000 Common shares at exercise prices of \$18.53, \$13.625, \$9.87, \$8.09, \$9.13, and \$9.70 per Common share, respectively. Each Independent Director will be

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

awarded an option to purchase an additional 1,000 Common shares on January 1 of each year. At December 31, 2004, 6,000 options were exercisable at prices ranging from \$8.09 to \$9.87 per Common share.

| | 2004 | | 2003 | | 2002 | |
|-----------------------------|---------------------|----------------|---------------------|----------------|---------------------|----------------|
| | Number of Shares | Exercise Price | Number of Shares | Exercise Price | Number of Shares | Exercise Price |
| Outstanding at January 1, | 98,250 | \$8.09-18.53 | 105,750 | \$9.87-18.53 | 183,750 | \$13.63-18.53 |
| Granted | 3,000 | \$9.13 | 3,000 | \$8.09 | 3,000 | \$ 9.87 |
| Canceled | (24,500) | \$8.09-18.53 | (10,500) | \$9.87-18.53 | (81,000) | \$13.63-18.53 |
| Outstanding at December 31, | 76,750 | \$8.09-18.53 | 98,250 | \$8.09-18.53 | 105,750 | \$ 9.87-18.53 |

NOTE 13. ADVISORY AGREEMENT

Although the Board of Directors is directly responsible for managing the affairs of ARI and for setting the policies, which guide it, the day-to-day operations of ARI are performed by Prime, a contractual advisor under the supervision of the Board. The duties of the advisor include, among other things, locating, investigating, evaluating and recommending real estate and mortgage loan investment and sales opportunities as well as financing and refinancing sources. Prime, as advisor, also serves as a consultant in connection with the preparation of ARI's business plan and investment policy decisions made by the Board.

Prime, an affiliate, has been providing advisory services to ARI since October 1, 2003. Prime is indirectly owned by Gene E. Phillips and a trust for the children of Gene E. Phillips. Mr. Phillips is not an officer or director of Prime, but serves as a representative of the trust, is involved in daily consultation with the officers of Prime, and has significant influence over the conduct of Prime's business, including the rendering of advisory services and the making of investment decisions for itself and for ARI.

The Advisory Agreement provides that Prime shall receive base compensation at the rate of 0.0625% per month (0.75% on an annualized basis) of ARI's Average Invested Assets.

In addition to base compensation, the Advisory Agreement provides that Prime, or an affiliate of Prime, receive an acquisition fee for locating, leasing or purchasing real estate for ARI's benefit; a disposition fee for the sale of each equity investment in real estate; a loan arrangement fee; an incentive fee equal to 10.0% of net income for the year in excess of a 10.0% return on stockholders' equity, and 10.0% of the excess of net

capital gains over net capital losses, if any; and a mortgage placement fee, on mortgage loans originated or purchased.

The Advisory Agreement further provides that Prime shall bear the cost of certain expenses of its employees not directly identifiable to ARI's assets, liabilities, operations, business or financial affairs, and miscellaneous administrative expenses relating to the performance of its duties under the Advisory Agreement.

If and to the extent that Prime or any director, officer, partner or employee of Prime, shall be requested to render services to ARI other than those required to be rendered by Prime under the Advisory Agreement, such additional services, if performed, will be compensated separately on terms agreed upon between each party from time-to-time.

The Advisory Agreement automatically renews from year to year unless terminated in accordance with its terms. Management believes that the terms of the Advisory Agreement are at least as fair as could be obtained from unaffiliated third parties.

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Affiliates of Prime provided property management services to ARI. Currently, Triad Realty Services, Ltd. (Triad), an affiliate, and Carmel Realty, Inc. (Carmel) provide property management services to ARI's properties for a fee of 6.0% or less of the monthly gross rents collected on the residential properties under its management and 3.0% or less of the monthly gross rents collected on the commercial properties under its management. Triad and Carmel subcontract 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 subcontracts the property-level management and leasing of 30 of ARI's commercial properties (shopping centers, office buildings and individual warehouses) to Regis I. Regis I receives property and construction management fees and leasing commissions in accordance with the terms of its property-level management agreement with Triad. Since January 1, 2003, Regis Hotel I, LLC, has managed ARI's 11 hotels. The sole member of Regis I and Regis Hotel I, LLC is Highland. Carmel is a company previously owned by First Equity Properties, Inc., which is a company affiliated with Prime. On May 1, 2004, Regis I acquired the ownership of Carmel.

NOTE 15. ADVISORY FEES, PROPERTY MANAGEMENT FEES, ETC.

Fees and cost reimbursements to Prime, BCM and their affiliates were as follows:

| | <u>2004</u> | <u>2003</u> | <u>2002</u> |
|----------------------------|------------------|------------------|-----------------|
| Fees | | | |
| Advisory fee | \$ 10,728 | \$ 9,345 | \$ 5,899 |
| Net income fee | 1,933 | | |
| Loan arrangement | 1,927 | 1,256 | 689 |
| Property acquisition fees | 133 | 371 | 13 |
| | <u>\$ 14,721</u> | <u>\$ 10,972</u> | <u>\$ 6,601</u> |
| Cost reimbursements | | | |
| | <u>\$ 4,568</u> | <u>\$ 5,182</u> | <u>\$ 2,546</u> |

Fees paid to Triad, an affiliate, and Regis I, a related party:

| | <u>2004</u> | <u>2003</u> | <u>2002</u> |
|-------------|-------------|-------------|-------------|
| Fees | | | |

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| | | | |
|---|-------------------|-------------------|-------------------|
| Real estate brokerage | \$ 8,376 | \$ 6,247 | \$ 5,322 |
| Property acquisition fee | 445 | | |
| Construction supervision fee | 5,625 | 4,050 | 1,937 |
| Property and construction management and leasing commissions* | 6,725 | 4,273 | 4,325 |
| | <u> </u> | <u> </u> | <u> </u> |
| | \$ 21,171 | \$ 14,570 | \$ 11,584 |
| | <u> </u> | <u> </u> | <u> </u> |

* Net of property management fees paid to subcontractors, other than affiliates of Prime and BCM.

NOTE 16. INCOME TAXES

Effective January 1, 2004, TCI became eligible to file a consolidated Federal income tax return with ARI.

During the third quarter of 2000, due to a concentration of ownership, TCI no longer met the requirements for tax treatment as a Real Estate Investment Trust (REIT), as defined by Sections 856 through 860 of the

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Internal Revenue Code of 1986, as Amended (the Code). Under the Code, TCI is prohibited from re-qualifying for REIT status for at least 5 years after January 1, 2001.

There was no deferred tax expense <benefit> recorded for the period as a result of the uncertainty of the future use of the deferred tax asset.

The Federal income tax expense differs from the amount computed by applying the corporate tax rate of 35% to the income before income taxes as follows:

| | <u>2004</u> |
|---|-------------|
| Computed expected income tax <benefit> expense | 11,800 |
| Book to tax differences in gains on sale of property | (17,400) |
| Gain from Debt Settlement not recorded for tax purposes | (2,400) |
| Book to tax differences from entities not consolidated for tax purposes | 3,600 |
| Book to tax differences of depreciation and amortization | 3,500 |
| Impairment Charges not recorded for Tax Purposes | 1,500 |
| Use of Net Operating Loss carryforward | (1,200) |
| Other | 600 |
| | <u>\$</u> |

The tax effect of temporary differences that give rise to the deferred tax asset are as follows:

| | <u>2004</u> |
|------------------------------------|------------------|
| Net Operating Losses | <u>\$ 13,679</u> |
| Basis difference of | |
| Real Estate Holdings and Equipment | (6,218) |
| Notes Receivable | 4,052 |
| Investments | (9,360) |
| Goodwill and Intangibles | (5,068) |
| Notes Payable | 47,132 |
| Deferred Gains | 29,292 |

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| | |
|----------------------------------|-----------|
| Total | 121,479 |
| Deferred Tax Valuation Allowance | (121,479) |
| Net Deferred Tax Asset | \$ |

ARI has prior tax net operating losses and capital loss carryforwards of approximately \$123 million expiring through the year 2023.

ARI had a loss for federal income tax purposes after the use of net operating loss carryforwards in 2002 and losses for federal income tax purposes for 2003; therefore, it recorded no provision for income taxes. ARI'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, the difference in the allowance for estimated losses, depreciation on owned properties, and investments in equity method real estate entities. At December 31, 2003, ARI's tax basis in its net assets was exceeded by their basis for financial statement purposes by \$61.6 million. This amount is more than offset by notes payable and deferred revenue, which have a financial statement basis that exceeds their tax basis by \$134.8 million. As a result, aggregate future income for income

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

tax purposes will be less than such amount for financial statement purposes by approximately \$73.2 million. Certain of the net operating and capital loss carryforwards may be subject to limitation under the current tax laws.

At December 31, 2003, ARI had a net deferred tax asset of \$76.9 million due to tax deductions available to it in future years. However, as management cannot determine that it is more likely than not that ARI will realize the benefit of the deferred tax asset, a 100% valuation allowance has been established.

TCI had net income for federal income tax purposes before the application of operating loss carryforwards in 2003 and 2002; therefore, TCI recorded no provision for income taxes. TCI'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, TCI's tax basis in its net assets was exceeded by their net basis for financial statement purposes by approximately \$87.4 million and TCI's tax basis in its net liabilities was exceeded by their net basis for financial statement purposes by approximately \$91.9 million. As a result, aggregate future income for income tax purposes will be less than such amount for financial statement purposes by approximately \$4.5 million. TCI's state income tax expense is included in general and administrative expense on the Consolidated Statements of Operations.

NOTE 17. RENTS UNDER OPERATING LEASES

ARI's operations include the leasing of commercial properties (office buildings, shopping centers and a merchandise mart). The leases, thereon, expire at various dates through 2020. The following is a schedule of minimum future rents under non-cancelable operating leases as of December 31, 2004:

| | |
|------------|-----------|
| 2005 | \$ 24,117 |
| 2006 | 19,764 |
| 2007 | 14,068 |
| 2008 | 10,405 |
| 2009 | 6,956 |
| Thereafter | 23,226 |
| | <hr/> |
| | \$ 98,536 |
| | <hr/> |

MRI conducts its operations from leased facilities, which include office space, a warehouse, and 58 restaurant locations for which a lease was signed and the restaurant was either open at December 31, 2004 or scheduled to open thereafter. The leases expire over the next 17 years. MRI

also leases vehicles under operating leases.

The following is a schedule of minimum future rent commitments under operating leases as of December 31, 2004:

| | |
|------------|-----------|
| 2005 | \$ 2,234 |
| 2006 | 1,966 |
| 2007 | 1,707 |
| 2008 | 1,512 |
| 2009 | 1,109 |
| Thereafter | 2,487 |
| | <hr/> |
| | \$ 11,015 |
| | <hr/> |

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AMERICAN REALTY INVESTORS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Total facilities and vehicle rent expense relating to these leases was \$2.3 million in 2004, \$2.5 million in 2003, and \$2.5 million in 2002.

NOTE 18. 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 administrative expenses. Management evaluates the performance of each of the operating segments and allocates resources to them based on their net operating income and cash flow. Items of income that are not reflected in the segments are equity in loss of investees, gain on settlement of debt, gain on condemnation award, loss on sale of investments in equity investees, gain on foreign current transactions, equity in gain on sale of real estate by equity investees and other income which totaled \$19.4 million in 2004, \$11.7 million in 2003, and \$8.3 million in 2002. Expenses that are not reflected in the segments are general and administrative expenses, minority interest, provision for asset impairment, provision for loan losses, advisory fees, net income fees, litigation settlement expenses, write-down of assets held for sale, loss on foreign currency transactions and discontinued operations, which totaled \$57.5 million in 2004, \$63.5 million in 2003, and \$32.5 million in 2002. Excluded from operating segment assets are assets of \$114.1 million in 2004, \$94.8 million in 2003, and \$141.2 million in 2002 which are not identifiable with an operating segment. There are no intersegment revenues and expenses and ARI conducted all of its business within the United States, with the exception of Hotel Sofia (Bulgaria), which began operations in 2001 and was sold in March 2003; RAK (South Korea), which ARI acquired in 2002 and sold in June 2003; and Hotel Akademia (Poland), which began operations in 2002. See NOTE 2. REAL ESTATE and NOTE 3. NOTES AND INTEREST RECEIVABLE.

Presented below is the operating income of each operating segment and each segment's assets for 2004, 2003 and 2002.

| | <u>Commercial Properties</u> | <u>Apartments</u> | <u>Hotels</u> | <u>Land</u> | <u>MRI</u> | <u>Receivables/ Other</u> | <u>Total</u> |
|-------------------------------|----------------------------------|-------------------|-----------------|-------------------|-----------------|-------------------------------|------------------|
| 2004 | | | | | | | |
| Operating revenue | \$ 49,931 | \$ 76,186 | \$ 38,303 | \$ 610 | \$ 34,525 | \$ 342 | \$ 199,897 |
| Interest income | | | | | | 5,347 | 5,347 |
| Operating expenses | 35,372 | 50,519 | 28,857 | 7,115 | 26,713 | 763 | 149,339 |
| Operating income (loss) | <u>\$ 14,559</u> | <u>\$ 25,667</u> | <u>\$ 9,446</u> | <u>\$ (6,505)</u> | <u>\$ 7,812</u> | <u>\$ 4,926</u> | <u>\$ 55,905</u> |
| Depreciation and amortization | \$ 11,700 | \$ 8,631 | \$ 3,995 | \$ 950 | \$ 56 | | \$ 25,332 |
| Interest | 13,665 | 26,050 | 5,916 | 12,966 | 1,488 | 7,554 | 67,639 |
| Capital expenditures | 13,619 | 193,502 | 4,530 | 31,280 | 1,527 | | 224,558 |
| Assets | 179,368 | 500,121 | 85,457 | 218,476 | 20,615 | 72,661 | 1,076,698 |
| | <u>Commercial Properties</u> | <u>Apartments</u> | <u>Hotels</u> | <u>Land</u> | <u>MRI</u> | <u>Receivables/ Other</u> | <u>Total</u> |

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| Property Sales | | | | | | | | |
|--------------------------------|----|-------------------|----|-------------------|----|-------------------|----|-------------------|
| Sales price | \$ | 215,444 | \$ | 63,772 | \$ | 40,052 | \$ | 319,268 |
| Cost of sales | | 142,031 | | 40,637 | | 27,690 | | 210,358 |
| Deferred current gain | | 2,661 | | 2,542 | | 581 | | 5,784 |
| Recognized prior deferred gain | | 5,649 | | | | | | 5,649 |
| | | <u> </u> | | <u> </u> | | <u> </u> | | <u> </u> |
| Gain (loss) on sale | \$ | 76,401 | \$ | 20,593 | \$ | 11,781 | \$ | 108,775 |
| | | <u> </u> | | <u> </u> | | <u> </u> | | <u> </u> |

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| | Commercial Properties | Apartments | Hotels | Land | MRI | Receivables/ Other | Total |
|--------------------------------|----------------------------------|-------------------|-----------------|-------------------|-----------------|-------------------------------|------------------|
| 2003 | | | | | | | |
| Operating revenue | \$ 42,928 | \$ 54,733 | \$ 35,725 | \$ 615 | \$ 33,057 | \$ 1,841 | \$ 168,899 |
| Interest income | | | | | | 9,222 | 9,222 |
| Operating expenses | 28,002 | 39,809 | 27,198 | 5,671 | 26,051 | 390 | 127,121 |
| Operating income (loss) | \$ 14,926 | \$ 14,924 | \$ 8,527 | \$ (5,056) | \$ 7,006 | \$ 10,673 | \$ 51,000 |
| Depreciation and amortization | \$ 8,407 | \$ 4,213 | \$ 4,976 | \$ | \$ 1,484 | \$ 34 | \$ 19,114 |
| Interest | 12,249 | \$ 16,150 | 5,072 | 17,479 | 1,127 | 6,523 | 58,699 |
| Capital expenditures | 5,763 | 53,178 | 3,391 | 3,978 | 1,615 | | 67,925 |
| Assets | 294,849 | 389,204 | 89,228 | 281,454 | 20,766 | 70,595 | 1,146,096 |
| Property Sales | | | | | | | |
| Sales price | \$ 99,386 | \$ 90,378 | 26,820 | \$ 67,283 | | | \$ 283,867 |
| Cost of sales | 67,521 | 56,231 | 26,851 | 39,883 | | | 190,486 |
| Deferred current gain | 12,288 | 4,887 | | 3,493 | | | 20,668 |
| Recognized prior deferred gain | | | | 19,924 | | | 19,924 |
| Gain (loss) on sale | \$ 19,577 | \$ 29,260 | \$ (31) | \$ 43,831 | | | \$ 92,637 |
| 2002 | | | | | | | |
| Operating revenue | \$ 16,106 | \$ 20,129 | \$ 27,675 | \$ 575 | \$ 32,036 | \$ 246 | \$ 96,767 |
| Interest income | | | | | | 3,145 | 3,145 |
| Operating expenses | 12,076 | 13,226 | 20,977 | 6,002 | 25,286 | 528 | 78,095 |
| Operating income (loss) | \$ 4,030 | \$ 6,903 | \$ 6,698 | \$ (5,427) | \$ 6,750 | \$ 2,863 | \$ 21,817 |
| Depreciation and amortization | \$ 1,870 | \$ 1,449 | \$ 1,920 | \$ | \$ 1,268 | \$ 39 | \$ 6,546 |
| Interest | 5,031 | 7,212 | 3,822 | 19,763 | 840 | 11,351 | 48,019 |
| Capital expenditures | 15,567 | 16,203 | 832 | 3,092 | 2,869 | | 38,563 |
| Assets | 135,750 | 92,322 | 90,540 | 147,430 | 21,912 | 82,133 | 570,087 |
| Property Sales | | | | | | | |
| Sales price | \$ 63,524 | \$ 79,800 | | \$ 127,750 | | | \$ 271,074 |

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| | | | | |
|--------------------------------|----------|-----------|-----------|-----------|
| Cost of sales | 54,777 | 42,579 | 75,718 | 173,074 |
| Deferred current gain | 5,320 | 8,942 | 36,135 | 50,397 |
| Recognized prior deferred gain | | | 830 | 830 |
| Gain on sale | \$ 3,427 | \$ 28,279 | \$ 16,727 | \$ 48,433 |

NOTE 19. DISCONTINUED OPERATIONS

Effective January 1, 2002, ARI 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.

