

Edgar Filing: AMERICAN REALTY INVESTORS INC - Form 10-Q/A

AMERICAN REALTY INVESTORS INC  
Form 10-Q/A  
October 11, 2002

UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549

FORM 10-Q/A  
AMENDMENT NO. 1

[X] QUARTERLY REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF  
1934 FOR THE QUARTER ENDED JUNE 30, 2002

-----  
Commission File Number 1-15663  
-----

AMERICAN REALTY INVESTORS, INC.

-----  
(Exact Name of Registrant as Specified in Its Charter)

Nevada

75-2847135

-----  
(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)

Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the Registrant was required to file such reports) and (2) has been subject to such filing requirements for the past 90 days.

Yes  No

---

APPLICABLE ONLY TO CORPORATE ISSUERS:

Indicate the number of shares outstanding of each of the issuer's classes of Common Stock, as of the latest practicable date.

Common Stock, \$.01 par value

11,375,127

-----  
(Class)

-----  
(Outstanding at July 31, 2002)

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This Form 10-Q/A Amendment No. 1 amends the Registrant's Quarterly Report on Form 10-Q for the quarter ended June 30, 2002 as follows:

ITEM 1. FINANCIAL STATEMENTS

Consolidated Balance Sheets - pages 2, 3
Consolidated Statements of Operations - pages 4, 5
Consolidated Statements of Stockholders' Equity - page 6
Consolidated Statements of Cash Flows - page 8

NOTE 1. "BASIS OF PRESENTATION" - page 9
NOTE 2. "REAL ESTATE" - pages 10, 11
NOTE 10. "OPERATING SEGMENTS - pages 21, 22
NOTE 11. "DISCONTINUED OPERATIONS" - page 23

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

Liquidity and Capital Resources - pages 29, 30
Results of Operations - pages 33, 35

This amendment is made to revise the accounting for gain recognition in connection with a property transaction in the first quarter of 2002. For the three months ended June 30, 2002, the change resulted in an increase in the net loss from \$(14,112,000) to \$(14,638,000) and a corresponding change in earnings per share from a net loss of \$(1.29) per share to a net loss of \$(1.34) per share. For the six months ended June 30, 2002, the change resulted in an increase in the net loss from \$(12,907,000) to \$(23,575,000) and a corresponding change in earnings per share from a net loss of \$(1.24) per share to a net loss of \$(2.18) per share. Total assets at June 30, 2002 were reduced by \$10,668,000.

PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

The accompanying Consolidated Financial Statements as of and for the three and six month period ended June 30, 2002, have not been audited by independent certified public accountants but in the opinion of the management of American Realty Investors, Inc. ("ARI"), all adjustments (consisting of normal recurring accruals) necessary for a fair presentation of consolidated results of operations, consolidated financial position and consolidated cash flows at the dates and for the periods indicated, have been included.

AMERICAN REALTY INVESTORS, INC.
CONSOLIDATED BALANCE SHEETS

Table with columns for Assets, June 2002, and dollar amounts. Includes entry for Real estate held for investment valued at \$ 442,000.

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Less - accumulated depreciation .....	(112,
	-----
	329,
Real estate held for sale .....	195,
Notes and interest receivable	
Performing (\$26,420 in 2002 and \$18,896 in 2001 from affiliates) .....	28,
Nonperforming (\$6,499 in 2002 and \$6,994 in 2001 from affiliates) .....	7,
	-----
	35,
Less--allowance for estimated losses .....	(2,
	-----
	33,
Pizza parlor equipment .....	11,
Less - accumulated depreciation .....	(4,
	-----
	7,
Leasehold interest - oil and gas properties .....	
Less - accumulated depletion .....	
	-----
Oilfield equipment .....	
Less - accumulated depreciation .....	
	-----
Marketable equity securities, at market value .....	
Cash and cash equivalents .....	2,
Investments in equity investees .....	81,
Intangibles, net of accumulated amortization (\$2,696 in 2002 and \$2,666 in 2001) .....	15,
Other assets (\$1,591 in 2002 from affiliates) .....	36,
	-----
	\$ 702,
	=====