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For 2004, 2003 and 2002, income from discontinued operations relates to 23 properties and leasehold interests in oil and gas properties that ARI sold during 2002, 32 properties that ARI sold during 2003, 27 properties that ARI sold during 2004, and three properties that ARI sold during 2005 that are classified as held-for-sale at December 31, 2004. The following table summarizes revenue and expense information for these properties sold and held-for-sale.

| | <u>2004</u> | <u>2003</u> | <u>2002</u> |
|---|------------------|------------------|------------------|
| Revenue | | | |
| Rental | \$ 30,414 | \$ 51,810 | \$ 46,158 |
| Property operations | 18,161 | 30,757 | 28,297 |
| | <u>12,253</u> | <u>21,053</u> | <u>17,861</u> |
| Expenses | | | |
| Interest | 12,368 | 21,025 | 17,814 |
| Depreciation | 5,108 | 8,105 | 7,699 |
| | <u>17,476</u> | <u>29,130</u> | <u>25,513</u> |
| Net loss from discontinued operations | (5,223) | (8,077) | (7,652) |
| Gain on sale of real estate | 96,994 | 48,806 | 31,706 |
| Write-down of assets held for sale | (2,498) | (12,036) | (479) |
| Equity in gain on sale of real estate by equity investees | 2,212 | 716 | 24,069 |
| | <u>\$ 91,485</u> | <u>\$ 29,409</u> | <u>\$ 47,644</u> |

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

NOTE 20. QUARTERLY RESULTS OF OPERATIONS

The following is a tabulation of quarterly results of operations for the years 2004 and 2003 (unaudited):

Three Months Ended

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| | <u>March 31,</u> | <u>June 30,</u> | <u>September 30,</u> | <u>December 31,</u> |
|---|----------------------|--------------------|----------------------|---------------------|
| 2004 | | | | |
| Operating income | \$ 12,029 | \$ 8,865 | \$ 12,829 | \$ 9,023 |
| Gain on land sales | 3,752 | | 827 | 7,202 |
| Pizza parlor gross margin | 1,956 | 1,899 | 1,879 | 2,078 |
| | <u>17,737</u> | <u>10,764</u> | <u>15,535</u> | <u>18,303</u> |
| Income from operations | | | | |
| Equity in income (loss) of investees | (145) | (56) | 56 | 104 |
| Interest and other income | 1,676 | 2,011 | 3,739 | 15,100 |
| | <u>1,531</u> | <u>1,955</u> | <u>3,795</u> | <u>15,204</u> |
| Total other income | | | | |
| Total other expenses | 31,320 | 28,435 | 26,362 | 56,998 |
| | <u>(12,052)</u> | <u>(15,716)</u> | <u>(7,032)</u> | <u>(23,491)</u> |
| Net loss from continuing operations | | | | |
| Discontinued operations | 13,435 | 6,264 | 45 | 71,741 |
| Net income (loss) | 1,383 | (9,452) | (6,987) | 48,250 |
| Preferred dividend requirement | (650) | (650) | (651) | (650) |
| | <u>\$ 733</u> | <u>\$ (10,102)</u> | <u>\$ (7,638)</u> | <u>\$ 47,600</u> |
| Net income (loss) attributable to Common shares | | | | |

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| | Three Months Ended | | | |
|---|---------------------------|-------------------|----------------------|---------------------|
| | March 31, | June 30, | September 30, | December 31, |
| Earnings per share | | | | |
| Net income (loss) from continuing operations | \$ (1.19) | \$ (1.54) | \$ (.73) | \$ (2.30) |
| Discontinued operations | 1.26 | .59 | | 6.81 |
| Net income (loss) attributable to Common shares | <u>\$.07</u> | <u>\$ (.95)</u> | <u>\$ (.73)</u> | <u>\$ 4.51</u> |
| 2003 | | | | |
| Operating income | \$ 4,041 | \$ 8,724 | \$ 12,640 | \$ 9,367 |
| Gain on land sales | 19,971 | 959 | 15,498 | 7,403 |
| Pizza parlor gross margin | 1,460 | 1,712 | 1,738 | 2,096 |
| Income from operations | 25,472 | 11,395 | 29,876 | 18,866 |
| Equity in income (loss) of investees | (4,339) | 269 | (204) | (162) |
| Interest and other income | 2,238 | 3,646 | 1,850 | 16,901 |
| Total other income | (2,101) | 3,915 | 1,646 | 16,739 |
| Total other expenses | 18,404 | 28,851 | 34,951 | 41,148 |
| Net income (loss) from continuing operations | 4,967 | (13,541) | (3,429) | (5,543) |
| Discontinued operations | 2,224 | 7,767 | 15,107 | 4,311 |
| Net income (loss) | 7,191 | (5,774) | 11,678 | (1,232) |
| Preferred dividend requirement | (588) | (633) | (587) | (543) |
| Net income (loss) attributable to Common shares | <u>\$ 6,603</u> | <u>\$ (6,407)</u> | <u>\$ 11,091</u> | <u>\$ (1,775)</u> |
| Earnings per share | | | | |
| Net income (loss) from continuing operations | \$.39 | \$ (1.33) | \$ (.38) | \$ (.53) |
| Discontinued operations | .20 | .73 | 1.42 | .38 |
| Net income (loss) attributable to Common shares | <u>\$.59</u> | <u>\$ (.60)</u> | <u>\$ 1.04</u> | <u>\$ (.15)</u> |

Quarterly results presented differ from those previously reported in ARI's Form 10-Q due to the reclassification of the operations of properties sold or held for sale to discontinued operations in accordance with SFAS 144.

NOTE 21. DERIVATIVE FINANCIAL INSTRUMENTS

During the first quarter of 2002, ARI entered into an interest rate swap agreement with a bank. This agreement contained a notional amount of \$12.8 million and required ARI to pay the bank a fixed rate of 4.3%, and required the bank to pay to ARI based on the 30-day LIBOR rate. This agreement was entered into in order to effectively fix the rate on ARI's debt associated with the Limestone Canyon property. In December 2003, ARI sold this property to UHF, a related party. The swap agreement expired on December 9, 2004.

ARI did not designate the interest rate swap agreement as a hedge, as defined within Statement of Financial Accounting Standards No. 133, *Accounting for Derivative Instruments and Hedging Activities*, and as such, changes in the fair value of the swap agreement were recognized in earnings during the period of change and reflected in the statement of operations as interest expense.

Amounts paid or received under the swap agreement were settled monthly and were reflected as a reduction in the liability when paid. Interest expense for 2003 was decreased by \$191,000, and interest expense for 2002

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AMERICAN REALTY INVESTORS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

was increased by \$912,000, representing both amounts paid to the bank under the agreement and changes in the fair value of the related liability.

NOTE 22. COMMITMENTS, CONTINGENCIES, AND LIQUIDITY

Liquidity. Although management anticipated that ARI would generate excess cash from operations in 2004, such excess cash did not materialize and, therefore, was not sufficient to discharge all of ARI's debt obligations as they became due. ARI relied on additional borrowings, and sales of land and income producing properties to meet its cash requirements. In 2005, ARI will rely on aggressive land sales, selected income producing property sales and, to the extent necessary, additional borrowings to meet its cash requirements.

Partnership Buyouts. ARI is the limited partner in 11 partnerships currently constructing residential properties. As permitted in the respective partnership agreements, ARI intends to purchase the interests of the general and any other limited partners in these partnerships subsequent to the completion of these projects. The amounts paid to buyout the nonaffiliated partners are limited to development fees earned by the nonaffiliated partners, and are set forth in the respective partnership agreements. The total amount of the expected buyouts as of December 31, 2004 is approximately \$2.2 million.

Commitments. During 2002, MRI, then a wholly-owned subsidiary of ARI, sold two restaurants to a corporation owned in part by an officer of MRI. In conjunction with the sale of these restaurants, MRI guaranteed the bank debt incurred by the related party. The guaranty applies to all current debt and to all future debt of the related party until such time as the guaranty is terminated by MRI. The amount of the debt outstanding that is subject to the guaranty is \$953,000 at December 31, 2004. In July 2003, ARI sold its interest in MRI to Gruppa for \$18.5 million, receiving \$7.4 million in cash after debt assumption and providing purchase money financing of \$2.3 million (see NOTE 3. NOTES RECEIVABLE). ARI owns 20.0% of Gruppa, thereby retaining a 20.0% interest in MRI. ARI remains as the guarantor of \$8.7 million of assumed debt and is one of the guarantors of \$7.5 million in new debt obtained by Gruppa. Due to the debt guarantees and ARI's continuing ownership interest in MRI, management has determined that this should be accounted for as a financing transaction. In September 2003, ARI sold the note to Syntek West for \$2.3 million, plus accrued but unpaid interest, to reduce affiliate debt.

Litigation. In August 2002, ARI obtained a favorable jury verdict in the legal action entitled *American Realty Trust v. Matisse Partners, L.L.C.* (*Matisse*). However, the judge set aside the jury verdict and imposed a judgment against ARI in excess of \$6.0 million, including interest. The judgment was appealed, and, in the opinion of ARI's management and legal counsel, there was a reasonable probability that the adverse judgment will be set aside and the jury verdict reinstated. Therefore, ARI did not recognize any expense nor establish any reserve for this judgment. In November 2002, ARI posted a \$6.0 million supersedes bond. In July 2003, ARI obtained a letter of credit, which was substituted for the \$6.0 million bond. The \$6.0 million cash was returned to ARI. In April 2003, an additional judgment was issued against ARI for \$1.4 million in legal fees. ARI also appealed this judgment and posted a \$1.4 million bond in May 2003. ARI did not recognize any expense nor establish any reserve for this additional judgment. In December 2003, the United States Court of Appeals for the Fifth Circuit ruled in favor of ARI, with respect to the damages and the legal fees awarded by the judge, and \$1.1 million of the \$1.4 million bond was returned to ARI.

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On August 10, 2004, American Realty Investors, Inc., Transcontinental Realty Investors, Inc. and Income Opportunity Realty Investors, Inc. 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*

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Realty, Inc., Metra Capital LLC, Innovo Group, Inc., Joseph Mizrachi, Simon Mizrachi, Hubert Guez, Third Millennium Partners LLC, Third Millennium Partners, Inc., Third Millennium Group, LLC and Sunridge Management Group, Inc., Defendants. Plaintiffs' complaint alleges that Joseph Mizrachi, a former director of 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 controlled by, Joseph Mizrachi. Plaintiffs' complaint alleges that the overall transaction required the establishment of a sinking fund by the Defendants and the 22 limited partnerships as a trust for the benefit of certain preferred shareholders of Innovo Group, Inc. and the payment of certain proceeds to the Plaintiffs. Plaintiffs assert that payments have not been made pursuant to the agreement of the parties. Plaintiffs allege that Defendants' conduct constituted a common business enterprise alleges breach of contract and derivative claims on behalf of Innovo Group, Inc. against Joseph Mizrachi and others and requests declaratory relief involving the Plaintiffs' rights in the partnerships, an accounting of proceeds, and the creation of a constructive trust. Plaintiffs' complaint also alleges that Joseph Mizrachi engaged in fraud, negligent misrepresentation and/or breach of fiduciary duty and seeks unspecified damages, attorneys' fees, a constructive trust be established, and other relief.

In September 2001, ARI obtained a security loan in the amount of \$20.0 million from Sunset Management, LLC (Sunset). ARI received net cash of \$16.1 million after the payment of various closing costs and \$3.4 million repayment of principal and accrued interest on an existing loan with the same lender. Of the total loan amount, \$19.5 million bears interest at 24.0% per annum, while the remaining \$500,000 bears interest at 20.0% per annum. The loan is secured by 3,672,305 shares of TCI common stock held by BCM and wholly-owned subsidiaries of ARI. The loan required monthly payments of interest only and matured in September 2002. In September 2002, \$15.0 million in principal was repaid. Sunset orally agreed in September 2002 to extend the maturity date of the loan and accept substitute collateral for the shares of TCI common stock after the \$15.0 million pay down. Sunset did not honor the agreement, which resulted in litigation filed in Texas state court during October 2002, styled *American Realty Trust, Inc., ART Williamsburg, Inc., Basic Capital Management, Inc. and EQK Holdings, Inc. v. Sunset Management, LLC, et al.*, Cause No. 02-09433-I in the 162nd Judicial Court of Dallas County, Texas. See NOTE 8. MARGIN BORROWINGS.

Other Litigation. ARI 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 ARI's financial condition, results of operations or liquidity.

In January 2001, ARI exercised its option under the loan documents to extend the maturity date of three loans with a principal balance of \$30.0 million secured by three office buildings in New Orleans, Louisiana. The lender had disputed ARI's right to extend the loans. This dispute was the subject of litigation pending in the United States District Court for the Eastern District of Louisiana. On September 11, 2003, ARI settled with the lender. On September 18, 2003, ARI paid \$5.0 million to lender, which gave ARI the right to retire the remaining debt outstanding on the three office buildings on or before December 10, 2003 for \$20.0 million. ARI paid the remaining \$20.0 million on December 10, 2003, which resulted in a \$4.4 million gain on settlement of debt. BCM also agreed to enter into a time sharing agreement with the lender for use of BCM's airplane for 200 hours. BCM requested that ARI reimburse BCM for these costs at the rate of \$2,750 per hour, which was approved by ARI's Board of Directors. ARI has accrued \$550,000 in general and administrative expenses for this reimbursement to BCM.

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Activities subsequent to December 31, 2004 not already reflected elsewhere in this Form 10-K are disclosed below.

In 2005, ARI purchased the following property:

| <u>Property</u> | <u>Location</u> | <u>Acres</u> | <u>Purchase Price</u> | <u>Net Cash Paid</u> | <u>Debt Incurred</u> | <u>Interest Rate</u> | <u>Maturity Date</u> |
|------------------------------|--------------------|--------------|-----------------------|----------------------|----------------------|----------------------|----------------------|
| Land | | | | | | | |
| Katrina ⁽¹⁾ | Palm Desert, CA | 23.0 Acres | \$ 4,184 | \$ | \$ | | |
| Keenan Bridge ⁽²⁾ | Farmers Branch, TX | 7.5 Acres | 510 | 14 | | | |
| Mandahl Bay | US Virgin Islands | 50.8 Acres | 7,000 | 4,101 | 3,500 | 7.0% | 07/05 |
| Mandahl Bay (Gilmore) | US Virgin Islands | 1.0 Acres | 96 | 99 | | | |

(1) Exchanged for note receivable. See NOTE 3. NOTES AND INTEREST RECEIVABLE.

(2) Exchanged for the Bee Street and 2524 Valley View Land Parcels.

In 2005, ARI sold the following property:

| <u>Property</u> | <u>Location</u> | <u>Units/Acres/ Sq. Ft.</u> | <u>Sales Price</u> | <u>Net Cash Received/ (Paid)</u> | <u>Debt Discharged</u> | <u>Gain on Sale</u> |
|-------------------|-----------------|---------------------------------|--------------------|--------------------------------------|------------------------|---------------------|
| Apartments | | | | | | |
| Longwood | Long Beach, MS | 200 Units | \$ 6,461 | \$ 9 | \$ 6,262 | \$ 8 |
| Land | | | | | | |
| Katrina | Palm Desert, CA | 9.9 Acres | 2,616 | 574 | | 1,323 |
| Katrina | Palm Desert, CA | 13.6 Acres | 3,703 | 548 | | 1,706 |
| Katrina | Palm Desert, CA | 5.5 Acres | 1,325 | 1,281 | | 619 |
| Katrina | Palm Desert, CA | 6.5 Acres | 1,695 | 322 | | 818 |
| Katrina | Palm Desert, CA | 7.4 Acres | 2,028 | 203 | | 1,052 |
| Katrina | Palm Desert, CA | 81.2 Acres | 19,878 | (596) | 5,100 | 9,387 |
| Katrina | Palm Desert, CA | 24.8 Acres | 6,402 | 1,027 | | 2,947 |
| Katy | Katy, TX | 130.6 Acres | 12,400 | 4,981 | 6,601 | 5,630 |
| Nashville | Nashville, TN | 1.2 Acres | 304 | 236 | | 226 |

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| | | | | | | |
|-----------------------------|----------------|-----------------|--------|-------|-------|--------|
| Vista Ridge | Lewisville, TX | 4.4 Acres | 950 | (92) | 914 | 440 |
| Office Building | | | | | | |
| Institute Place | Chicago, IL | 144,915 Sq. Ft. | 14,460 | 4,843 | 7,792 | 10,554 |
| Industrial Warehouse | | | | | | |
| 5700 Tulane | Atlanta, GA | 67,850 Sq. Ft. | 816 | 738 | | 332 |

In 2005, ARI financed/refinanced or obtained second mortgage financing on the following:

| <u>Property</u> | <u>Location</u> | <u>Acres/Sq. Ft.</u> | <u>Debt Incurred</u> | <u>Debt Discharged</u> | <u>Net Cash Received</u> | <u>Interest Rate</u> | <u>Maturity Date</u> |
|-------------------------|-------------------|----------------------|----------------------|------------------------|--------------------------|----------------------|----------------------|
| Land | | | | | | | |
| Nashville | Nashville, TN | 109.6 Acres | \$ 7,000 | \$ | \$ 6,341 | 7.5% | 02/07 |
| Shopping Centers | | | | | | | |
| Dunes Plaza | Michigan City, IN | 223,869 Sq. Ft. | 3,750 | 2,685 | 658 | 7.5 ⁽¹⁾ | 01/10 |

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AMERICAN REALTY INVESTORS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(1) Variable rate.

In February 2005, ARI received a loan in the amount of \$4,975,000 that is guaranteed by BCM and Prime. The note bears interest at 8.0% per annum, requires semiannual interest payments and matures in July 2006. The loan is collateralized by partnership interests in various apartments owned by ARI. At maturity, the lender has the option to convert the outstanding loan balance into general and limited partnership units in each of the partnerships, subject to HUD approval.

In February 2005, ARI sold a 9.9 acre tract of its Katrina land parcel for \$2.6 million, receiving \$574,000 after payment of closing costs and providing purchase money financing of \$2.0 million. The loan bears interest at 8.0%, requires quarterly payments of interest, and matures in February 2008.

In February 2005, ARI sold a 13.6 acre tract of its Katrina land parcel for \$3.7 million, receiving \$548,000 after payment of closing costs and providing purchase money financing of \$2.8 million. The loan bears interest at 8.0%, requires quarterly payments of interest, and matures in February 2008.

In February 2005, ARI sold a 6.5 acre tract of its Katrina land parcel for \$1.7 million, receiving \$322,000 after payment of closing costs and providing purchase money financing of \$1.3 million. The loan bears interest at 8.0%, requires quarterly payments of interest, and matures in February 2007.

In February 2005, ARI sold a 7.4 acre tract of its Katrina land parcel for \$2.0 million, receiving \$203,000 after payment of closing costs and providing purchase money financing of \$1.5 million. The loan bears interest at 8.0%, requires quarterly payments of interest, and matures in February 2007.

In February 2005, ARI sold an 81.2 acre tract of its Katrina land parcel for \$19.9 million, paying \$596,000 after payment of closing costs and providing purchase money financing of \$14.9 million. The loan bears interest at 8.0%, requires quarterly payments of interest, and matures in February 2007.

In March 2005, ARI sold a 24.8 acre tract of its Katrina land parcel for \$6.4 million, receiving \$1 million after payment of closing costs and providing purchase money financing of \$4.8 million. The loan bears interest at 8.0%, requires quarterly payments of interest, and matures in March 2007.

NOTE 24. RESTATEMENT OF 2003 FINANCIAL STATEMENTS

During 2004, ARI discovered an error in the depreciation calculation for a commercial property purchased in 2003. The correction of the error resulted in a restatement for 2003 that increased net income by \$1.2 million, increased total assets by \$0.7 million, and decreased minority interest by \$0.5 million (from amounts originally reported).

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SCHEDULE III

AMERICAN REALTY INVESTORS, INC.

CONSOLIDATED REAL ESTATE AND ACCUMULATED DEPRECIATION

December 31, 2004

| Property/Location | Encumbrances | Initial Cost | | Cost Capitalized Subsequent to Acquisition | | Gross Amounts of Which Carried at End of Year | | | Accumulated Depreciation | Date of Construction | Date Acquired | Life on Which Depreciation In Latest Statement of Operation is Computed |
|---|--------------|--------------|---------------------------|--|-------------------------|---|--------------|-----------|--------------------------|----------------------|---------------|---|
| | | Land | Building and Improvements | Improve-ments | Other | Land | Improvements | (1) Total | | | | |
| (dollars in thousands) | | | | | | | | | | | | |
| Properties Held for Investment | | | | | | | | | | | | |
| Apartments | | | | | | | | | | | | |
| 4400, Midland, TX | \$ 999 | \$ 349 | \$ 1,396 | \$ | \$ (116) ⁽⁴⁾ | \$ 349 | \$ 1,280 | \$ 1,629 | \$ 229 | 1981 | 4/98 | 40 years |
| Apple Lane, Lawrence, KS | 1,387 | 168 | 1,259 | | (95) ⁽⁴⁾ | 168 | 1,164 | 1,332 | 159 | 1989 | 1/00 | 40 years |
| Arbor Point, Odessa, TX | 1,994 | 321 | 1,285 | 525 | (142) ⁽⁴⁾ | 321 | 1,668 | 1,989 | 760 | 1975 | 8/96 | 5-40 years |
| Arlington Place, Pasadena, TX | 4,072 | 330 | 3,275 | 752 | (2) ⁽⁴⁾ | 330 | 4,025 | 4,355 | 3,421 | 1973 | 11/76 | 10-40 years |
| Ashton Way, Midland, TX | 999 | 384 | 1,536 | 52 | (131) ⁽⁴⁾ | 384 | 1,457 | 1,841 | 326 | 1978 | 4/98 | 5-40 years |
| Autumn Chase, Midland, TX | 805 | 141 | 1,265 | | (93) ⁽⁴⁾ | 141 | 1,172 | 1,313 | 146 | 1985 | 4/00 | 40 years |
| Baywalk, Galveston, TX | 5,304 | 679 | 6,106 | | (451) ⁽⁴⁾ | 679 | 5,655 | 6,334 | 497 | 1979 | 9/01 | 40 years |
| Blue Lake Villas II, Waxahachie, TX | 3,939 | 287 | | 4,166 | | 287 | 4,166 | 4,453 | | 2004 | 1/04 | |
| Blue Lake Villas, Waxahachie, TX | 10,664 | 762 | | 10,519 | (709) ⁽⁴⁾ | 762 | 9,810 | 10,572 | 495 | 2002 | 1/02 | 40 years |
| Bluffs At Vista Ridge | 11,701 | 2,585 | | 14,632 | (7) ⁽⁴⁾ | 2,585 | 14,625 | 17,210 | | (8) | 8/03 | |
| Breakwater Bay, Beaumont, TX | 9,331 | 740 | | 10,032 | | 740 | 10,032 | 10,772 | | 2003 | 5/03 | |
| Bridges on Kinsey, Tyler, TX | 9,691 | 862 | | 10,716 | | 862 | 10,716 | 11,578 | | (8) | 2/04 | |
| Bridgestone, Friendswood, TX | 2,017 | 169 | 1,780 | 192 | (58) ⁽⁴⁾ | 169 | 1,914 | 2,083 | 1,411 | 1979 | 6/82 | 18-40 years |
| By the Sea, Corpus Christi, TX | 5,324 | 644 | 5,797 | | (428) ⁽⁴⁾ | 644 | 5,369 | 6,013 | 493 | 1973 | 8/01 | 40 years |
| Capitol Hill, Little Rock, AR | 9,489 | 932 | 973 | 7,954 | | 932 | 8,927 | 9,859 | 95 | 2003 | 3/03 | 40 years |
| Chateau Bayou, Ocean Springs, MS | 3,773 | 591 | 2,364 | | | 591 | 2,364 | 2,955 | 404 | 1973 | 3/02 | 40 years |
| Chateau, Bellevue, NE | 3,214 | 130 | 1,723 | 141 | 9 ⁽⁴⁾ | 130 | 1,873 | 2,003 | 1,389 | 1968 | 2/81 | 7-40 years |
| Courtyard, Midland, TX | 972 | 151 | 1,359 | | (100) ⁽⁴⁾ | 151 | 1,259 | 1,410 | 121 | 1976 | 5/01 | 40 years |
| Coventry, Midland, TX | 1,180 | 236 | 369 | 173 | (52) ⁽⁴⁾ | 236 | 490 | 726 | 246 | 1977 | 8/96 | 5-40 years |
| Dakota Arms, Lubbock, TX | 11,438 | 921 | | 11,776 | | 921 | 11,776 | 12,697 | | (8) | 1/04 | 40 years |
| DeSoto Ranch, DeSoto, TX | 16,201 | 1,472 | | 17,854 | (949) ⁽⁴⁾ | 1,472 | 16,905 | 18,377 | 421 | 2002 | 5/02 | 40 years |
| Echo Valley (Mariposa Villas), Dallas, TX | 12,312 | 788 | | 13,130 | (295) ⁽⁴⁾ | 788 | 12,835 | 13,623 | 352 | 2002 | 1/02 | 40 years |
| | 4,082 | 279 | 2,821 | | (581) ⁽⁴⁾ | 279 | 2,240 | 2,519 | 1,069 | 1963 | 1/88 | 5-40 years |

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| | | | | | | | | | | | | |
|-------------------------------------|--------|-------|-------|--------|----------------------|-------|--------|--------|-------|------|-------|------------|
| El Chapparal, San Antonio, TX | | | | | | | | | | | | |
| Fairway View Estates, El Paso, TX | 4,921 | 548 | 4,530 | 261 | (356) ⁽⁴⁾ | 548 | 4,435 | 4,983 | 849 | 1977 | 3/99 | 40 years |
| Fairways, Longview, TX | 3,412 | 657 | 1,532 | 119 | (402) ⁽⁴⁾ | 657 | 1,249 | 1,906 | 515 | 1980 | 3/93 | 5-40 years |
| Falcon Lakes, Arlington, TX | 13,578 | 1,437 | | 15,375 | (933) ⁽⁴⁾ | 1,437 | 14,442 | 15,879 | 738 | 2001 | 10/01 | 40 years |
| Fountain Lake, Texas City, TX | 3,199 | 861 | 2,585 | 19 | (461) ⁽⁴⁾ | 861 | 2,143 | 3,004 | 663 | 1975 | 12/94 | 5-40 years |
| Fountains of Waterford, Midland, TX | 1,667 | 311 | 852 | 1,538 | (180) ⁽⁴⁾ | 311 | 2,210 | 2,521 | 1,437 | 1977 | 5/98 | 5-40 years |
| Foxwood, Memphis, TN | 5,633 | 218 | 3,188 | 950 | 221 ⁽⁴⁾ | 218 | 4,359 | 4,577 | 3,324 | 1974 | 8/79 | 5-40 years |
| Governor Square, Tallahassee, FL | 4,373 | 245 | 2,207 | | | 245 | 2,207 | 2,452 | 152 | 1974 | 3/02 | 40 years |

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SCHEDULE III

(Continued)

AMERICAN REALTY INVESTORS, INC.

CONSOLIDATED REAL ESTATE AND ACCUMULATED DEPRECIATION

December 31, 2004

| Property/Location | Encumbrances | Initial Cost | | | Cost Capitalized Subsequent to Acquisition | Gross Amounts of Which Carried at End of Year | | | Accumulated Depreciation | Date of Construction | Date Acquired | Life on Which Depreciation In Latest Statement of Operation is Computed |
|---|--------------|--------------|---------------------------|--------|--|---|--------------|-----------|--------------------------|----------------------|---------------|---|
| | | Land | Building and Improvements | Other | | Land | Improvements | (1) Total | | | | |
| (dollars in thousands) | | | | | | | | | | | | |
| Properties Held for Investment (continued) | | | | | | | | | | | | |
| Apartments (continued) | | | | | | | | | | | | |
| Harper's Ferry, Lafayette, LA | \$ 3,276 | \$ 349 | \$ 1,398 | \$ 223 | \$ (131) ⁽⁴⁾ | \$ 349 | \$ 1,490 | \$ 1,839 | \$ 609 | 1972 | 2/92 | 5-40 years |
| Heather Creek, Mesquite, TX | 12,008 | 1,100 | | 12,237 | | 1,100 | 12,237 | 13,337 | 196 | 2003 | 3/03 | 40 years |
| Hunters Glen, Midland, TX | 1,825 | 519 | 2,075 | 321 | (194) ⁽⁴⁾ | 519 | 2,202 | 2,721 | 680 | 1982 | 1/98 | 5-40 years |
| Island Bay, Galveston, TX | 14,912 | 2,095 | 18,852 | | (1,392) ⁽⁴⁾ | 2,095 | 17,460 | 19,555 | 1,647 | 1973 | 9/01 | 40 years |
| Kingsland Ranch, Houston, TX | 21,893 | 1,188 | | 23,384 | | 1,188 | 23,384 | 24,572 | | (8) | 3/03 | |
| Laguna Vista, Farmers Branch, TX | 1,522 | 288 | | 1,736 | | 288 | 1,736 | 2,024 | | (8) | 12/04 | |
| Lake Forest, Houston, TX | 12,067 | 334 | | 12,918 | | 334 | 12,918 | 13,252 | | (8) | 1/04 | |
| Limestone Canyon, Austin, TX | 12,405 | 1,998 | | 12,246 | 1,902 ⁽⁷⁾ | 1,998 | 13,075 | 15,073 | 1,617 | 1997 | 7/98 | 40 years |
| Limestone Ranch, Lewisville, TX | 12,735 | 1,620 | | 13,057 | (976) ⁽⁴⁾ | 1,620 | 12,081 | 13,701 | 856 | 2001 | 5/01 | 40 years |
| Longwood, Long Beach, MS | 6,258 | 667 | 6,006 | | (192) ⁽⁴⁾ | 667 | 5,814 | 6,481 | 263 | 1972 | 4/03 | 40 years |
| Marina Landing, Galveston, TX | 12,773 | 1,240 | 11,161 | | (824) ⁽⁴⁾ | 1,240 | 10,337 | 11,577 | 925 | 1985 | 9/01 | 40 years |
| Med Villas, San Antonio, TX | 2,701 | 712 | 2,848 | | | 712 | 2,848 | 3,560 | 486 | 1967 | 2/98 | 40 years |
| Mountain Plaza, El Paso, TX | 5,184 | 837 | 3,347 | 139 | (287) ⁽⁴⁾ | 837 | 3,199 | 4,036 | 720 | 1972 | 1/98 | 5-40 years |
| Oak Park IV, Clute, TX | 960 | 224 | 674 | 27 | (150) ⁽⁴⁾ | 224 | 551 | 775 | 182 | 1981 | 6/94 | 5-40 years |
| Oak Tree, Grandview, MO | 3,924 | 304 | 3,543 | 245 | 418 ⁽⁴⁾ | 304 | 4,206 | 4,510 | 2,495 | 1968 | 3/82 | 18-40 years |
| Paramount Terrace, Amarillo, TX | 3,157 | 340 | 3,061 | | (226) ⁽⁴⁾ | 340 | 2,835 | 3,175 | 456 | 1983 | 5/00 | 40 years |
| Parc at Maumelle, Maumelle, AR | 2,204 | 1,153 | | 1,543 | | 1,153 | 1,543 | 2,696 | | (8) | 12/04 | |
| Plantation, Tulsa, OK | 2,258 | 344 | 2,396 | | (182) ⁽⁴⁾ | 344 | 2,214 | 2,558 | 411 | 1968 | 12/99 | 40 years |
| Quail Oaks, Balch Springs, TX | 2,761 | 90 | 2,160 | 152 | (334) ⁽⁴⁾ | 90 | 1,978 | 2,068 | 1,125 | 1982 | 2/87 | 5-40 years |
| Quail Point, Huntsville, AL | 3,526 | 184 | 2,716 | 267 | (25) ⁽⁴⁾ | 184 | 2,958 | 3,142 | 2,576 | 1960 | 8/75 | 10-40 years |

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| | | | | | | | | | | | | |
|---------------------------------------|--------|-------|-------|--------|------------------------|-------|--------|--------|-------|------|-------|-------------|
| River Oaks, Wiley, TX | 9,761 | 590 | | 11,767 | (807) ⁽⁴⁾ | 590 | 10,960 | 11,550 | 754 | 2001 | 10/01 | 40 years |
| Sendero Ridge, San Antonio, TX | 24,304 | 2,635 | | 26,721 | (1,653) ⁽⁴⁾ | 2,635 | 25,068 | 27,703 | 648 | 2001 | 11/01 | 40 years |
| Somerset, Texas City, TX | 2,800 | 936 | 2,811 | 179 | (683) ⁽⁴⁾ | 936 | 2,307 | 3,243 | 869 | 1985 | 12/93 | 5-40 years |
| Southgate, Odessa, TX | 1,719 | 335 | 1,338 | 318 | (132) ⁽⁴⁾ | 335 | 1,524 | 1,859 | 593 | 1976 | 8/96 | 5-40 years |
| Spy Glass, Mansfield, TX | 15,929 | 1,376 | | 15,961 | (965) ⁽⁴⁾ | 1,376 | 14,996 | 16,372 | 603 | 2002 | 3/02 | 40 years |
| Stonebridge at City Park, Houston, TX | 13,905 | 1,545 | | 13,957 | | 1,545 | 13,957 | 15,502 | | (8) | 1/04 | |
| Sun Hollow, El Paso, TX | 4,385 | 385 | 4,159 | 75 | (82) ⁽⁴⁾ | 385 | 4,152 | 4,537 | 3,170 | 1977 | 9/79 | 15-40 years |
| Sunchase, Odessa, TX | 3,432 | 742 | 2,842 | 458 | (269) ⁽⁴⁾ | 742 | 3,031 | 3,773 | 911 | 1981 | 10/97 | 5-40 years |

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SCHEDULE III

(Continued)

AMERICAN REALTY INVESTORS, INC.

CONSOLIDATED REAL ESTATE AND ACCUMULATED DEPRECIATION

December 31, 2004

| Property/Location | Encumbrances | Initial Cost | | | Cost Capitalized Subsequent to Acquisition | Gross Amounts of Which Carried at End of Year | | | Accumulated Depreciation | Date of Construction | Date Acquired | Life on Which Depreciation In Latest Statement of Operation is Computed |
|---|--------------|--------------|---------------------------|--------|--|---|--------------|-----------|--------------------------|----------------------|---------------|---|
| | | Land | Building and Improvements | Other | Other | Land | Improvements | (1) Total | | | | |
| (dollars in thousands) | | | | | | | | | | | | |
| Properties Held for Investment (continued) | | | | | | | | | | | | |
| Apartments (continued) | | | | | | | | | | | | |
| Sunset, Odessa, TX | \$ 1,712 | \$ 345 | \$ 1,382 | \$ | \$ 345 | \$ 1,382 | \$ 1,727 | \$ 236 | 1981 | 3/02 | 40 years | |
| Terrace Hills, El Paso, TX | 5,973 | 1,286 | 5,145 | 167 | (439) ⁽⁴⁾ | 1,286 | 4,873 | 6,159 | 1,070 | 1985 | 3/97 | 5-40 years |
| Timbers, Tyler, TX | 2,406 | 497 | 1,988 | | (165) ⁽⁴⁾ | 497 | 1,823 | 2,320 | 330 | 1973 | 12/97 | 40 years |
| Tivoli, Dallas, TX | 9,915 | 1,355 | | 12,590 | (927) ⁽⁴⁾ | 1,355 | 11,663 | 13,018 | 627 | 2001 | 12/01 | 40 years |
| Treehouse, Irving, TX | 5,754 | 312 | 2,807 | | | 312 | 2,807 | 3,119 | | 1974 | 5/04 | 5-40 years |
| Verandas at City View, Fort Worth, TX | 19,325 | 2,545 | | 20,596 | (1,034) ⁽⁴⁾ | 2,545 | 19,562 | 22,107 | 505 | 2001 | 9/01 | 40 years |
| Villa Del Mar, Wichita, KS | 3,517 | 387 | 3,134 | 116 | (13) ⁽⁴⁾ | 387 | 3,237 | 3,624 | 2,307 | 1971 | 10/81 | 17-40 years |
| Villager, Ft. Walton, FL | 800 | 125 | 1,145 | 2 | | 125 | 1,147 | 1,272 | 80 | 1972 | 3/02 | 40 years |
| Vistas at Pinnacle Park, Dallas, TX | 19,101 | 1,750 | 2,236 | 17,431 | (275) ⁽⁴⁾ | 1,750 | 19,392 | 21,142 | 247 | 2002 | 10/02 | 40 years |
| Vistas at Vance Jackson, San Antonio, TX | 11,917 | 1,265 | | 12,187 | | 1,265 | 12,187 | 13,452 | | (8) | 1/04 | |
| Waters Edge III, Gulfport, MS | 7,252 | 331 | 1,324 | (14) | | 331 | 1,310 | 1,641 | 215 | 1968 | 6/98 | 40 years |
| Waters Edge IV, Gulfport, MS | | 443 | | 4,258 | (377) ⁽⁴⁾ | 443 | 3,881 | 4,324 | 200 | 2001 | 11/01 | 40 years |
| Westwood, Mary Ester, FL | 3,457 | 149 | 1,337 | | | 149 | 1,337 | 1,486 | 92 | 1972 | 3/02 | 40 years |
| Westwood, Odessa, TX | | 85 | 341 | 91 | (34) ⁽⁴⁾ | 85 | 398 | 483 | 164 | 1977 | 8/96 | 5-40 years |
| Whispering Pines, Topeka, KS | 7,253 | 228 | 4,331 | 1,054 | 27 ⁽⁴⁾ | 228 | 5,412 | 5,640 | 4,168 | 1972 | 2/78 | 15-40 years |
| Wildflower Villas, Temple, TX | 7,527 | 1,119 | | 8,257 | | 1,119 | 8,257 | 9,376 | | (8) | 3/04 | |
| Willow Creek, El Paso, TX | 2,349 | 608 | 1,832 | 76 | (313) ⁽⁴⁾ | 608 | 1,595 | 2,203 | 512 | 1972 | 5/94 | 5-40 years |
| Willo-Wick, Pensacola, FL | 2,924 | 747 | 2,990 | 174 | (522) ⁽⁴⁾ | 747 | 2,642 | 3,389 | 847 | 1974 | 5/95 | 5-40 years |
| Windsong, Fort Worth, TX | 10,688 | 790 | | 11,524 | | 790 | 11,524 | 12,314 | 264 | 2003 | 7/03 | 40 years |
| Windsor Tower, Ocala, FL | 1,958 | 225 | 1,863 | | | 225 | 1,863 | 2,088 | 124 | 1982 | 3/02 | 40 years |
| Wood Hollow, San Antonio, TX | 7,965 | 888 | 10,079 | | | 888 | 10,079 | 10,967 | 7,456 | 1974 | 11/78 | 40 years |

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| | | | | | | | | | | | | |
|--------------------------------------|--------|-------|--------|--------|------------------------|-------|--------|--------|--------|------|------|-------------|
| Woodlake, Carrollton, TX | 8,212 | 585 | 5,848 | 1,041 | (154) ⁽⁴⁾ | 585 | 6,735 | 7,320 | 5,105 | 1979 | 8/78 | 15-40 years |
| Woodview, Odessa, TX | 1,942 | 716 | 2,864 | 102 | (245) ⁽⁴⁾ | 716 | 2,721 | 3,437 | 575 | 1974 | 5/98 | 5-40 years |
| Office Buildings | | | | | | | | | | | | |
| 1010 Commons, New Orleans, LA | 16,381 | 2,113 | 15,010 | 19,701 | (3,528) ⁽⁴⁾ | 2,113 | 31,183 | 33,296 | 11,076 | 1971 | 3/98 | 5-40 years |
| 225 Baronne, New Orleans, LA | 5,189 | 1,162 | 10,457 | 6,149 | (3,927) ⁽⁴⁾ | 1,162 | 12,679 | 13,841 | 6,249 | 1960 | 3/98 | 5-40 years |
| 9033 Wilshire Blvd., Los Angeles, CA | 6,539 | 956 | 8,609 | 583 | (658) ⁽⁴⁾ | 956 | 8,534 | 9,490 | 1,211 | 1957 | 4/00 | 5-40 years |
| AMOCO, New Orleans, LA | 8,365 | 894 | 3,582 | 7,078 | (1,825) ⁽⁴⁾ | 894 | 8,835 | 9,729 | 5,306 | 1974 | 7/97 | 5-40 years |
| Bay Plaza II, Tampa, FL | 3,315 | 506 | 4,550 | 178 | (343) ⁽⁴⁾ | 506 | 4,385 | 4,891 | 581 | 1985 | 6/00 | 40 years |

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SCHEDULE III

(Continued)

AMERICAN REALTY INVESTORS, INC.