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

AMERICAN REALTY INVESTORS, INC.  
CONSOLIDATED BALANCE SHEETS - Continued

Liabilities and Stockholders' Equity

Liabilities

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Notes and interest payable (\$6,181 in 2002 and \$1,598 in 2001 to affiliates) .....	
Margin borrowings .....	
Accounts payable and other liabilities (\$1,631 in 2002 and \$11,389 in 2001 to affiliates) .....	
Minority interest .....	
Series F Preferred Stock, 3,968.75 shares in 2001 (liquidation preference \$3,969) .....	
Commitments and contingencies	
Stockholders' equity	
Preferred Stock, \$2.00 par value, authorized 50,000,000 shares, issued and outstanding	
Series A, 3,324,910 shares in 2002 and 2,724,910 shares in 2001 (liquidation preference \$33,249), including 900,000 shares in 2002 and 300,000 shares in 2001 held by subsidiaries .....	
Series E, 50,000 shares in 2002 and 2001 (liquidation preference \$5,000) .....	
Common Stock, \$.01 par value, authorized 100,000,000 shares; issued 11,375,127 shares in 2002 and 2001 .....	
Paid-in capital .....	
Accumulated deficit .....	
Accumulated other comprehensive income .....	

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

AMERICAN REALTY INVESTORS, INC.  
CONSOLIDATED STATEMENTS OF OPERATIONS

	REVISED		REV
	For the Three Months		For
	Ended June 30,		
	2002	2001	2001
	-----	-----	-----
Property revenue	(dollars in thousands, e		
Rents .....	\$ 28,705	\$ 27,273	\$ 5
Property operations expenses .....	20,481	23,486	3
Operating income .....	8,224	3,787	1
Land operations			
Sales .....	15,121	13,087	2
Cost of sales .....	13,957	12,163	1
Gain on land sales .....	1,164	924	

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Pizza parlor operations			
Sales .....	9,736	8,733	1
Cost of sales .....	7,794	7,129	1
	-----	-----	-----
Gross margin .....	1,942	1,604	
Income from operations .....	11,330	6,315	2
Other income			
Interest income .....	785	776	
Equity in loss of investees .....	(5,221)	(3,841)	(
Loss on sale of investments in equity investees .....	--	(387)	
Other .....	142	44	
	-----	-----	-----
	(4,294)	(3,408)	(
Other expenses			
Interest .....	18,068	16,091	3
Depreciation and amortization .....	4,461	4,221	
General and administrative .....	3,169	1,557	
Advisory fee to affiliate .....	1,516	2,292	
Net income fee to affiliate .....	--	1,766	
Incentive fee to affiliate .....	--	4,314	
Minority interest .....	773	(95)	
	-----	-----	-----
	27,987	30,146	5
	-----	-----	-----
Net loss from continuing operations .....	(20,951)	(27,239)	(3
Discontinued operations:			
Income (loss) from operations .....	14	(6)	
Gain on sale of real estate .....	2,150	25,840	
Equity in gain on sale of real estate by equity investees .....	4,149	9,938	
	-----	-----	-----
Net income from discontinued operations .....	6,313	35,772	1
Net income (loss) .....	(14,638)	8,533	(2
Preferred dividend requirement .....	(589)	(606)	(
	-----	-----	-----
Net income (loss) applicable to Common shares .....	\$ (15,227)	\$ 7,927	\$ (2
	=====	=====	=====

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

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	Ended June 30,	
	2002	2001
	(dollars in thousands)	
Earnings per share		
Net loss from continuing operations .....	\$ (1.89)	\$ (1.89)
Discontinued operations .....	.55	.55
Net income (loss) applicable to Common shares .....	\$ (1.34)	\$ (1.34)
Weighted average Common shares used in computing earnings per share .....	11,375,127	10,127,127

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  
For the Six Months Ended June 30, 2002