CONSOLIDATED REAL ESTATE AND ACCUMULATED DEPRECIATION

December 31, 2004

| Property/Location | Encum- brances | Initial Cost | | | Cost Capitalized Subsequent to Acquisition | Gross Amounts of Which Carried at End of Year | | | Accum- ulated Depreci- ation | Date of Construc- tion | Date Acquired | Life on Which Depreciation In Latest Statement of Operation is Computed |
|---|-------------------|--------------|----------------------------------|--------|---|--|----------------------------------|----------|---------------------------------------|------------------------------|------------------|---|
| | | Land | Buildings and Improvements | Other | Other | Land | Buildings and Improvements | Total | | | | |
| (dollars in thousands) | | | | | | | | | | | | |
| Properties Held for Investment (continued) | | | | | | | | | | | | |
| Office Buildings (continued) | | | | | | | | | | | | |
| Bay Plaza, Tampa, FL | \$ 1,049 | \$ 895 | \$ 3,582 | \$ 557 | \$ (690) ⁽⁴⁾ | \$ 895 | \$ 3,449 | \$ 4,344 | \$ 1,083 | 1988 | 7/97 | 5-40 years |
| Cooley Building, Farmers Branch, TX | 2,585 | 729 | 2,918 | 124 | (1,136) ⁽⁴⁾ | 729 | 1,906 | 2,635 | 680 | 1996 | 5/99 | 5-40 years |
| Durham Centre | 12,026 | 4,233 | 16,932 | 1,470 | (2,775) ⁽⁴⁾ | 4,233 | 15,627 | 19,860 | 4,021 | 1988 | 7/97 | 40 years |
| Eton Square, Tulsa, OK | 10,045 | 1,469 | 13,217 | 1,941 | (1,015) ⁽⁴⁾ | 1,469 | 14,143 | 15,612 | 2,138 | 1985 | 9/99 | 5-40 years |
| Executive Court, Memphis, TN | | 271 | 2,099 | 749 | (1,149) ⁽⁴⁾ | 271 | 1,699 | 1,970 | 2,083 | 1980 | 12/04 | 5-40 years |
| Five Hickory Center | | | | 38 | | | 38 | 38 | | | | |
| Forum, Richmond, VA | 4,882 | 1,360 | 5,439 | 1,047 | (494) ⁽⁴⁾ | 1,360 | 5,992 | 7,352 | 2,210 | 1987 | 10/92 | 2-40 years |
| Four Hickory Center | 12,932 | 303 | 27,723 | 493 | (13,616) ⁽⁴⁾ | 303 | 14,600 | 14,903 | 953 | 2003 | 2001 | 5-40 years |
| Institute Place, Chicago, IL | 7,734 | 665 | 7,057 | 446 | (521) ⁽⁴⁾ | 665 | 6,982 | 7,647 | 4,646 | 1910 | 1/93 | 2-40 years |
| Lexington Center, Colorado Springs, CO | 3,887 | 1,103 | 4,413 | 711 | (404) ⁽⁴⁾ | 1,103 | 4,720 | 5,823 | 1,290 | 1986 | 12/97 | 3-40 years |
| One Hickory Center | 7,080 | 335 | 7,651 | 3,905 | (20) | 335 | 11,536 | 11,871 | 3,258 | 1998 | 2000 | 7-40 years |
| Parkway North, Dallas, TX | 3,487 | 1,173 | 4,692 | 1,021 | (452) ⁽⁴⁾ | 1,173 | 5,261 | 6,434 | 1,567 | 1980 | 2/98 | 2-40 years |
| Signature, Dallas, TX | 2,360 | 1,075 | 2,921 | 1,384 | (1,588) ⁽⁴⁾ | 1,075 | 2,717 | 3,792 | 687 | 1985 | 2/99 | 5-40 years |
| Two Hickory Center | 7,439 | 318 | 7,827 | 1,693 | (21) | 318 | 9,499 | 9,817 | 1,771 | 2000 | 2000 | 3-40 years |
| University Square, Anchorage, AK | 1,139 | 562 | 3,276 | 265 | (1,881) ⁽²⁾ (248) ⁽⁴⁾ | 562 | 1,412 | 1,974 | 1,528 | 1981 | 12/81 | 17-40 years |
| Westgrove Air Plaza, Addison, TX | 3,092 | 211 | 1,898 | 291 | (366) ⁽⁴⁾ | 211 | 1,823 | 2,034 | 515 | 1982 | 10/97 | 5-40 years |
| Hotels | | | | | | | | | | | | |
| Akademia, Wroclaw, Poland | 24,061 | 2,184 | | 19,543 | (1,132) ⁽⁴⁾ | 2,184 | 18,411 | 20,595 | 2,008 | 2001 | 2/01 | 40 years |
| Best Western Hotel, Virginia Beach, VA | 3,679 | 1,521 | 5,754 | 1,501 | (378) ⁽⁴⁾ | 1,521 | 6,877 | 8,398 | 2,168 | 1983 | 12/96 | 7-40 years |
| Chateau Inn, Fresno, CA | 1,985 | | 3,906 | 74 | (174) ⁽²⁾ | | 3,806 | 3,806 | 807 | 1989 | 10/97 | 7-40 years |
| City Suites, Chicago, IL | 3,629 | 950 | 3,847 | 1,104 | (390) ⁽⁴⁾ | 950 | 4,561 | 5,511 | 1,500 | 1995 | 12/98 | 5-40 years |
| | 3,988 | 1,139 | 4,555 | 985 | | 1,139 | 5,540 | 6,679 | 2,475 | 1902 | 12/90 | 5-40 years |

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|--|--------|-------|--------|-------|------------------------|-------|--------|--------|-------|------|-------|------------|
| Majestic Inn, San Francisco, CA | | | | | | | | | | | | |
| Piccadilly Airport, Fresno, CA | 4,718 | | 7,834 | 490 | (199) ⁽²⁾ | | 8,125 | 8,125 | 1,797 | 1970 | 10/97 | 7-40 years |
| Piccadilly Shaw, Fresno, CA | 5,478 | 2,392 | 9,567 | 958 | (493) ⁽²⁾ | 2,392 | 10,032 | 12,424 | 2,276 | 1973 | 10/97 | 7-40 years |
| Piccadilly University, Fresno, CA | 5,328 | | 12,011 | 297 | (289) ⁽²⁾ | | 12,019 | 12,019 | 2,373 | 1984 | 10/97 | 7-40 years |
| Quality Inn, Denver, CO | 3,520 | | 302 | 2,656 | (337) ⁽⁴⁾ | | 2,621 | 2,621 | 2,262 | 1974 | 6/94 | 7-40 years |
| The Majestic, Chicago, IL | | 572 | 2,287 | 1,600 | (292) ⁽⁴⁾ | 572 | 3,595 | 4,167 | 1,220 | 1995 | 12/98 | 5-40 years |
| Williamsburg Hospitality House, Williamsburg, VA | 11,020 | 4,049 | 16,195 | 2,875 | (1,979) ⁽²⁾ | 4,049 | 17,091 | 21,140 | 5,113 | 1973 | 09/97 | 7-40 years |

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AMERICAN REALTY INVESTORS, INC.

CONSOLIDATED REAL ESTATE AND ACCUMULATED DEPRECIATION

December 31, 2004

| Property/Location | Encum- brances | Initial Cost | | | Cost Capitalized Subsequent to Acquisition | Gross Amounts of Which Carried at End of Year | | | Accumu- lated Depreci- ation | Date of Construc- tion | Date Acquired | Life on Which Depreciation In Latest Statement of Operation is Computed |
|---|-------------------|--------------|---------------------------------|----------|---|--|--------------|--------------|---------------------------------------|------------------------------|------------------|---|
| | | Land | Building and Improvements | Other | Other | Land | Improvements | (1) Total | | | | |
| (dollars in thousands) | | | | | | | | | | | | |
| Properties Held for Investment (continued) | | | | | | | | | | | | |
| Hotels (continued) | | | | | | | | | | | | |
| Willows, Chicago, IL | \$ 3,490 | \$ 945 | \$ 3,779 | \$ 1,490 | \$ (411) ⁽⁴⁾ | \$ 945 | \$ 4,858 | \$ 5,803 | \$ 1,827 | 1995 | 12/98 | 5-40 years |
| Industrial Warehouses | | | | | | | | | | | | |
| 5360 Tulane, Atlanta, GA | 358 | 95 | 514 | 49 | (85) ⁽⁴⁾ | 95 | 478 | 573 | 334 | 1970 | 11/97 | 5-40 years |
| 5700 Tulane, Atlanta, GA | | | | 720 | (141) ⁽⁴⁾ | | 579 | 579 | 166 | 1998 | 11/97 | 40 years |
| Addison Hangar, Addison, TX | 4,308 | 928 | 1,481 | 33 | (162) ⁽⁴⁾ | 928 | 1,352 | 2,280 | 217 | 1992 | 12/99 | 5-40 years |
| Addison Hanger II, Addison, TX | | | 1,150 | 248 | (93) ⁽⁴⁾ | | 1,305 | 1,305 | 616 | 2000 | 12/99 | 5-40 years |
| Encon, Fort Worth, TX | 3,373 | 984 | 3,934 | 67 | (331) ⁽⁴⁾ | 984 | 3,670 | 4,654 | 721 | 1958 | 10/97 | 5-40 years |
| Space Center, San Antonio, TX | 1,043 | 247 | 1,332 | 112 | (235) ⁽⁴⁾ | 247 | 1,209 | 1,456 | 844 | 1970 | 11/97 | 5-40 years |
| Shopping Centers | | | | | | | | | | | | |
| Bridgeview Plaza | 6,319 | 870 | 7,830 | | (8,700) ⁽⁴⁾ | 870 | (870) | | | 1979 | 3/03 | |
| Cross County Mall, Mattoon, IL | 4,904 | 608 | 6,468 | 7,085 | (1,657) ⁽⁴⁾ | 608 | 11,896 | 12,504 | 10,400 | 1971 | 8/79 | 5-40 years |
| Cullman SC | 1,653 | 200 | 1,800 | | (133) ⁽⁴⁾ | 200 | 549 | 749 | 975 | 1979 | 3/03 | |
| | | | | | (1,118) ⁽⁴⁾ | | | | | | | |
| Dunes Plaza, Michigan City, IN | 2,705 | 1,230 | 5,430 | 1,897 | (482) ⁽⁵⁾ | 1,230 | 6,845 | 7,537 | 2,610 | 1978 | 3/92 | 5-40 years |
| | | | | | (538) ⁽⁴⁾ | | | | | | | |
| Promenade, Highlands Ranch, CO | 6,822 | 1,749 | 6,995 | 282 | (1,222) ⁽⁴⁾ | 1,749 | 6,055 | 7,804 | 1,698 | 1985 | 7/96 | 5-40 years |
| Merchandise Mart | | | | | | | | | | | | |
| Denver Mart, Denver, CO | 26,629 | 4,824 | 5,184 | 17,330 | 32 | 4,824 | 22,546 | 27,370 | 7,096 | 1965/1986 | 4/94 | 7-40 years |
| Single Family Residence | | | | | | | | | | | | |

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|---|---------|---------|---------|---------|----------------------|---------|---------|---------|---------|------|------|----------|
| Tavel Circle, Dallas, TX | 53 | 53 | 214 | | | 53 | 214 | 267 | 46 | 1978 | 5/96 | 30 years |
| | 772,791 | 104,982 | 436,457 | 469,679 | (76,635) | 104,982 | 830,039 | 934,483 | 172,030 | | | |
| Land | | | | | | | | | | | | |
| 1013 Commons, New Orleans, LA | | 615 | | 565 | (83) ⁽⁴⁾ | 579 | | 1,097 | 80 | | 8/98 | |
| 2301 Valley Branch, Farmers Branch, TX | 2,923 | 4,169 | | 84 | (285) ⁽⁴⁾ | 4,253 | | 3,968 | | | 9/02 | |
| 2524 Valley View Land, Farmers Branch, TX | | 200 | | | (48) ⁽²⁾ | 200 | (48) | 152 | | | 9/98 | |
| Alamo Springs, Dallas, TX | | 1,385 | | | (93) ⁽⁴⁾ | 1,385 | | 1,292 | | | 9/99 | |
| Backlick, Springfield, VA | | 74 | | | | 74 | | 74 | | | 1990 | |

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(Continued)

AMERICAN REALTY INVESTORS, INC.

CONSOLIDATED REAL ESTATE AND ACCUMULATED DEPRECIATION

December 31, 2004

| Property/Location | Encumbrances | Initial Cost | | Cost Capitalized Subsequent to Acquisition | Gross Amounts of Which Carried at End of Year | | | Accumulated Depreciation (1) | Date of Construction | Date Acquired | Life on Which Depreciation In Latest Statement of Operation is Computed |
|--------------------------------------|----------------------|--------------|---------------------------|--|---|--------------|--------|------------------------------|----------------------|---------------|---|
| | | Land | Building and Improvements | Other | Land | Improvements | Total | | | | |
| (dollars in thousands) | | | | | | | | | | | |
| Land (continued) | | | | | | | | | | | |
| Bee Street, Farmers Branch, TX | \$ | \$ 472 | \$ | \$ (114) ⁽²⁾ | \$ 472 | \$ (114) | \$ 358 | | | | 10/98 |
| Bonneau, Dallas County, TX | (6) | 1,102 | | | 1,102 | | 1,102 | | | | 2/98 |
| Centura, Farmers Branch, TX | 4,535 | 13,300 | 485 | (2,056) ⁽⁴⁾ | 13,591 | 224 | 7,353 | | | | 12/02 |
| | | | | (4,376) ⁽⁴⁾ | | | | | | | |
| Chase Oaks, Plano, TX | (6) | 4,511 | 377 | (3,898) ⁽³⁾ | 990 | | 990 | | | | 5/97 |
| Cooks Lane, Ft. Worth, TX | 550 | 1,046 | | | 1,046 | | 1,046 | | | | 6/04 |
| Croslin, Dallas, TX | | 327 | 6 | | 333 | | 333 | | | | 10/98 |
| Dalho, Farmers Branch, TX | (6) | 331 | | | 331 | | 331 | | | | 10/97 |
| Denton Coonrod, Denton, TX | 840 | 1,886 | | | 1,886 | | 1,886 | | | | 10/04 |
| DeSoto, DeSoto, TX | 1,265 | 2,651 | | | 2,651 | | 2,651 | | | | 10/04 |
| Dominion, Dallas, TX | 1,275 | 3,931 | | (264) ⁽⁴⁾ | 3,931 | | 3,667 | | | | 3/99 |
| Elm Fork Land, Denton County, TX | 4,700 | 17,294 | 206 | (10,481) ⁽³⁾ | 6,811 | | 6,811 | | | | 3/01 |
| | | | | (208) ⁽⁴⁾ | | | | | | | |
| Fiesta, San Angelo, TX | | 44 | | (3) ⁽⁴⁾ | 44 | (3) | 41 | | | | 12/91 |
| Folsom | | 1,781 | 450 | (150) ⁽⁴⁾ | 2,231 | | 2,081 | | | | 10/00 |
| Fruitland, Fruitland Park, FL | | 253 | | (110) ⁽⁴⁾ | 153 | | 143 | | | | 5/92 |
| FRWM Cummings, Farmers Branch, TX | | 1,284 | | | 1,284 | | 1,284 | | | | 5/98 |
| FT Wayne, Ft Wayne, IN | | 3 | | | 3 | | 3 | | | | 8/96 |
| Granbury Station, Ft. Worth, TX | 738 | 993 | | | 993 | | 993 | | | | 9/04 |
| Hollywood Casino, Farmers Branch, TX | 4,710 | 16,987 | 2 | (7,502) ⁽⁴⁾ | 16,989 | | 8,171 | | | | 6/02 |
| | | | | (1,316) ⁽⁴⁾ | | | | | | | |
| HSM, Farmers Branch, TX | 2,250 ⁽⁶⁾ | 2,361 | | | 2,361 | | 2,361 | | | | 8/98 |
| JHL Connell, Carrollton, TX | (6) | 1,451 | | (25) ⁽³⁾ | 1,426 | | 1,426 | | | | 2/98 |
| Katrina, Palm Desert, CA | 5,100 | 40,211 | 2,156 | (27,439) ⁽³⁾ | 10,125 | 2,156 | 12,281 | | | | 7/98 |
| | | | | (2,647) ⁽²⁾ | | | | | | | |
| Katy Road, Harris County, TX | 6,751 | 5,919 | 53 | | 5,919 | 53 | 5,972 | | | | 3/97 |
| Kelly Lots, Collin County, TX | 65 | 131 | | | 131 | | 131 | | | | 3/00 |
| | 1,954 | 1,908 | | | 1,908 | | 1,908 | | | | 6/04 |

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|-------------------------------------|-------|-------|--------------------|-------|-------|------|
| Lacy Longhorn, Farmers Branch, TX | | | | | | |
| LaDue, Farmers Branch, TX | 1,206 | 1,821 | | 1,821 | 1,821 | 9/04 |
| Lakeshore Villas, Harris County, TX | | 84 | (6) ⁽⁴⁾ | 84 | 78 | 3/02 |

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AMERICAN REALTY INVESTORS, INC.

CONSOLIDATED REAL ESTATE AND ACCUMULATED DEPRECIATION

December 31, 2004

| Property/Location | Encumbrances | Cost Capitalized Subsequent to Acquisition | | Gross Amounts of Which Carried at End of Year | | | Accumulated Depreciation (1) | Date of Construction | Date Acquired | Life on Which Depreciation In Latest Statement of Operation is Computed |
|--|--------------|--|---------------------------|---|----------|--------------|------------------------------|----------------------|---------------|---|
| | | Initial Cost | Building and Improvements | Other | Land | Improvements | | | | |
| (dollars in thousands) | | | | | | | | | | |
| Land (continued) | | | | | | | | | | |
| Lamar Parmer/Limestone II, Austin, TX | \$ | \$ 1,999 | \$ 564 | \$ (177) ⁽⁴⁾ | \$ 1,999 | \$ 564 | \$ 2,386 | | | 1/00 |
| Las Colinas I, Las Colinas, TX | | 14,076 | 28 | (13,891) ⁽³⁾ | 213 | | 213 | | | 5/95 |
| Las Colinas, Las Colinas, TX | | 995 | 5 | (67) ⁽⁴⁾ | 1,000 | | 933 | | | 1/96 |
| LCLLP, Los Colinas, TX | 3,121 | 4,950 | | (2,752) ⁽⁴⁾ | 4,950 | | 2,198 | | | 12/04 |
| Lemon Carlisle, Dallas, TX | 1,744 | 3,576 | 30 | (242) ⁽⁴⁾ | 3,606 | | 3,364 | | | 2/98 |
| Leone, Irving, TX | 1,210 | 1,625 | | | 1,625 | | 1,625 | | | 1996 |
| Lubbock, Lubbock, TX | | 224 | | | 224 | | 224 | | | 1/04 |
| Manhattan, Farmers Branch, TX | | 11,186 | 971 | (812) ⁽⁴⁾ | 12,136 | 20 | 11,345 | 36 | | 2/00 |
| Marine Creek, Ft. Worth, TX | 1,775 | 2,923 | 19 | (1,584) ⁽⁴⁾ | 2,923 | 19 | 24 | | | 6/02 |
| | | | | (1,334) ⁽⁴⁾ | | | | | | |
| Mason Park, Houston, TX | | 2,790 | 326 | (1,982) ⁽⁴⁾ | 1,602 | 326 | 1,134 | | | 6/02 |
| Mason/Goodrich, Houston, TX | | 11,914 | 279 | (11,008) ⁽³⁾ | 906 | 279 | 1,185 | | | 11/98 |
| McKinney 36, Collin County, TX | 1,751 | 2,203 | | (362) ⁽⁴⁾ | 1,973 | | 1,841 | | | 1/98 |
| McKinney Corners II, Collin County, TX | (6) | 5,911 | | (5,386) ⁽³⁾ | 525 | | 525 | | | 4/97 |
| Meloy/Portage, Kent, Ohio | 3,765 | 5,243 | | (124) ⁽²⁾ | 5,119 | | 5,119 | | | 2/04 |
| Mendoza, Dallas, TX | | 192 | | | 192 | | 192 | | | 10/98 |
| Mira Lago, Farmers Branch, TX | | 253 | | (40) ⁽⁴⁾ | 253 | | 213 | | | 5/01 |
| Nakash | 10 | 113 | | (8) ⁽⁴⁾ | 113 | | 105 | | | |
| Nashville, Nashville, TN | | 1,890 | 34 | (1,016) ⁽⁴⁾ | 1,890 | 34 | 908 | | | 6/02 |
| Nashville, Nashville, TN | | 7,774 | | (3,344) ⁽³⁾ | 4,430 | | 4,430 | | | 5/99 |
| Pac-Trust, Dallas, TX | | 1,232 | | (83) ⁽⁴⁾ | 1,232 | | 1,149 | | | 10/01 |
| Payne, Los Colinas, TX | | 17,500 | | (10,307) ⁽²⁾ | 17,500 | | 7,193 | | | 12/04 |
| Pioneer Crossing, Austin, TX | 6,266 | 23,255 | 2,866 | (17,469) ⁽³⁾ | 5,786 | 2,866 | 8,652 | | | 5/97 |
| Pulaski, Pulaski County, AR | 1,400 | 2,095 | | | 2,095 | | 2,095 | | | 6/03 |
| Railroad, Dallas, TX | | 782 | | | 782 | | 782 | | | 3/04 |
| Rochelle I, Los Colinas, TX | 2,547 | 3,750 | | (2,085) ⁽⁴⁾ | 3,750 | | 1,665 | | | 12/04 |

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|----------------------------------|-------|-------|--------------------------|-------|-------|-------|
| Rochelle II, Los Colinas, TX | 4,338 | 6,445 | (3,583) ⁽⁴⁾ | 6,445 | 2,862 | 12/04 |
| Rogers, Rogers, AR | 1,130 | 1,749 | | 1,749 | 1,749 | 4/04 |
| Round Mt, Austin, TX | | 5,740 | (5,442) ^(2,4) | 319 | 298 | 12/86 |
| Seminary West, Fort Worth, TX | | 234 | (16) ⁽⁴⁾ | 234 | 218 | 6/01 |

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December 31, 2004

| Property/Location | Encum- brances | Initial Cost | | | Gross Amounts of Which Carried at End of Year | | | Accumu- lated Depreci- ation | Date of Construc- tion | Date Acquired | Life on Which Depreciation In Latest Statement of Operation is Computed |
|--|----------------------|--------------|---------------------------------|--|--|---------------------------------|--------------|------------------------------------|------------------------------|------------------|---|
| | | Land | Building and Improvements | Cost Capitalized Subsequent to Acquisition Other | Land | Building and Improvements | (1) Total | | | | |
| (dollars in thousands) | | | | | | | | | | | |
| Land (continued) | | | | | | | | | | | |
| Sheffield Village, Grand Prairie, TX | \$ 975 | \$ 1,643 | \$ | \$ | \$ 1,643 | \$ | \$ 1,643 | \$ | | 9/03 | |
| Siskiyou, Siskiyou County, CA | | 3 | | | 3 | | 3 | | | 8/96 | |
| Sladek Land, Travis County, TX | | 764 | | | 764 | | 764 | | | 5/00 | |
| Stagliano, Farmers Branch, TX | (6) | 566 | | | 566 | | 566 | | | 12/97 | |
| Thompson II, Dallas County, TX | | 505 | | (31) ⁽³⁾ | 474 | | 474 | | | 7/98 | |
| Thompson, Farmers Branch, TX | | 948 | | | 948 | | 948 | | | 10/97 | |
| Tomlin, Farmers Branch, TX | | 1,878 | | | 1,878 | | 1,878 | | | 10/97 | |
| Travelers, Farmers Branch, TX | 22,802 | 25,000 | | (2,354) ⁽²⁾ | 25,000 | (2,354) | 22,646 | | | 11/03 | |
| Valley Ranch, Irving, TX | | 6,500 | | (1,479) ⁽⁴⁾ | 6,500 | | 5,021 | | | 12/04 | |
| Valley View 34, Farmers Branch, TX | | 1,652 | 1,035 | 32 | 1,652 | 1,067 | 2,719 | 18 | | 8/96 | 7 Years |
| Valwood, Dallas, TX | 9,842 | 13,969 | 989 | (3,123) ⁽³⁾ | 10,846 | 989 | 11,835 | | | 8/96 | |
| Vineyards II, Grapevine, TX | 1,309 | 6,934 | 7 | (2,373) ⁽³⁾ | 4,568 | | 4,568 | | | 6/99 | |
| Vineyards, Grapevine, TX | 2,165 | 4,982 | | (515) ⁽³⁾ | 4,982 | (515) | 4,467 | | | 10/97 | |
| Vista Ridge, Lewisville, TX | 9,661 ⁽⁶⁾ | 16,322 | 440 | (10,159) ⁽³⁾ | 6,163 | 440 | 6,603 | | | 9/98 | |
| | 8,750 | 13,534 | 34 | | 13,534 | 34 | 13,568 | | | 7/98 | |

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Walker, Dallas

County, TX

West End, Dallas,

| | | | | | | | | | |
|----|-------|--------|--|----|------------------------|-------|----|-------|------|
| TX | 1,061 | 11,405 | | 77 | (4,013) ⁽³⁾ | 7,392 | 77 | 6,968 | 8/97 |
| | | | | | (501) ⁽⁴⁾ | | | | |

| | | | | | | | | | |
|--|---------|---------|----|--------|-----------|---------|-------|---------|-----|
| | 124,484 | 377,749 | 34 | 12,054 | (168,734) | 257,591 | 6,114 | 221,103 | 134 |
|--|---------|---------|----|--------|-----------|---------|-------|---------|-----|

| | | | | | | | | | |
|--|------------|------------|------------|------------|--------------|------------|------------|--------------|------------|
| | \$ 897,275 | \$ 482,731 | \$ 436,491 | \$ 481,733 | \$ (245,369) | \$ 362,573 | \$ 836,153 | \$ 1,155,586 | \$ 172,164 |
|--|------------|------------|------------|------------|--------------|------------|------------|--------------|------------|

(1) The aggregate cost for federal income tax purposes is \$1,070.9 million.

(2) Write down of property to estimated net realizable value.

(3) Cost basis assigned to portion of property sold.

(4) Purchase accounting basis adjustment.

(5) Forgiveness of debt and cash received deducted from the basis of the property, offset by land acquired in 1992.

(6) Pledged as collateral on a loan primarily secured by another parcel of land.

(7) Construction period interest and taxes.

(8) Property under construction.

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SCHEDULE III

(Continued)

AMERICAN REALTY INVESTORS, INC.

REAL ESTATE AND ACCUMULATED DEPRECIATION (Continued)

| | <u>2004</u> | <u>2003</u> | <u>2002</u> |
|--|---------------------------------------|-------------------|-------------------|
| | As Restated (dollars in thousands) | | |
| Reconciliation of Real Estate | | | |
| Balance at January 1, | \$ 1,233,057 | \$ 567,731 | \$ 712,284 |
| Additions | | | |
| Initial consolidation of TCI properties | | 866,464 | |
| Acquisitions and improvements | 198,006 | 139,006 | 58,931 |
| Deductions | | | |
| Sales of real estate | (249,703) | (261,694) | (199,313) |
| Purchase accounting write down | (8,434) | (58,558) | |
| Property write down | (17,340) | (19,892) | (4,171) |
| | <u> </u> | <u> </u> | <u> </u> |
| Balance at December 31, | \$ 1,155,586 | \$ 1,233,057 | \$ 567,731 |
| | <u> </u> | <u> </u> | <u> </u> |
| Reconciliation of Accumulated Depreciation | | | |
| Balance at January 1, | \$ 179,021 | \$ 101,689 | \$ 121,796 |
| Additions | | | |
| Initial consolidation of TCI properties | | 84,550 | |
| Depreciation | 30,440 | 28,832 | 13,142 |
| Deductions | | | |
| Sales of real estate | (37,297) | (36,050) | (33,249) |
| | <u> </u> | <u> </u> | <u> </u> |
| Balance at December 31, | \$ 172,164 | \$ 179,021 | \$ 101,689 |
| | <u> </u> | <u> </u> | <u> </u> |

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SCHEDULE IV

AMERICAN REALTY INVESTORS, INC.

MORTGAGE LOANS ON REAL ESTATE

December 31, 2004

| Description | Interest Rate | Final Maturity Date | Periodic Payment Terms | Prior Liens | Face Amount of Mortgage | Carrying Amounts of Mortgage (1)(2) | Principal Amount of Loans Subject to Delinquent Principal or Interest |
|---|---------------|---------------------|--|-------------|-------------------------|-------------------------------------|---|
| (dollars in thousands) | | | | | | | |
| FIRST MORTGAGE | | | | | | | |
| 400 St. Paul | 7.0% | 03/07 | Monthly interest only payments. | \$ | \$ 5,400 | \$ 4,768 | \$ |
| Secured by an office building in Dallas, TX Includes LOC of \$250,000 | | | | | | | |
| La Quinta Village Center, LLC | 8.0% | 02/06 | Interest accrual and payments based on completion dates not yet met. | | 5,650 | 5,650 | |
| First lien on 134.3 gross acres in Palm Desert, CA | | | | | | | |
| NAP Mason Park | 18.0% | 05/03 | All principal & interest due at maturity. | | 1,360 | 1,360 | 1,360 |
| First lien DOT on 13 acres in Harris County, TX | | | | | | | |
| Mason Creek, L.P. | 10.0% | 03/06 | Monthly interest payments. | | 523 | 523 | |
| 1 st lien on 8 acres, Harris County, TX | | | | | | | |
| WRAPAROUND MORTGAGE | | | | | | | |
| In the Pines, LLC | 7.0% | 04/05 | Property and interest due at maturity. | | 575 | 575 | |
| 2 nd lien on apartment building in Gainesville, Florida | | | | | | | |
| Nakash | | | Monthly interest only payments. | 10 | 902 | 902 | |
| Secured by a shopping center in Malden, MO | | | | | | | |
| JUNIOR MORTGAGE | | | | | | | |
| Dallas Fund XVII | Varies | 05/03 | One note bearing interest at the default rate of 18%. | | 4,303 | 3,161 | |
| Secured by an assignment of partnership interests and litigation proceeds | | | | | | | |
| One Hickory | 5.49% | 09/04 | Monthly interest only payments. | 7,306 | 11,974 | 11,974 | |

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| | | | | | | |
|---|-------|--------|--|--------|-------|-------|
| Secured by an office building in Farmers Branch, TX | | | | | | |
| Palmer Lane Golf, Inc. | 8.0% | 09/06 | All interest & principal due at maturity. | 14,625 | 2,250 | 2,250 |
| First lien on 367 acres of land in Travis County, TX. Non-recourse note | | | | | | |
| Pinemont | 10.4% | 07/08 | Monthly principal and interest payments. | 204 | 467 | 225 |
| Secured by an office building in Houston, TX | | | | | | |
| Pioneer Development | 10.0% | 10/08 | Interest only payments start in November 2007. | 12,000 | 2,386 | 2,626 |
| Secured by 33.33 acres of unimproved land in Travis County, TX | | | | | | |
| United Housing of Chase Oaks | 4.0% | Demand | Excess property cash flow payments. | | 341 | 341 |
| 2 nd lien on 22 acres of land in Collin County, TX | | | | | | |

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SCHEDULE IV

(Continued)

AMERICAN REALTY INVESTORS, INC.

MORTGAGE LOANS ON REAL ESTATE

December 31, 2004

| Description | Interest Rate | Final Maturity Date | Periodic Payment Terms | Prior Liens | Face Amount of Mortgage | Carrying Amounts of Mortgage (1)(2) | Principal Amount of |
|---|---------------|---------------------|---|-------------|-------------------------|-------------------------------------|---|
| | | | | | | | Loans Subject to Delinquent Principal or Interest |
| (dollars in thousands) | | | | | | | |
| OTHER | | | | | | | |
| Apartment Development Services | 12.0% | 06/05 | Principal and interest due at maturity. | \$ | \$ | 300 | \$ 300 \$ |
| Secured by 100% interest in partnership | | | | | | | |
| Blue Lake at Marine Creek | 6.0% | 12/07 | Excess cash flow payments. | | 1,468 | 270 | |
| Guaranteed by Unified Housing Foundation | | | | | | | |
| Countryside, L.P. | 7.25% | 01/07 | Quarterly interest payments. | | 2,300 | 2,300 | |
| Secured by Class A partnership units in TCI Countryside, L.P. | | | | | | | |
| Countryside, L.P. | 7.25% | 07/13 | Quarterly interest payments. | | 1,050 | 210 | |
| Secured by Class A partnership units in TCI Countryside, L.P. | | | | | | | |
| Edwin Schreiber | 8.5% | 06/06 | Interest only paid quarterly. | | 200 | 200 | |
| Class A limited partnership interests in Encino Executive Plaza Limited | | | | | | | |
| UHF Kensington | 12.0% | 04/09 | Excess property cash flow. | | 125 | 125 | |
| 100% interest in UH of Kensington, LLC. | | | | | | | |
| SSG Management | 8.5% | 06/06 | Interest only paid quarterly. | | 296 | 296 | |
| Class A limited partnership interests in Encino Executive Plaza Limited | | | | | | | |
| Sarah Gross | 8.5% | 06/06 | Interest only paid quarterly. | | 951 | 951 | |
| Class A limited partnership interests in Encino Executive Plaza Limited | | | | | | | |

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| | | | | | | |
|--|------------|-------|---|-------|-------|-------|
| Barry Gross | 8.5% | 06/06 | Interest only paid quarterly. | 120 | 120 | |
| Class A limited partnership interests in Encino Executive Plaza Limited | | | | | | |
| Realty Advisors | Prime+2.0% | 11/06 | All principal and interest are due at maturity. | 5,633 | 5,633 | |
| Secured by a pledge of 850,000 shares of ARI Common Stock owned by BCM | | | | | | |
| Desert Wells 237, LLC | 12.0% | 03/03 | All principal and interest due at maturity. | 3,568 | 4,667 | 4,667 |
| Second lien DOT on 238 acres on Palm Desert, CA | | | | | | |
| Robert Baylis | 10.0% | 09/17 | Interest only paid quarterly. | 194 | 194 | |
| Class A limited partnership interests in Edina Park Plaza Associates L.P. | | | | | | |
| Herrick Partners | 10.0% | 09/17 | Interest only paid quarterly. | 92 | 92 | |
| Class A limited partnership interests in Edina Park Plaza Associates, L.P. | | | | | | |

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SCHEDULE IV

(Continued)

AMERICAN REALTY INVESTORS, INC.

MORTGAGE LOANS ON REAL ESTATE

December 31, 2004

| Description | Interest Rate | Final Maturity Date | Periodic Payment Terms | Prior Liens | Face Amount of Mortgage | Carrying Amounts of Mortgage (1)(2) | Principal Amount of Loans Subject to Delinquent Principal or Interest |
|---|---------------|---------------------|-------------------------------|-------------|-------------------------|-------------------------------------|---|
| (dollars in thousands) | | | | | | | |
| 2410 Partnership | 10.0% | 09/17 | Interest only paid quarterly. | \$ | \$ 145 | \$ 145 | \$ |
| Class A limited partnership interests in Edina Park Plaza Associates, LP. | | | | | | | |
| Michale Witte | 10.0% | 09/17 | Interest only paid quarterly. | | 96 | 96 | |
| Class A limited partnership interests in Edina Park Plaza Associates, LP. | | | | | | | |
| Richard Schmaltz | 10.0% | 09/17 | Interest only paid quarterly. | | 203 | 203 | |
| Class A limited partnership interests in Edina Park Plaza Associates, LP. | | | | | | | |
| Willingham Trust | 10.0% | 09/17 | Interest only paid quarterly. | | 96 | 96 | |
| Class A limited partnership interests in Edina Park Plaza Associates, LP. | | | | | | | |
| Michael Monier | 10.0% | 09/17 | Interest only paid quarterly. | | 304 | 304 | |
| Class A limited partnership interests in Edina Park Plaza Associates, LP. | | | | | | | |
| Harold Wolfe | 10.0% | 09/17 | Interest only paid quarterly. | | 193 | 193 | |
| Class A limited partnership interests in Edina Park Plaza Associates, LP. | | | | | | | |
| Compton Partners | 10.0% | 09/17 | Interest only paid quarterly. | | 289 | 289 | |
| Class A limited partnership interests in Edina Park Plaza Associates, LP. | | | | | | | |
| Christine Tunney | 10.0% | 09/17 | Interest only paid quarterly. | | 48 | 48 | |

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Class A limited partnership interests
in Edina Park Plaza Associates, LP.

| | | | | | |
|----------------------|-------|-------|-------------------------------|----|----|
| Edward Samson | 10.0% | 09/17 | Interest only paid quarterly. | 96 | 96 |
|----------------------|-------|-------|-------------------------------|----|----|

Class A limited partnership interests
in Edina Park Plaza Associates, LP.

| | | | | | |
|-------------------------------|-------|-------|-------------------------------|-----|-----|
| Hammon Operating Corp. | 10.0% | 09/17 | Interest only paid quarterly. | 193 | 193 |
|-------------------------------|-------|-------|-------------------------------|-----|-----|

Class A limited partnership interests
in Edina Park Plaza Associates, LP.

| | | | | | |
|----------------------------|-------|-------|-------------------------------|----|----|
| Palmer Brown Madden | 10.0% | 09/17 | Interest only paid quarterly. | 96 | 96 |
|----------------------------|-------|-------|-------------------------------|----|----|

Class A limited partnership interests
in Edina Park Plaza Associates, LP.

| | | | | | |
|--------------------------|-------|-------|-------------------------------|-----|-----|
| Quintin Smith Jr. | 10.0% | 09/17 | Interest only paid quarterly. | 193 | 193 |
|--------------------------|-------|-------|-------------------------------|-----|-----|

Class A limited partnership interests
in Edina Park Plaza Associates, LP.

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SCHEDULE IV

(Continued)

AMERICAN REALTY INVESTORS, INC.

MORTGAGE LOANS ON REAL ESTATE

December 31, 2004

| Description | Interest Rate | Final Maturity Date | Periodic Payment Terms | Prior Liens | Face Amount of Mortgage | Carrying Amounts of Mortgage (1)(2) | Principal Amount of Loans Subject to Delinquent Principal or Interest |
|---|---------------|---------------------|-------------------------------|-------------|-------------------------|-------------------------------------|---|
| (dollars in thousands) | | | | | | | |
| William Ingram | 10.0% | 09/17 | Interest only paid quarterly. | \$ | \$ 96 | \$ 96 | \$ |
| Class A limited partnership interests in Edina Park Plaza Associates, LP. | | | | | | | |
| Earl Samson | 10.0% | 09/17 | Interest only paid quarterly. | | 96 | 96 | |
| Class A limited partnership interests in Edina Park Plaza Associates, LP. | | | | | | | |
| Mary Ann MacLean | 10.0% | 09/17 | Interest only paid quarterly. | | 193 | 193 | |
| Class A limited partnership interests in Edina Park Plaza Associates, LP. | | | | | | | |
| Peter Van Dyk Berg | 10.0% | 09/17 | Interest only paid quarterly. | | 193 | 193 | |
| Class A limited partnership interests in Edina Park Plaza Associates, LP. | | | | | | | |
| William Urkie | 10.0% | 09/17 | Interest only paid quarterly. | | 96 | 96 | |
| Class A limited partnership interests in Edina Park Plaza Associates, LP. | | | | | | | |
| Sherman Bull | 10.0% | 09/17 | Interest only paid quarterly. | | 193 | 193 | |
| Class A limited partnership interests in Edina Park Plaza Associates, LP. | | | | | | | |
| David Monier | 10.0% | 09/17 | Interest only paid quarterly. | | 96 | 96 | |
| Class A limited partnership interests in Edina Park Plaza Associates, LP. | | | | | | | |
| Trust Joseph Monier | 10.0% | 09/17 | Interest only paid quarterly. | | 32 | 32 | |

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Class A limited partnership interests
in Edina Park Plaza Associates, LP.

| | | | | | |
|--|-------|-------|-------------------------------|----|----|
| Trust-Brett & Nicole Monier | 10.0% | 09/17 | Interest only paid quarterly. | 32 | 32 |
|--|-------|-------|-------------------------------|----|----|

Class A limited partnership interests
in Edina Park Plaza Associates, LP.

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SCHEDULE IV

(Continued)

AMERICAN REALTY INVESTORS, INC.

MORTGAGE LOANS ON REAL ESTATE

December 31, 2004

| Description | Interest Rate | Final Maturity Date | Periodic Payment Terms | Prior Liens | Face Amount of Mortgage | Carrying Amounts of Mortgage (1)(2) | Principal Amount of Loans Subject to Delinquent Principal or Interest |
|---|---------------|---------------------|---|-------------|-------------------------|-------------------------------------|---|
| | | | | | | | |
| Trust-David Monier | 10.0% | 09/17 | Interest only paid quarterly. | \$ | \$ 32 | \$ 32 | \$ |
| Class A limited partnership interests in Edina Park Plaza Associates, LP. | | | | | | | |
| NAP Mason Park | 9.0% | 02/03 | Principal and interest due at maturity. | | 200 | 200 | 200 |
| 2 nd Lien on 13 acres of land Harris County, TX | | | | | | | |
| UNSECURED | | | | | | | |
| BCM K-Mart Cary | 7.5% | 04/05 | Monthly interest payments. | | 1,523 | 1,523 | |
| BCM Texstar Warehouse | 7.5% | 04/05 | Monthly interest payments. | | 1,252 | 1,252 | |
| Commercial Ventures | 8.5% | 04/05 | Monthly interest payments. | | 425 | 425 | |
| One Realco | Prime +2.0% | 02/07 | All principal and interest due at maturity. | | 18,000 | 9,949 | |
| Today Forest Park Investment | 0.0% | None | Partnership distribution as available. | | 678 | 678 | |
| Treetops/Colony Meadows | 18.0% | 04/03 | All principal and interest due at maturity. | | 1,017 | 1,017 | 1,017 |
| Harvest Hill, LLC | 12.0% | 09/13 | Interest compounded annually. All principal and interest are due at maturity. | | 1,429 | 1,604 | |
| Harvest Hill I, LLC | 12.0% | 09/13 | Interest compounded annually. All principal and interest are due at maturity. | | 1,426 | 1,600 | |
| Harvest Hill III, LLC | 12.0% | 09/13 | Interest compounded annually. All principal and interest are due at maturity. | | 2,127 | 2,387 | |
| | | | | \$ 34,145 | \$ 83,516 | 73,359 | \$ 7,244 |
| Interest receivable | | | | | | 1,167 | |
| Allowance for estimated losses | | | | | | (1,865) | |

\$ 72,661

-
- (1) The aggregate cost for federal income tax purposes is \$73.4 million.
 - (2) Interest rates and maturity dates shown are as stipulated in the loan documents at December 31, 2004. Where applicable, these rates have been adjusted at issuance to yield between 8.0% and 12.0%.