	Series A Preferred Stock	Series E Preferred Stock	Common Stock	Paid-in Capital	Accumul Defic
	-----	-----	-----	-----	-----
	(dollars in thousands, e				
Balance, January 1, 2002 .....	\$ 4,850	\$ 100	\$ 114	\$112,184	\$ (31,184)
Comprehensive income					
Foreign currency translation gain .....	--	--	--	--	--
Net loss .....	--	--	--	--	(23,184)
Common Stock dividends (pre-merger) .....					
	--	--	--	--	--
Preferred dividends					
Series A Preferred Stock (\$.50 per share) ...	--	--	--	--	(1,184)
Series E Preferred Stock (\$.30 per share) .....	--	--	--	--	--

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Balance, June 30, 2002 .....	\$ 4,850	\$ 100	\$ 114	\$112,184	\$(56,
	=====	=====	=====	=====	=====

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

AMERICAN REALTY INVESTORS, INC.  
CONSOLIDATED STATEMENTS OF CASH FLOWS

					REVI
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					2
					----
					(do
Cash Flows From Operating Activities					
Rents collected .....					\$ 5
Pizza parlor sales collected .....					1
Interest collected .....					
Distributions received from equity investees' operating cash flow .....					
Payments for property operations .....					(3
Payments for pizza parlor operations .....					(1
Interest paid .....					(3
Advisory fee paid to affiliate .....					(
Distributions to minority interest holders .....					(
General and administrative expenses paid .....					(
Other .....					(
					----
Net cash used in operating activities .....					(2
Cash Flows From Investing Activities					
Collections on notes receivable .....					(
Pizza parlor equipment purchased .....					3
Proceeds from sale of real estate .....					(
Notes receivable funded .....					
Earnest money/escrow deposits .....					
Investment in real estate entities .....					(
Acquisition of real estate .....					(
Construction and development .....					(
Real estate improvements .....					(
Acquisition of leasehold interests .....					
Purchase of oilfield equipment .....					
					----
Net cash provided by investing activities .....					2
Cash Flows from Financing Activities					
Proceeds from notes payable .....					7
Payments on notes payable .....					(6
Deferred borrowing costs .....					(

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Net (payments to)/advances from affiliates .....	(
Margin borrowings, net .....	(
Repurchase of Common Stock .....	(
Preferred dividends paid .....	(
Common dividends paid .....	---
Net cash (used in) provided by financing activities .....	(
Net increase in cash and cash equivalents .....	
Cash and cash equivalents, beginning of period .....	---
Cash and cash equivalents, end of period .....	\$
	===

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

AMERICAN REALTY INVESTORS, INC.  
CONSOLIDATED STATEMENTS OF CASH FLOWS - Continued

	REVISE
	For
	-----
	20
	-----
	(dol
Reconciliation of net income (loss) to net cash used in operating activities	
Net income (loss) .....	\$ (23
Adjustments to reconcile net income (loss) to net cash used in operating activities	
Depreciation and amortization .....	8
Gain on sale of real estate .....	(11
Distributions from equity investees' operating cash flow .....	
Distributions to minority interest holders .....	
Equity in (income) loss of investees .....	
Loss on sale of investments in equity investees .....	
Increase in accrued interest receivable .....	1
(Increase) decrease in other assets .....	1
Increase (decrease) in accrued interest payable .....	1
Increase (decrease) in accounts payable and other liabilities .....	---
Net cash used in operating activities .....	\$ (21
	=====
Schedule of noncash investing and financing	
Notes payable assumed by buyer on sale of real estate .....	\$ 56
Exchange of real estate at carrying value .....	
Notes receivable from sale of real estate .....	



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Issuance of Series F Preferred Stock .....	
Cancellation of Series F Preferred Stock .....	(3)
Note receivable from sale of leasehold interests .....	1
Sale of real estate to affiliate to satisfy debt .....	24
Acquisition of assets from affiliate to satisfy debt .....	(16)

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

AMERICAN REALTY INVESTORS, INC.  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1. BASIS OF PRESENTATION

The accompanying Consolidated Financial Statements have been prepared in conformity with generally accepted accounting principles for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. Dollar amounts in tables are in thousands, except per share amounts. Certain balances for 2001 have been reclassified to conform to the 2002 presentation.