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SCHEDULE IV

(Continued)

AMERICAN REALTY INVESTORS, INC.

MORTGAGE LOANS ON REAL ESTATE

| | <u>2004</u> | <u>2003</u> | <u>2002</u> |
|---|------------------------|-------------------|-------------------|
| | (dollars in thousands) | | |
| Balance at January 1, | \$ 71,178 | \$ 83,092 | \$ 31,413 |
| Additions | | | |
| New mortgage loans | 46,660 | 67,464 | 63,273 |
| Initial consolidation of TCI loans | | 15,873 | |
| Funding of existing loans | 1,296 | | 2,686 |
| Deductions | | | |
| Collections of principal | (12,368) | (56,592) | (14,280) |
| Conversion to property interest | | (1,612) | |
| Mortgages eliminated from consolidation of partnerships | (23,754) | | |
| Reclass to accounts receivable | (1,387) | | |
| Sale of Notes Receivable | (8,266) | (37,047) | |
| | <u> </u> | <u> </u> | <u> </u> |
| Balance at December 31, | \$ 73,359 | \$ 71,178 | \$ 83,092 |
| | <u> </u> | <u> </u> | <u> </u> |

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ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

Effective June 1, 2004, the Audit Committee of the Board of Directors of ARI engaged the Plano, Texas firm of Farmer, Fuqua & Huff, P.C. as the independent accountants to audit ARI's financial statements. During the Registrant's two most recent fiscal years and any subsequent interim period, ARI did not consult with Farmer, Fuqua & Huff, P.C. or any of its members about the application of accounting principles to any specified transaction or any other matter. The decision to change accountants was approved by the Audit Committee of the Board of Directors of TCI consisting of Ted R. Munselle (Chairman), Martin L. White and Sharon Hunt.

The engagement effective June 1, 2004 of Farmer, Fuqua & Huff, P.C. as the new independent accountant for ARI necessarily results in the termination or dismissal of the principal accountant which audited ARI's financial statements for the past two fiscal years ended December 31, 2002 and 2003, BDO Seidman, LLP. BDO Seidman, LLP's anticipated fee proposal estimate to ARI for the balance of 2004 after the first quarter ended was expected to be greater than the fee proposal of Farmer, Fuqua & Huff, P.C. for the same work. During the Registrant's two most recent fiscal years and the subsequent interim period through June 1, 2004, there were no disagreements between the Registrant and BDO Seidman, LLP concerning any matter of accounting principles or practices, financial statement disclosure or auditing scope or procedure which disagreements, if not resolved to BDO Seidman, LLP's satisfaction would have caused them to make reference to the subject matter of the disagreement in connection with their report; there were no reportable events as described in Item 304(a)(1)(v) of Regulation S-K.

BDO Seidman, LLP's reports dated April 11, 2003 and April 15, 2004 on ARI's financial statements for the years ended December 31, 2002 and 2003 did not contain any adverse opinion or disclaimer of opinion, nor were they qualified or modified as to uncertainty, audit scope or accounting principles. Each report did contain an emphasis paragraph highlighting that management has indicated its intent to sell income-producing properties and refinance or extend debt secured by real estate to meet its liquidity needs.

ITEM 9A. CONTROLS AND PROCEDURES

As required by rule 13a-15(b), ARI's management, including the Acting Principal Executive Officer and Principal Accounting Officer, conducted an evaluation as of the end of the period covered by this report, of the effectiveness of ARI's disclosure controls and procedures as defined in Exchange Act Rule 13a-15(e). Based on that evaluation, the chief executive officer and the chief financial officer concluded that ARI's disclosure controls and procedures were effective as of the end of the period covered by this report. As required by rule 13a-15(d), ARI's management, including the Acting Principal Executive Officer and Principal Accounting Officer, also conducted an evaluation of ARI's internal controls over financial reporting to determine whether any changes occurred during the fourth fiscal quarter that have materially affected, or are reasonably likely to materially affect, ARI's internal control over financial reporting. Based on the evaluation, there has been no such change during the fourth fiscal quarter.

During 2004, ARI discovered an error in the depreciation calculation for a commercial property purchased in 2003. The correction of the error resulted in a restatement for 2003 that increased net income by \$1.2 million, increased total assets by \$0.7 million, and decreased minority interest by \$0.5 million (from amounts originally reported).

ARI intends to continually review and evaluate the design and effectiveness of its disclosure controls and procedures over time, and to correct any deficiencies that it may discover in the future. The goal is to ensure that management has timely access to all material financial and non-financial information concerning ARI's business.

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It should be noted that any system of controls, however well designed and operated, can only provide reasonable, and not absolute, assurance that the objectives of the system will be met. In addition, the design of any control system is based in part upon certain assumptions about the likelihood of future events.

ITEM 9B. OTHER INFORMATION

Not applicable.

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PART III

ITEM 10. *DIRECTORS, EXECUTIVE OFFICERS AND ADVISOR OF THE REGISTRANT*

Directors

The affairs of American Realty Investors, Inc. (ARI) are managed by a Board of Directors. The Directors are elected at the annual meeting of stockholders or are appointed by the incumbent Board and serve until the next annual meeting of stockholders or until a successor has been elected or appointed.

It is the Board's objective that a majority of the Board consists of independent directors. For a Director to be considered independent, the Board must determine that the Director does not have any direct or indirect material relationship with ARI. The Board has established guidelines to assist it in determining director independence which conform to, or are more exacting than, the independence requirements in the New York Stock Exchange listing rules. The independence guidelines are set forth in ARI's Corporate Governance Guidelines. The text of this document has been posted on ARI's Internet website at <http://www.amrealtytrust.com> and is available in print to any shareholder who requests it. In addition to applying these guidelines, the Board will consider all relevant facts and circumstances in making an independence determination.

ARI has adopted a code of conduct that applies to all Directors, officers and employees, including our principal executive officer, principal financial officer and principal accounting officer. Stockholders may find our code of conduct on our website by going to our website address at <http://www.amrealtytrust.com>. We will post any amendments to the code of conduct, as well as any waivers that are required to be disclosed by the rules of the SEC or the New York Stock Exchange on our website.

Our Board of Directors has adopted charters for our Audit, Compensation and Governance and Nominating Committees of the Board of Directors. Stockholders may find these documents on our website by going to the website address at <http://www.amrealtytrust.com>. You may also obtain a printed copy of the materials referred to by contacting us at the following address:

American Realty Investors, Inc.

Attn: Investor Relations

1800 Valley View Lane, Suite 300

Dallas, Texas 75234

Telephone: 469-522-4200

All members of the Audit Committee and the Nominating and Corporate Governance Committee must be independent directors. Members of the Audit Committee must also satisfy additional independence requirements, which provide (i) that they may not accept, directly or indirectly, any

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consulting, advisory, or compensatory fee from ARI or any of its subsidiaries other than their Director's compensation (other than in their capacity as a member of the Audit Committee, the Board of Directors, or any other committee of the Board), and (ii) no member of the Audit Committee may be an affiliated person of ARI or any of its subsidiaries, as defined by the Securities and Exchange Commission.

The current Directors of ARI are listed below, together with their ages, terms of service, all positions and offices with ARI, its former advisor (BCM), or current advisor (Prime), which took over as contractual advisor for BCM on July 1, 2003, their principal occupations, business experience and directorships with other companies during the last five years or more. The designation Affiliated, when used below with respect to a Director, means that the Director is an officer, director or employee of BCM, Prime or an officer of ARI or an officer or director of an affiliate of ARI. The designation Independent, when used below with respect to a Director, means that the Director is neither an officer of ARI nor a director, officer or employee of BCM or Prime (but may be a director of ARI), although ARI may have certain business or professional relationships with such Director as discussed in ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS Certain Business Relationships.

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TED P. STOKELY: Age 71, Director and Chairman of the Board (Affiliate) (since November 2002).

General Manager (since January 1995) of ECF Senior Housing Corporation, a nonprofit corporation; General Manager (since January 1993) of Housing Assistance Foundation, Inc., a nonprofit corporation; Part-time unpaid consultant (since January 1993) and paid consultant (April 1992 to December 1992) of Eldercare Housing Foundation, a nonprofit corporation; General Manager (since April 2002) of Unified Housing Foundation, Inc., a nonprofit corporation; Director (since April 1990) and Chairman of the Board (since January 1995) of Income Opportunity Realty Investors, Inc. (IORI) and Transcontinental Realty Investors, Inc. (TCI).

HENRY A. BUTLER: Age 54, Director (Affiliate) (since July 2003).

Broker Land Sales (since 1992) for BCM and Director (December 2001 to July 2003) of IORI.

SHARON HUNT: Age 62, Director (Independent) (since February 2004).

Licensed Realtor in the Dallas, Texas area with Cook Realtors; President and Owner of Sharon s Pretzels, Inc., a Dallas, Texas food products entity; Director (1991 to 2000) of a 501(c)(3) non-profit corporation involved in the acquisition, renovation and operation of real estate; and Director (since February 2004) of TCI.

TED R. MUNSELLE: Age 49, Director (Independent) (since February 2004).

Vice President and Chief Financial Officer (since October 1998) of Landmark Nurseries, Inc.; employed in the accounting industry from 1977 until 1998; Certified Public Accountant in the State of Texas; and Director (since February 2004) of TCI.

MARTIN L. WHITE: Age 65, Director (Independent) (since July 2003).

Chief Executive Officer (since 1995) of Builders Emporium, Inc.; Chairman and Chief Executive Officer (since 1993) of North American Trading Company Ltd.; President and Chief Operating Officer (since 1992) of Community Based Developers, Inc.; and Director (January 1995 to March 2004) of IORI.

Board Meetings and Committees

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The Board of Directors held 16 meetings during 2004. For such year, no incumbent Director attended fewer than 75.0% of the aggregate of (1) the total number of meetings held by the Board during the period for which he had been a Director and (2) the total number of meetings held by all committees of the Board on which he served during the periods that he served.

The Board of Directors has standing Audit, Compensation and Governance and Nominating Committees. The Audit Committee was formed on February 19, 2004, and its function is to review ARI's operating and accounting procedures. A Charter of the Audit Committee has also been adopted by the Board. The Audit Committee is an audit committee for purposes of Section 3(a)(58) of the Securities Exchange Act of 1934. The current members of the Audit Committee, all of whom are independent within the meaning of the SEC Regulations, the listing standards of the New York Stock Exchange, Inc. and ARI's Corporate Governance Guidelines, are Messrs. White and Munselle (Chairman) and Ms. Hunt. Mr. Ted R. Munselle, a member of the Committee, is qualified as an Audit Committee financial expert within the meaning of SEC Regulations, and the Board has determined that he has accounting and related financial management expertise within the meaning of the listing standards of the New York Stock Exchange, Inc. All of the members of the Audit Committee meet the experience requirements of the listing standards of the New York Stock Exchange. The Audit Committee met 12 times during 2004.

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The Governance and Nominating Committee is responsible for developing and implementing policies and practices relating to corporate governance, including reviewing and monitoring implementation of ARI's Corporate Governance Guidelines. In addition, the Committee develops and reviews background information on candidates for the Board and makes recommendations to the Board regarding such candidates. The Committee also prepares and supervises the Board's annual review of director independence and the Board's performance self-evaluation. The Charter of the Governance and Nominating Committee was adopted on March 22, 2004. The members of the Committee are Messrs. White (Chairman) and Munselle and Ms. Hunt.

The Board has also formed a Compensation Committee of the Board of Directors, adopted a Charter for the Compensation Committee on March 22, 2004, and selected Messrs. Munselle (Chairman) and White and Ms. Hunt as the members of such Committee.

The members of the Board of Directors on the date of this Report and the Committees of the Board on which they serve are identified below:

| | <u>Audit Committee</u> | <u>Governance and Nominating Committee</u> | <u>Compensation Committee</u> |
|-----------------|------------------------|--|-------------------------------|
| Ted P. Stokley | | | |
| Henry A. Butler | | | |
| Sharon Hunt | ü | ü | ü |
| Ted R. Munselle | ü | ü | ü |
| Martin L. White | ü | ü | ü |

During February 2004, the Board adopted its Corporate Governance Guidelines. The Guidelines adopted by the Board meet or exceed the new listing standards adopted during the year by the New York Stock Exchange, Inc. Pursuant to the Guidelines, the Board undertook its annual review of director independence, and during this review, the Board considered transactions and relationships between each director or any member of his or her immediate family and ARI and its subsidiaries and affiliates, including those reported under Certain Relationships and Related Transactions below. The Board also examined transactions and relationships between directors or their affiliates and members of ARI's senior management or their affiliates. As provided in the Guidelines, the purpose of such review was to determine whether such relationships or transactions were inconsistent with the determination that the director is independent.

Executive Officers

Executive officers of ARI are Mark W. Branigan, Executive Vice President Multi-Family Construction, Louis J. Corna, Executive Vice President Tax, General Counsel/Tax Counsel and Secretary, and Scott T. Lewis, Executive Vice President and Chief Financial Officer, all of whom are employed by Prime. None of the executive officers receives any direct remuneration from ARI nor do any hold any options granted by ARI. Their positions with ARI are not subject to a vote of stockholders. The ages, terms of service and all positions and offices with ARI, Prime, BCM, other affiliated entities, other principal occupations, business experience, and directorships with other publicly held companies during the last five years or more are set forth below.

MARK W. BRANIGAN, 50

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Executive Vice President Multi-Family Construction (since September 2004); Executive Vice President Residential (June 2001 to September 2004), Director (September 2000 to June 2001) and Executive Vice President and Chief Financial Officer (August 2000 to June 2001) of ARI, TCI, IORI and BCM; Executive Vice President Multi-Family Construction (since September 2004); Executive Vice President Residential (July 2003 to September 2004) of Prime and PIAMI; Vice President Director of Construction (August 1999 to August 2000) and Executive Vice President Residential Asset Management (January 1992 to October 1997) of BCM, TCI; and IORI Vice President Director of Construction (August

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1999 to August 2000) and Executive Vice President Residential Asset Management (January 1992 to October 1997) of American Realty Trust, Inc. (ART); Real Estate Consultant (November 1997 to July 1999).

LOUIS J. CORNA, 57

Executive Vice President, General Counsel/Tax Counsel and Secretary (since February 2004), Executive Vice President Tax (October 2001 to February 2004), Executive Vice President Tax and Chief Financial Officer (June 2001 to October 2001) and Senior Vice President Tax (December 2000 to June 2001) of ARI, TCI, IORI and BCM; Executive Vice President, General Counsel/Tax Counsel and Secretary (since February 2004), Executive Vice President Tax (July 2003 to February 2004) of Prime and PIAMI; Private Attorney (January 2000 to December 2000); Vice President Taxes and Assistant Treasurer (March 1998 to January 2000) of IMC Global, Inc.; Vice President Taxes (July 1991 to February 1998) of Whitman Corporation.

SCOTT T. LEWIS, 44

Executive Vice President and Chief Financial Officer (since December 2004), Vice President and Principal Accounting Officer (July 2004 to November 2004) of the Company, ARI, TCI, and Prime. For more than seven years prior to July 2004, Mr. Lewis was employed in various accounting capacities by Insignia/ESG, a publicly-held real estate company, directing finance and operations for the central/southeast region in his last position from 2002 through February 2004; Certified Public Accountant (since 1990).

In addition to the foregoing executive officers, the Company has several vice presidents and assistant secretaries who are not listed herein.

Code of Ethics

ARI has adopted a code of ethics entitled Code of Business Conduct and Ethics that applies to all directors, officers, and employees (including those of the contractual Advisor to ARI). In addition, ARI has adopted a code of ethics entitled Code of Ethics for Senior Financial Officers that applies to the principal executive officer, president, principal financial officer, chief financial officer, principal accounting officer, and controller.

The text of these documents has been posted on ARI's internet website at <http://www.amrealtytrust.com> and are available in print to any stockholder who requests them.

Compliance with Section 16(a) of the Securities Exchange Act of 1934

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Under the securities laws of the United States, ARI's Directors, executive officers, and any persons holding more than 10 percent of ARI's shares of Common Stock are required to report their ownership and any changes in that ownership to the Securities and Exchange Commission (the Commission). Specific due dates for these reports have been established and ARI is required to report any failure to file by these dates during 2003. All of these filing requirements were satisfied by ARI's Directors and executive officers and 10 percent holders. In making these statements, ARI has relied on the written representations of its incumbent Directors and executive officers and its 10 percent holders and copies of the reports that they have filed with the Commission.

The Advisor

Prior to July 1, 2003, BCM served as advisor to ARI. The current advisor is Prime. See NOTE 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES Organization and Business. The Advisory Agreement described in this section contains the same terms as the prior Advisory Agreement with BCM.

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Although the Board of Directors is directly responsible for managing the affairs of ARI and for setting the policies, which guide it, the day-to-day operations of ARI are performed by Prime, a contractual advisor under the supervision of the Board. The duties of the advisor include, among other things, locating, investigating, evaluating and recommending real estate and mortgage loan investment and sales opportunities as well as financing and refinancing sources. Prime also serves as consultant in connection with ARI's business plan and investment policy decisions made by the Board.

Prime, an affiliate, serves as advisor to ARI. Prime is indirectly owned by Gene E. Phillips (20.0%) and by a trust for the children of Gene E. Phillips (80.0%). Mr. Phillips is not an officer or director of Prime, but serves as a representative of the trust, is involved in daily consultation with the officers of Prime and has significant influence over the conduct of Prime's business, including the rendering of advisory services and the making of investment decisions for itself and ARI. As of March 24, 2005, PIAMI owned 1,437,208 shares of ARI's Common Stock, approximately 12.6% of the shares then outstanding.

The Advisory Agreement provides for the advisor to receive monthly base compensation at the rate of 0.0625% per month (0.75% on an annualized basis) of Average Invested Assets.

In addition to base compensation, Prime, an affiliate of Prime, or a related party receives the following forms of additional compensation:

(1) an acquisition fee for locating, leasing or purchasing real estate for ARI in an amount equal to the lesser of (1) the amount of compensation customarily charged in similar arm's-length transactions or (2) up to 6.0% of the costs of acquisition, inclusive of commissions, if any, paid to non-affiliated brokers;

(2) a disposition fee for the sale of each equity investment in real estate in an amount equal to the lesser of (1) the amount of compensation customarily charged in similar arm's-length transactions or (2) 3.0% of the sales price of each property, exclusive of fees, if any, paid to non-affiliated brokers;

(3) a loan arrangement fee in an amount equal to 1.0% of the principal amount of any loan made to ARI arranged by Prime;

(4) an incentive fee equal to 10.0% of net income for the year in excess of a 10.0% return on stockholders' equity, and 10.0% of the excess of net capital gains over net capital losses, if any, realized from sales of assets;

(5) a mortgage placement fee, on mortgage loans originated or purchased, equal to 50.0%, measured on a cumulative basis, of the total amount of mortgage origination and placement fees on mortgage loans advanced by ARI for the fiscal year.

The ARI Advisory Agreement further provides that Prime shall bear the cost of certain expenses of its employees, excluding fees paid to ARI's Directors; rent and other office expenses of both Prime and ARI (unless ARI maintains office space separate from that of Prime); costs not

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directly identifiable to ARI's assets, liabilities, operations, business or financial affairs; and miscellaneous administrative expenses relating to the performance by Prime of its duties under the Advisory Agreement.

The terms of TCI's Advisory Agreement with Prime are not identical to those of TCI's Advisory Agreement. The provisions of TCI's Advisory Agreement are:

- (1) The TCI Advisory Agreement provides for Prime to be responsible for the day-to-day operations of TCI 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% of TCI's net income.
- (2) The TCI Advisory Agreement also provides for Prime to receive an annual incentive sales fee equal to 10.0% of the amount, if any, by which the aggregate sales consideration for all real estate sold by TCI

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during such fiscal year exceeds the sum of: (1) the cost of each such property as originally recorded in TCI's books for tax purposes (without deduction for depreciation, amortization or reserve for losses), (2) capital improvements made to such assets during the period owned, and (3) all closing costs, (including real estate commissions) incurred in the sale of such real estate; provided, however, no incentive fee shall be paid unless (a) such real estate sold in such fiscal year, in the aggregate, has produced an 8.0% simple annual return on the net investment including capital improvements, calculated over the holding period before depreciation and inclusive of operating income and sales consideration and (b) the aggregate net operating income from all real estate owned for each of the prior and current fiscal years shall be at least 5.0% higher in the current fiscal year than in the prior fiscal year.

- (3) Pursuant to the TCI Advisory Agreement, Prime, or an affiliate of Prime, is to receive an acquisition commission for supervising the acquisition, purchase or long-term lease of real estate equal to the lesser of (1) up to 1.0% of the cost of acquisition, inclusive of commissions, if any, paid to nonaffiliated brokers or (2) the compensation customarily charged in arm's-length transactions by others rendering similar property acquisition services as an ongoing public activity in the same geographical location and for comparable property, provided that the aggregate purchase price of each property (including acquisition fees and real estate brokerage commissions) may not exceed such property's appraised value at acquisition.
- (4) The TCI Advisory Agreement requires Prime or any affiliate of Prime to pay to TCI, one-half of any compensation received from third parties with respect to the origination, placement or brokerage of any loan made by TCI; provided, however, that the compensation retained by Prime or any affiliate of Prime shall not exceed the lesser of (1) 2.0% of the amount of the loan commitment or (2) a loan brokerage and commitment fee which is reasonable and fair under the circumstances.
- (5) The TCI Advisory Agreement also provides that Prime or an affiliate of Prime is to receive a mortgage or loan acquisition fee with respect to the acquisition or purchase of any existing mortgage loan by TCI equal to the lesser of (1) 1.0% of the amount of the loan purchased or (2) a brokerage or commitment fee which is reasonable and fair under the circumstances. Such fee will not be paid in connection with the origination or funding of any mortgage loan by TCI.
- (6) Under the TCI Advisory Agreement, Prime or an affiliate of Prime also is to receive a mortgage brokerage and equity refinancing fee for obtaining loans or refinancing on properties equal to the lesser of (1) 1.0% of the amount of the loan or the amount refinanced or (2) a brokerage or refinancing fee which is reasonable and fair under the circumstances; provided, however, that no such fee shall be paid on loans from Prime or an affiliate of Prime without the approval of TCI's Board of Directors. No fee shall be paid on loan extensions.
- (7) Under the TCI Advisory Agreement, Prime receives reimbursement of certain expenses incurred by it in the performance of advisory services.
- (8) Under the TCI Advisory Agreement, all or a portion of the annual advisory fee must be refunded by the Advisor if the Operating Expenses of TCI (as defined in the Advisory Agreement) exceed certain limits specified in the Advisory Agreement based on the book value, net asset value, and net income of TCI during the fiscal year. Prime was required to refund \$1.3 million of the 2003 advisory fee under this provision.

If and to the extent that ARI shall request Prime, or any director, officer, partner or employee of Prime, to render services to ARI other than those required to be rendered by Prime under the Advisory Agreement, such additional services, if performed, will be compensated separately on terms agreed upon between such party and ARI from time-to-time.

The Advisory Agreement automatically renews from year to year unless terminated in accordance with its terms. ARI's management believes that the terms of the Advisory Agreement are at least as fair as could be obtained from unaffiliated third parties.

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Situations may develop in which the interests of ARI are in conflict with those of one or more directors or officers in their individual capacities or of Prime, or of their respective affiliates. In addition to services performed for ARI, as described above, Prime actively provides similar services as agent for, and advisor to, other real estate enterprises, including persons and entities involved in real estate development and financing, including IORI and TCI. The Advisory Agreement provides that Prime may also serve as advisor to other entities.

As advisor, Prime is a fiduciary of ARI's public investors. In determining to which entity a particular investment opportunity will be allocated, Prime will consider the respective investment objectives of each entity and the appropriateness of a particular investment in light of each such entity's existing mortgage note and real estate portfolios and business plan. To the extent any particular investment opportunity is appropriate to more than one such entity, such investment opportunity will be allocated to the entity that has had funds available for investment for the longest period of time, or, if appropriate, the investment may be shared among various entities. See ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS Certain Business Relationships.

The managers and principal officers of Prime are set forth below:

| | |
|---------------------|--|
| Mickey N. Phillips: | Manager |
| Ryan T. Phillips: | Manager |
| Mark W. Branigan: | Executive Vice President Residential Construction |
| Louis J. Corna: | Executive Vice President Tax, General Counsel/Tax Counsel and Secretary |
| Scott T. Lewis: | Acting Principal Executive Officer, Executive Vice President and Chief Financial Officer |
| Dan S. Allred: | Senior Vice President Land Development |

Mickey N. Phillips is the brother of Gene E. Phillips, and Ryan T. Phillips is the son of Gene E. Phillips. Gene E. Phillips indirectly owns 20.0% of Prime and serves as a representative of the trust established for the benefit of his children, which indirectly owns 80.0% of Prime and, in such capacity, has substantial contact with the management of Prime and input with respect to its performance of advisory services for ARI.

Property Management and Real Estate Brokerage

Affiliates of Prime provided property management services to ARI. Currently, Triad and Carmel provide property management services to ARI's properties for a fee of 6.0% or less of the monthly gross rents collected on the residential properties under its management and 3.0% or less of the monthly gross rents collected on the commercial properties under its management. Triad and Carmel subcontract with other entities for the provision of the property-level management services at various rates. The general partner of Triad is BCM. The limited partner of Triad is Highland. Triad subcontracts the property-level management and leasing of 30 of ARI's commercial properties (shopping centers, office buildings and individual warehouses) to Regis I, which 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. Regis I is owned by Highland. Since January 1, 2003, Regis Hotel I, LLC, has managed ARI's 11 hotels. The sole member of Regis I and Regis Hotel I, LLC is Highland. Carmel is a company previously owned by First Equity Properties, Inc., which is a company affiliated with Prime. On May 1, 2004, Regis I acquired the ownership of Carmel.

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Regis I, a related party, provides real estate brokerage services to ARI and receives brokerage commissions in accordance with the Advisory Agreement.

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ITEM 11. EXECUTIVE COMPENSATION

ARI has no employees; payroll or benefit plans and pays no compensation to its executive officers. The Directors and executive officers of ARI who are also officers or employees of Prime are compensated by Prime. Such affiliated Directors and executive officers perform a variety of services for Prime and the amount of their compensation is determined solely by Prime. Prime does not allocate the cash compensation of its officers among the various entities for which it serves as advisor. See ITEM 10. DIRECTORS, EXECUTIVE OFFICERS AND ADVISOR OF THE REGISTRANT The Advisor for a more detailed discussion of compensation payable to Prime by ARI.

The only direct remuneration paid by ARI is to those Directors who are not officers or employees of Prime or its affiliated companies. Each non-employee Director is compensated at the rate of \$45,000 per year, plus \$300 per Audit Committee meeting attended. Effective January 1, 2004, the Chairman of the Board of Directors is compensated at the rate of \$49,500 per year. The Chairman of the Audit Committee receives an annual fee of \$500. Also, each non-employee Director receives an additional fee of \$1,000 per day for any special services rendered outside of their ordinary duties as Director, plus reimbursement of expenses. During 2004, \$208,000 was paid to non-employee Directors in total Directors fees for all services including the annual fee for service during the period January 1, 2004 through December 31, 2004, and 2004 special service fees as follows: Earl D. Cecil, \$23,000; Sharon Hunt, \$42,000; Ted R. Munselle, \$42,000; Ted P. Stokely, \$50,000; and Martin L. White, \$51,000.

In January 1999, stockholders approved the Director's Stock Option Plan (the Director's Plan) which provides for options to purchase up to 40,000 shares of Common Stock. Options granted pursuant to the Director's Plan are immediately exercisable and expire on the earlier of the first anniversary of the date on which a Director ceases to be a Director or ten years from the date of grant. Each Independent Director was granted an option to purchase 1,000 shares at an exercise price of \$17.71 per share on January 11, 1999, the date stockholders approved the plan. On January 1, 2000, 2001, 2002, 2003, and 2004, each Independent Director was granted an option to purchase 1,000 shares at an exercise price of \$18.53, \$13.625, \$9.87, \$8.09, and \$9.13 per share, respectively. Each Independent Director will be awarded an option to purchase an additional 1,000 shares on January 1 of each year. At December 31, 2004, 1,000 options were exercisable at \$9.87 per share, 2,000 options were exercisable at \$8.09 per share, and 3,000 options were exercisable at \$9.13 per share.

In January 1998, stockholders approved the 1997 Stock Option Plan (the Option Plan), which provides for options to purchase up to 300,000 shares of Common Stock. At December 31, 2004, there were 70,750 options outstanding under the Option Plan. No options were granted under the Option Plan in 2004.

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The following graph compares the cumulative total stockholder return on ARI's shares (ART's shares prior to August 2000) of Common Stock with the Dow Jones Equity Market Index (Total U.S. Market Index) and the Dow Jones Real Estate Investment Index (Real Estate Index). The comparison assumes that \$100 was invested on December 31, 1999 in shares of Common Stock and in each of the indices and further assumes the reinvestment of all dividends. Past performance is not necessarily an indicator of future performance.

| | <u>1999</u> | <u>2000</u> | <u>2001</u> | <u>2002</u> | <u>2003</u> | <u>2004</u> |
|-------------------------|-------------|-------------|-------------|-------------|-------------|-------------|
| ARI | 100.00 | 80.18 | 58.06 | 47.59 | 53.71 | 57.06 |
| Real Estate Index | 100.00 | 127.51 | 142.56 | 147.75 | 202.25 | 265.38 |
| Total U.S. Market Index | 100.00 | 90.87 | 80.04 | 62.37 | 81.54 | 91.45 |

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The following table provides information as of December 31, 2004 regarding compensation plans under which equity securities of ARI are authorized for issuance.

Equity Compensation Plan Information

| Plan Category | Number of Securities to be Issued Upon Exercise of Outstanding Options, Warrants and Rights | Weighted-Average Exercise Price of Outstanding Options, Warrants and Rights | Number of Securities Remaining Available for Future Issuance Under Equity Compensation Plans (Excluding Securities Reflected in Column (a)) |
|--|---|---|---|
| | (a) | (b) | (c) |
| Equity compensation plans approved by security holders | 76,750 | \$ 15.84 | 263,250 |

See NOTE 12. STOCK OPTIONS for information regarding the material features of the above plans.

Security Ownership of Certain Beneficial Owners. The following table sets forth the ownership of ARI's Common Stock both beneficially and of record, both individually and in the aggregate, for those persons or entities known by ARI to be the owner of more than 5.0% of the shares of ARI's Common Stock as of the close of business on March 24, 2005.

| Name and Address of Beneficial Owner | Amount and Nature of Beneficial Ownership | Approximate Percent of Class (1) |
|---|---|----------------------------------|
| Basic Capital Management, Inc. 1800 Valley View Lane Suite 300 Dallas, Texas 75234 | 6,703,045 ⁽²⁾ | 61.5% |
| Prime Income Asset Management, Inc. 1800 Valley View Lane | 1,437,208 ⁽³⁾ | 13.2% |

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Suite 300

Dallas, Texas 75234

| | | |
|---|------------------------|------|
| Transcontinental Realty Investors, Inc. | 746,972 ⁽⁴⁾ | 6.9% |
|---|------------------------|------|

1800 Valley View Lane

Suite 300

Dallas, Texas 75234

| | | |
|-----------------------|-----------------------------|-------|
| Realty Advisors, Inc. | 8,140,253 ⁽²⁾⁽³⁾ | 74.7% |
|-----------------------|-----------------------------|-------|

1800 Valley View Lane

Suite 300

Dallas, Texas 75234

| | | |
|------------------|--------------------------------|-------|
| Ryan T. Phillips | 8,167,855 ⁽²⁾⁽³⁾⁽⁵⁾ | 75.0% |
|------------------|--------------------------------|-------|

1800 Valley View Lane

Suite 300

Dallas, Texas 75234

-
- (1) Percentages are based upon 10,895,972 shares outstanding as of March 24, 2005.
 - (2) Includes 6,703,045 shares owned by BCM, over which each of the directors of BCM, Ryan T. Phillips and Mickey Ned Phillips, may be deemed to be beneficial owners by virtue of their positions as directors of BCM. The directors of BCM disclaim beneficial ownership of such shares.

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- (3) Includes 1,437,208 shares owned by PIAMI, over which each of the directors of PIAMI, Ryan T. Phillips and Mickey Ned Phillips, may be deemed to be beneficial owners by virtue of their positions as directors of PIAMI. The directors of PIAMI disclaim beneficial ownership of such shares.
- (4) Each of the directors of TCI, Henry A. Butler, Sharon Hunt, Ted R. Munselle, Ted P. Stokely, and Martin L. White, may be deemed to be the beneficial owners by virtue of their positions as directors of TCI. The directors of TCI disclaim such beneficial ownership.
- (5) Includes 27,602 shares owned by the Gene E. Phillips Children's Trust. Ryan T. Phillips is a beneficiary of the trust.

Security Ownership of Management. The following table sets forth the ownership of shares of ARI's Common Stock, both beneficially and of record, both individually in the aggregate, for the Directors and executive officers of ARI, as of the close of business on March 24, 2005.

| <u>Name of Beneficial Owner</u> | <u>Number of Shares Beneficially Owned</u> | <u>Percent of Class (1)</u> |
|---|--|---------------------------------|
| Mark W. Branigan | 8,887,225 ⁽⁴⁾⁽⁵⁾⁽⁶⁾ | 81.6% |
| Henry A. Butler | 746,972 ⁽³⁾ | 6.9% |
| Louis J. Corna | 8,887,225 ⁽⁴⁾⁽⁵⁾⁽⁶⁾ | 81.6% |
| Sharon Hunt | 747,972 ⁽²⁾⁽³⁾ | 6.9% |
| Scott T. Lewis | 8,887,225 ⁽⁴⁾⁽⁵⁾⁽⁶⁾ | 81.6% |
| Ted R. Munselle | 747,972 ⁽²⁾⁽³⁾ | 6.9% |
| Ted P. Stokely | 749,972 ⁽²⁾⁽³⁾ | 6.9% |
| Martin L. White | 748,972 ⁽²⁾⁽³⁾ | 6.9% |
| All Directors and Executive Officers as a group (8 persons) | 8,894,225 ⁽⁴⁾⁽⁵⁾⁽⁶⁾⁽⁷⁾ | 81.6% |

- (1) Percentage is based upon 10,895,972 shares outstanding as of March 24, 2005.
- (2) Each of Messrs. Munselle, Stokely, and White and Ms. Hunt a director, have options to purchase shares of Common Stock of ARI, which are exercisable within 60 days of March 18, 2005.
- (3) Includes 746,972 shares owned by TCI, over which the members of the Board of Directors of ARI may be deemed to be the beneficial owners by virtue of their positions as members of the Board of Directors of TCI. The members of the Board of Directors of ARI disclaim beneficial ownership of such shares.
- (4) Includes 746,972 shares owned by TCI, over which the executive officers of ARI may be deemed to be the beneficial owners by virtue of their positions as executive officers of TCI. The executive officers of ARI disclaim beneficial ownership of such shares.
- (5) Includes 6,703,045 shares owned by BCM, over which the executive officers of ARI may be deemed to be the beneficial owners by virtue of their positions as executive officers of BCM. The executive officers of ARI disclaim beneficial ownership of such shares.
- (6) Includes 1,437,208 shares owned by PIAMI, over which the executive officers of ARI may be deemed to be the beneficial owners by virtue of their positions as executive officers of PIAMI. The executive officers of ARI disclaim beneficial ownership of such shares.
- (7) Includes 7,000 shares which may be acquired by the Directors of ARI pursuant to stock option plans.

ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS

Policies with Respect to Certain Activities

Article ELEVENTH of ARI's Articles of Incorporation provides that ARI shall not, directly or indirectly, contract or engage in any transaction with (1) any director, officer or employee of ARI, (2) any director, officer or employee of the advisor, (3) the advisor or (4) any affiliate or associate (as such terms are defined in Rule 12b-2 under the Securities Exchange Act of 1934, as amended) of any of the aforementioned persons, unless (a) the material facts as to the relationship among or financial interest of the relevant individuals or persons and as to the contract or transaction are disclosed to or are known by ARI's Board of Directors or the appropriate

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committee thereof and (b) ARI's Board of Directors or committee thereof determines that such contract or transaction is fair to ARI and simultaneously authorizes or ratifies such contract or transaction by the affirmative vote of a majority of independent directors of ARI entitled to vote thereon.

Article ELEVENTH defines an Independent Director (for purposes of that Article) as one who is neither an officer or employee of ARI, nor a director, officer or employee of ARI's advisor. This definition predates ARI's director independence guidelines adopted in February 2004.

ARI's policy is to have such contracts or transactions approved or ratified by a majority of the disinterested Directors with full knowledge of the character of such transactions, as being fair and reasonable to the stockholders at the time of such approval or ratification under the circumstances then prevailing. Such Directors also consider the fairness of such transactions to ARI. Management believes that, to date, such transactions have represented the best investments available at the time and they were at least as advantageous to ARI as other investments that could have been obtained.

ARI may enter into future transactions with entities the officers, directors or stockholders of which are also officers, directors or stockholders of ARI, if such transactions would be beneficial to the operations of ARI and consistent with ARI's then-current investment objectives and policies, subject to approval by a majority of disinterested Directors as discussed above.

ARI does not prohibit its officers, directors, stockholders, or related parties from engaging in business activities of the types conducted by ARI.

Certain Business Relationships

Prime, ARI's advisor, is a company for which Messrs. Branigan, Corna, and Lewis serve as executive officers. Prime is a company indirectly owned by Gene E. Phillips and a trust established for the benefit of the children of Gene E. Phillips.

The executive officers of ARI also serve as executive officers of TCI, and Messrs. Branigan and Corna also serve as executive officers of IORI. As such, they owe fiduciary duties to that entity as well as to Prime under applicable law. TCI has the same relationship with Prime, as does ARI.

Effective July 1, 2003, PAMI became the advisor to ARI and TCI. PAMI is owned by Realty Advisors (80.0%) and Syntek West, (20.0%). Syntek West is owned by Gene Phillips. Effective August 18, 2003, PAMI changed its name to PIAMI. On October 1, 2003, Prime, which is 100% owned by PIAMI, replaced PIAMI as the advisor to ARI and TCI.

ARI contracts with affiliates of Prime for property management services. Currently, Triad, an affiliate, and Carmel provide such property management services. The general partner of Triad is BCM. The limited partner of Triad is Highland, a related party. Triad subcontracts the property-level management of 30 of ARI's commercial properties (office buildings, shopping centers, and industrial warehouses) to Regis I, a

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related party. Regis I also provides real estate brokerage services to ARI and receives brokerage commissions in accordance with the Advisory Agreement. Regis Hotel I, LLC manages ARI's 11 hotels. The sole member of Regis I and Regis Hotel I, LLC is Highland. Carmel is a company previously owned by First Equity Properties, Inc., which is a company affiliated with Prime. On May 1, 2004, Regis I acquired the ownership of Carmel. See ITEM 2. PROPERTIES Investments in Real Estate Companies and Real Estate Partnerships.

At December 31, 2004, ARI owned approximately 82.2% of TCI's outstanding common stock and approximately 19.7% of IORI's outstanding common stock, through its interest in TCI.

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Related Party Transactions

Historically, ARI, TCI, IORI, BCM, and Prime 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 ARI as could have been obtained from unrelated parties.

Operating Relationships

In October 2003, ARI entered into a lease with Prime for space at the One Hickory Centre Office Building. The lease was for 59,115 sq. ft. (approximately 59.0% of the building), has a term of three years, and provided for annual base rent of \$1.3 million, or \$21.50 per sq. ft. Effective May 1, 2004, the lease was amended to 54,404 sq. ft. (approximately 56% of the building), with an annual base rent of \$1.2 million, or \$21.50 per sq. ft.

ARI received rents of \$69,000 from BCM for BCM's lease at Addison Hanger. BCM owns a corporate jet that is housed at the hanger, and ARI has available space at the hanger.

In 2004, ARI paid Prime, its affiliates, and a related party \$8.4 million in advisory fees, \$1.9 million in net income fees, \$1.9 million in loan arrangements, \$578,000 in property acquisition fees, \$8.4 million in real estate brokerage commissions, \$5.6 million in construction supervision fees, and \$6.7 million in property and construction management fees and leasing commissions, net of property management fees paid to subcontractors, other than affiliates of Prime. In addition, as provided in the Advisory Agreement, Prime received cost reimbursements of \$4.6 million.

Partnership Transactions

BCM has entered into put agreements with certain holders of the Class A limited partner units of Ocean Beach Partners, L.P. The Class A units are convertible into Series D Cumulative Preferred Stock of ARI. The put price of the Series D Preferred Stock is \$20.00 per share plus accrued but unpaid dividends.

BCM has entered into put agreements with the holders of the Class A units of ART Palm, L.P. Such Class A units are convertible into Series C Cumulative Convertible Preferred Stock of ARI. The put price for the Class A units is \$1.00 per unit and the put price for either the Series C Preferred Stock or ARI's Common Stock is 90.0% of the average daily closing price of ARI's Common Stock for the prior 20 trading days. The put agreement calls for ARI to repurchase the outstanding Class A units as follows: December 31, 2005, 875,000 units; and December 31, 2006, 5,938,750 units.

Advances and Loans

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From time-to-time, ARI and its affiliates have made advances to each other, which have not had specific repayment terms, do not bear interest, are unsecured, and have been reflected in ARI's financial statements as other assets or other liabilities. At December 31, 2004, after accounting for affiliate purchases and sales, amounts still owed by ARI were \$260,000 and \$1.2 million to IORI and Regis I, respectively. Also at December 31, 2004, ARI was owed \$13.6 million and \$1.4 million by Prime and Regis I, respectively.

In January 2004, ARI issued 200,000 shares of Series A 10.0% Cumulative Convertible Preferred Stock to Prime, ARI's advisor. In February 2004, 50,000 additional shares were issued to Prime. ARI's affiliate receivable was increased by \$2.5 million.

In February 2004, ARI obtained an unsecured loan of \$5.0 million. The proceeds of \$5.0 million were received by an affiliate of ARI, increasing ARI's affiliate receivable.

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In February 2004, ARI obtained financing of \$7.5 million on the Katy land tract. The funds, along with additional cash of \$6.3 million, were sent to an affiliate. Subsequently, the affiliate paid off the existing loan balance on an ARI property.

In March 2001, ARI funded \$13.6 million of a \$15.0 million unsecured line of credit to One Realco Corporation (One Realco). A wholly-owned subsidiary of One Realco owns approximately 2.1% of the outstanding shares of ARI s Common Stock. One Realco periodically borrows money to meet its cash obligations. The line of credit bore interest at 12.0% per annum. All principal and interest were due at maturity in February 2002. The line of credit is guaranteed by BCM. In June 2001, \$394,000 in principal and \$416,000 in interest was collected. In December 2001, \$21,000 in principal and \$804,000 in interest was collected. In February 2002, the line of credit was increased to \$18.0 million, accrued but unpaid interest of \$217,000 was added to the principal, and the maturity date was extended to February 2004. In March 2002, ARI funded an additional \$1.8 million, increasing the outstanding principal balance to \$15.5 million. In October 2002, \$856,900 in interest was collected, by the return of 85,690 shares of ARI Series A Preferred Stock. In June 2003, ARI sold a participating interest in \$5.8 million of the \$15.5 million balance to BCM; receiving 314,141 TCI shares from BCM (see NOTE 1. BASIS OF PRESENTATION). In February 2004, \$2.3 million in interest was collected, accrued but unpaid interest of \$161,000 was added to the principal, the maturity date was extended to February 2007, and the interest rate was changed to 3.0% over the prime rate, currently 8.5%. All principal and interest are due at maturity. Ronald E. Kimbrough, Acting Principal Executive Officer, Executive Vice President and Chief Financial Officer of ARI until May 31, 2004, was a 10.0% shareholder of One Realco until July 31, 2004. Mr. Kimbrough did not participate in the day-to-day operations or management of One Realco.

In March 2004, ARI obtained financing of \$11.5 million on a hotel property. The proceeds of \$11.0 million were received by an affiliate, increasing ARI s affiliate receivable.

In April 2004, \$825,000 was advanced under a security loan arrangement with a financial institution. The proceeds were paid to an affiliate, increasing ARI s affiliate receivable.

In July 2004, ARI obtained a loan of \$3.2 million secured by a contract for sale of the Waters Edge III Apartments. The proceeds of \$3.2 million were received by an affiliate, increasing ARI s affiliate receivable.

In October 2004, ARI advanced \$3.3 million to the Class A Limited Partners of Edina Park Plaza Associates, Limited Partnership, of which ARI is the general partner. The loans bear interest at 10.0% per annum and mature in September 2017. Interest due to ARI will be deducted from the quarterly return owed by ARI to the Class A Limited Partners, eliminating the quarterly payments. The outstanding principal is due at maturity.

In October 1999, ARI funded a \$4.7 million loan to Realty Advisors, Inc., an affiliate. The loan, to provide funds for acquisitions or working capital needs, was secured by all of the outstanding shares of common stock of American Reserve Life Insurance Company. The loan bore interest at 10.25% per annum, and matured in November 2001. In January 2000, \$100,000 was collected. In November 2001, the maturity date was extended to November 2004. The collateral was changed to a pledge of 850,000 shares of ARI Common Stock owned by BCM. The interest rate was changed to 2.0% over the prime rate, currently 7.75% per annum, and the accrued but unpaid interest of \$984,000 was added to the principal. The new principal balance is \$5.6 million. In September 2003, \$673,000 in accrued interest was collected. In August 2004, \$342,000 in accrued interest was collected. In November 2004, the maturity date was extended to November 2006. All principal and accrued interest are due at maturity.

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In October 2003, ARI borrowed \$1.6 million from IORI, which was then advanced to the Class A Limited Partners of Encino Executive Plaza, Ltd. The loan bore interest at 2.0% per annum and matures in June 2006. All principal and interest are due at maturity. Effective January 1, 2004, the interest rate was changed to 5.49%.

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Property Transactions

In December 2003, ARI sold seven properties to subsidiaries of Unified Housing Foundation, Inc. (UHF), a Texas Non-Profit 501(c) 3 Corporation. ARI sold 39.3 acres of Pioneer Crossing land for \$3.9 million, 10.7 acres of Marine Creek land for \$1.5 million, the Limestone at Vista Ridge Apartments for \$19.0 million, the Cliffs of El Dorado Apartments for \$13.4 million, the Limestone Canyon Apartments for \$18.0 million, the Sendero Ridge Apartments for \$29.4 million, and Tivoli Apartments for \$16.1 million. All of the transactions included the assumption of debt and notes receivable to ARI for the remainder of the purchase price. Ted Stokely, Chairman of the Board of ARI, is the General Manager of UHF. Richard Humphrey, who is employed by Regis Realty I, LLC, an affiliate, is President of UHF. Due to UHF being considered a related party to ARI and ARI having continued involvement and control of these entities, these transactions have not been recorded as sales. Instead, these transactions will be accounted for on the deposit method, and the properties and corresponding debt will continue to be consolidated by ARI. All of these transactions were approved by ARI's Board of Directors. Mr. Stokely abstained from voting on all of these transactions. The loans on Limestone Canyon apartments and Limestone at Vista Ridge apartments were approved by their prospective lenders for transfer to the purchasing entities. ARI has guaranteed the loans on both of these transfers. Also, Marine Creek land and the Cliffs of El Dorado apartments were recognized as sales during 2004. See NOTE 2. REAL ESTATE. Management is currently seeking lender approval on the transfer of the notes associated with the Tivoli apartments and Sendero Ridge apartments.

In December 2003, ARI sold a tract of Marine Creek land to a subsidiary of United Housing Foundation, Inc. (UHF) for \$1.5 million, receiving cash and a note receivable. This sale was not recognized as a sale at that time because UHF is a related party and ARI has continuing involvement and control. In February 2004, Marine Creek was refinanced by UHF, which paid in full ARI's note payable on the land. ARI recorded the sale of the land and received a note receivable of \$270,000, which was the difference between the sales price and the amount of ARI's note payable. The note bears interest at 6.0%, requires quarterly payments from available surplus cash and matures in December 2007. See Note 9. RELATED PARTY TRANSACTIONS.

In May 2004, ARI purchased the Treehouse Apartments from an affiliate, with a net purchase price of \$7.5 million after assumption of debt and a note receivable, less cash received of \$0.5 million. The note receivable was from the sale of the Cliffs of El Dorado Apartments to a related party in 2003. At that time, the sale of the Cliffs of El Dorado was not recorded as a sale for accounting purposes. ARI recorded the sale of the Cliffs of El Dorado in May 2004, due to payment received for the Cliffs of El Dorado note receivable.

In September 2004, ARI sold Limestone Canyon II land to a subsidiary of UHF for \$720,000 in the form of a seller note receivable. Due to no cash received and common control, ARI has elected to continue consolidating this tract of land until the requirements for a sale have been met. No sale was recognized and no note receivable has been recorded.

In April 2002, ARI and TCI sold 21 apartment properties to partnerships controlled by Metra Capital, LLC (Metra). Innovo Group, Inc. (Innovo) is a limited partner in the partnerships that purchased the properties. Joseph Mizrachi, then a director of ARI, controlled approximately 11.67% of the outstanding common stock of Innovo. Management determined to treat the sales as financing transactions, and ARI and TCI continue to report the assets and the new debt incurred by Metra on their financial statements. The partnership agreements for each of these partnerships state that the Metra Partners, as defined, receive cash flow distributions at least quarterly in an amount sufficient to provide them with a 15.0% cumulative compounded annual rate of return on their invested capital, as well as a cumulative compounded annual amount of 0.50% of the average outstanding balance of the mortgage indebtedness secured by any of these properties. These distributions to the Metra Partners have priority over distributions to any other partners. At December 31, 2004, 16 of the properties remained on ARI's balance sheet, and ARI's other liabilities included \$1.4 million owed to the Metra Partners related to cash received by ARI upon the sale of these apartments in April 2002.

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The following table sets forth the aggregate fees for professional services rendered to ARI for the years 2004 and 2003 by ARI's principal accounting firms, Farmer, Fuqua and Huff, L.P. and BDO Seidman, LLP:

| Type of Fee | 2004 | | 2003 ⁽¹⁾ |
|-------------------------|---------------------------|---------------------------|---------------------------|
| | Farmer, Fuqua & Huff | BDO Seidman | |
| Audit Fees | \$ 188,614 ⁽²⁾ | \$ 310,626 ⁽³⁾ | \$ 596,155 ⁽⁴⁾ |
| Audit Related Fees | | | |
| Tax Fees ⁽⁵⁾ | 9,550 ⁽⁶⁾ | 219,433 ⁽⁷⁾ | 210,422 ⁽⁸⁾ |
| All Other Fees | | | 13,605 ⁽⁹⁾ |
| Total | \$ 198,164 | \$ 530,059 | \$ 820,182 |

(1) All 2003 accounting fees were paid to BDO Seidman, LLP.

(2) Includes \$86,148 paid by TCI.

(3) Includes \$102,184 paid by TCI.

(4) Includes \$219,524 paid by TCI.

(5) Tax fees include fees for tax planning, tax consultation, return preparation, and review of tax returns.

(6) All paid by TCI.

(7) Includes \$50,021 paid by TCI.

(8) Includes \$61,093 paid by TCI.

(9) All other fees for 2003 are related to an ARI Form 8-K (\$750), ARI's tender offer for the common shares of TCI and IORI (\$3,735), and for training (\$9,120).

All services rendered by the principal auditors are permissible under applicable laws and regulations and were pre-approved by either the Board of Directors or the Audit Committee, as required by law. The fees paid the principal auditors for services as described in the above table fall under the categories listed below:

Audit Fees. These are fees for professional services performed by the principal auditor for the audit of the Company's annual financial statements and review of financial statements included in the Company's 10-Q filings and services that are normally provided in connection with statutory and regulatory filing or engagements.

Audit-Related Fees. These are fees for assurance and related services performed by the principal auditor that are reasonably related to the performance of the audit or review of the Company's financial statements. These services include attestations by the principal auditor that are not required by statute or regulation and consulting on financial accounting/reporting standards.

Tax Fees. These are fees for professional services performed by the principal auditor with respect to tax compliance, tax planning, tax consultation, returns preparation and review of returns. The review of tax returns includes the Company and its consolidated subsidiaries.

All Other Fees. These are fees for other permissible work performed by the principal auditor that do not meet the above category descriptions.

These services are actively monitored (as to both spending level and work content) by the Audit Committee to maintain the appropriate objectivity and independence in the principal auditor's core work, which is the audit of the Company's consolidated financial statements.

Under the Sarbanes-Oxley Act of 2002 (the SO Act), and the rules of the Securities and Exchange Commission (the SEC), the Audit Committee of the Board of Directors is responsible for the appointment, compensation and oversight of the work of the independent auditor. The purpose of the provisions of the SO Act and the SEC rules for the Audit Committee role in retaining the independent auditor is two-fold. First, the

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authority and responsibility for the appointment, compensation, and oversight of the auditors should be with directors who are independent of management. Second, any non-audit work performed by the auditors should be reviewed and approved by these same independent directors to ensure that any non-audit services performed by the auditor do not impair the independence of the independent auditor. To implement the provisions of the SO Act, the SEC issued rules specifying the types of services that an independent may not provide to its audit client, and governing the Audit Committee's administration of the engagement of the independent auditor. As part of this responsibility, the Audit Committee is required to preapprove the audit and non-audit services performed by the independent auditor in order to assure that they do not impair the auditor's independence. Accordingly, the Audit Committee has adopted a pre-approval policy of audit and non-audit services (the Policy), which sets forth the procedures and conditions pursuant to which services to be performed by the independent auditor are to be preapproved. Consistent with the SEC rules establishing two different approaches to pre-approving non-prohibited services, the Policy of the Audit Committee covers pre-approval of audit services, audit-related services, international administration tax services, non-U.S. income tax compliance services, pension and benefit plan consulting and compliance services, and U.S. tax compliance and planning. At the beginning of each fiscal year, the Audit Committee will evaluate other known potential engagements of the independent auditor, including the scope of work proposed to be performed and the proposed fees, and the approve or reject each service, taking into account whether services are permissible under applicable law and the possible impact of each non-audit service on the independent auditor's independence from management. Typically, in addition to the generally pre-approved services, other services would include due diligence for an acquisition that may or may not have been known at the beginning of the year. The Audit Committee has also delegated to any member of the Audit Committee designated by the Board or the financial expert member of the Audit Committee responsibilities to preapprove services to be performed by the independent auditor not exceeding \$25,000 in value or cost per engagement of audit and non-audit services, and such authority may only be exercised when the Audit Committee is not in session.

Except for the fees of \$9,120 in 2003 for training, all the fees for 2004 and 2003 were pre-approved by the Audit Committee or were within the pre-approved guidelines for permitted non-audit services and fees established by the Audit Committee, and there were no instances of waiver of approved requirements or guidelines during the same periods.

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PART IV

ITEM 15. EXHIBITS AND FINANCIAL STATEMENT SCHEDULES

(a) The following documents are filed as part of this Report:

1. Consolidated Financial Statements

Reports of Independent Registered Public Accounting Firms

Consolidated Balance Sheets December 31, 2004 and 2003

Consolidated Statements of Operations Years Ended December 31, 2004, 2003 and 2002

Consolidated Statements of Stockholders Equity Years Ended December 31, 2004, 2003 and 2002

Consolidated Statements of Cash Flows Years Ended December 31, 2004, 2003 and 2002

Notes to Consolidated Financial Statements

2. Financial Statement Schedules

Schedule III Real Estate and Accumulated Depreciation

Schedule IV Mortgage Loans on Real Estate

All other schedules are omitted because they are not applicable or because the required information is shown in the financial statements or the notes thereto.

3. Incorporated Financial Statements

Consolidated Financial Statements of Income Opportunity Realty Investors, Inc. (Incorporated by reference to Item 8. of Income Opportunity Realty Investors, Inc. s Annual Report on Form 10-K for the year ended December 31, 2004).

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(b) Exhibits.

The following documents are filed as Exhibits to this Report:

| Exhibit Number | Description |
|---------------------------|---|
| 3.1 | Certificate of Restatement of Articles of Incorporation of American Realty Investors, Inc., dated August 3, 2000 (incorporated by reference to Exhibit 3.0 to the Registrant's Quarterly Report on Form 10-Q for the quarter ended September 30, 2000). |
| 3.2 | Certificate of Correction of Restated Articles of Incorporation of American Realty Investors, Inc., dated August 29, 2000 (incorporate by reference to Exhibit 3.1 to the Registrant's Quarterly Report on Form 10-Q for the quarter ended September 30, 2000). |
| 3.3 | Articles of Amendment to the Restated Articles of Incorporation of American Realty Investors, Inc. decreasing the number of authorized shares of and eliminating Series B Cumulative Convertible Preferred Stock dated August 26, 2003 (incorporated by reference to Exhibit 3.3 to the Registrant's Quarterly Report on Form 10-Q for the quarter ended September 30, 2003). |
| 3.4 | Articles of Amendment to the Restated Articles of Incorporation of American Realty Investors, Inc. decreasing the number of authorized shares of and eliminating Series I Cumulative Preferred Stock dated October 1, 2003 (incorporated by reference to Exhibit 3.4 to the Registrant's Quarterly Report on Form 10-Q for the quarter ended September 30, 2003). |
| 3.5 | By-laws of American Realty Investors, Inc. (incorporated by reference to Exhibit 3.2 to the Registrant's Registration Statement on Form S-4, filed on December 30, 1999). |
| 4.1 | Certificate of Designations, Preferences and Relative Participating or Optional or Other Special Rights, and Qualifications, Limitations or Restrictions Thereof of Series F Redeemable Preferred Stock of American Realty Investors, Inc., dated June 11, 2001 (incorporated by reference to Exhibit 4.1 to the Registrant's Annual Report on Form 10-K for the year ended December 31, 2001). |
| 4.2 | Certificate of Withdrawal of Preferred Stock, Decreasing the Number of Authorized Shares of and Eliminating Series F Redeemable Preferred Stock, dated June 18, 2002 (incorporated by reference to Exhibit 3.0 to the Registrant's Quarterly Report on Form 10-Q for the quarter ended June 30, 2002). |
| 4.3 | Certificate of Designation, Preferences and Rights of the Series I Cumulative Preferred Stock of American Realty Investors, Inc., dated February 3, 2003 (incorporated by reference to Exhibit 4.3 of the Registrant's Annual Report on Form 10-K for the year ended December 31, 2002). |
| 10.1 | Advisory Agreement between American Realty Investors, Inc. and Prime Income Asset Management, LLC, dated October 1, 2003 (incorporated by reference to Exhibit 10.0 to the Registrant's Current Report on Form 8-K, dated October 1, 2003). |
| 10.2 | Second Amendment to Modification of Stipulation of Settlement dated October 17, 2001 (incorporated by reference to Exhibit 10.1 to Registrant's Registration Statement on Form S-4, dated February 24, 2002). |
| 14.0* | Code of Ethics for Senior Financial Officers. |
| 21.1* | Subsidiaries of the Registrant. |
| 31.1* | Rule 13a-14(a) Certification by Acting Principal Executive Officer and Chief Financial Officer. |
| 32.1* | Certification Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. |

* Filed herewith

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SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

Dated: March 31, 2005

AMERICAN REALTY INVESTORS, INC.

By: /s/ SCOTT T. LEWIS
Scott T. Lewis
 Executive Vice President and Chief Financial Officer
 (Principal Financial and Accounting Officer and Acting
 Principal Executive Officer)

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the date indicated.

| <u>Signature</u> | <u>Title</u> | <u>Date</u> |
|------------------------|--|----------------|
| /s/ TED P. STOKELY | Chairman of the Board and | March 31, 2005 |
| Ted P. Stokely | Director | |
| /s/ HENRY A. BUTLER | Director | March 31, 2005 |
| Henry A. Butler | | |
| /s/ SHARON HUNT | Director | March 31, 2005 |
| Sharon Hunt | | |
| /s/ TED R. MUNSELLE | Director | March 31, 2005 |
| Ted R. Munselle | | |
| /s/ MARTIN L. WHITE | Director | March 31, 2005 |
| Martin L. White | | |
| /s/ SCOTT T. LEWIS | Executive Vice President and Chief Financial Officer (Principal Financial and Accounting Officer and Acting Principal Executive Officer) | March 31, 2005 |
| Scott T. Lewis | | |

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ANNUAL REPORT ON FORM 10-K

EXHIBIT INDEX

For the Year Ended December 31, 2004

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- 21.1* Subsidiaries of the Registrant.
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- 32.1* Certification Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

* Filed herewith.