The financial statements and accompanying footnotes have been amended to revise the accounting for gain recognition in connection with a property transaction in the first quarter of 2002. For the three months ended June 30, 2002 the change resulted in an increase in the net loss from \$(14,112,000) to \$(14,638,000) and a corresponding change in earnings per share from a net loss of \$(1.29) per share to a net loss of \$(1.34) per share. For the six months ended June 30, 2002, the change resulted in an increase in the net loss from \$(12,907,00) to \$(23,575,000) and a corresponding change in earnings per share from a net loss of \$(1.24) per share to a net loss of \$(2.18) per share. Total assets at June 30, 2002 were reduced by \$10,668,000.

Operating results for the six month period ended June 30, 2002, are not necessarily indicative of the results that may be expected for the year ending December 31, 2002. For further information, refer to the Consolidated Financial Statements and Notes thereto included in ARI's Annual Report on Form 10-K for the year ended December 31, 2001 (the "2001 Form 10-K").

On January 1, 2002, ARI adopted Statement 144, "Accounting for the Impairment or Disposal of Long-Lived Assets" ("SFAS No. 144"). The Statement superceded Statement 121, "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed of" ("SFAS No. 121") and Accounting Principles Board Opinion No. 30, "Reporting the Results of Operations - Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions" ("APB 30"), for segments of a business to be disposed of. SFAS 144 retains the requirements of SFAS No. 121 relating to the recognition and measurement of an impairment loss and resolves certain implementation issues resulting from SFAS No. 121. The adoption of SFAS No. 144 did not have a material impact on the consolidated financial position or

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results of operations of ARI.

In April 2002, the FASB issued Statement 145, "Rescission of FASB Statements No. 4, 44 and 64, Amendment of FASB Statement No. 13, and Technical Correction" ("SFAS No. 145"). Statement 4, "Reporting Gains and Losses from Extinguishment of Debt" ("SFAS No. 4"), required that gains and losses from the extinguishment of debt that were included in the determination of net income be aggregated and, if material, classified as an extraordinary item. The provisions of SFAS No. 145 related to the rescission of SFAS No. 4 become effective in fiscal years beginning after May 15, 2002. The adoption of SFAS No. 145 will not have a material impact on the consolidated financial position or results of operations of ARI.

In June 2002, the FASB issued SFAS No. 146, "Accounting for Costs Associated with Exit or Disposal Activities," which addresses accounting for restructuring and similar costs. SFAS No. 146 supersedes previous accounting guidance, principally Emerging Issues Task Force ("EITF") Issue No. 94-3. ARI will adopt the provisions of SFAS No. 146 for restructuring activities initiated after December 31, 2002. SFAS No. 146 requires that the liability for costs associated with an exit or disposal activity be recognized when the liability is incurred. Under EITF No. 94-3, a liability for an exit cost was recognized at the date

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### AMERICAN REALTY INVESTORS, INC. NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - Continued

#### NOTE 1. BASIS OF PRESENTATION (Continued)

of a company's commitment to an exit plan. SFAS No. 146 also establishes that the liability should initially be measured and recorded at fair value. Accordingly, SFAS No. 146 may affect the timing of recognizing future restructuring costs as well as the amount recognized.

#### NOTE 2. REAL ESTATE

In 2002, ARI purchased the following properties:

Property	Location	Units/ Sq.Ft./Acres	Purchase Price	Net Cash Paid	Debt Incurred
First Quarter					
Shopping Center Plaza on Bachman Creek/(1)/	Dallas, TX	80,278 Sq.Ft.	\$ 3,103	\$ --	\$ --
Second Quarter					
Apartments					
Pinecrest/(2)/	North Augusta, SC	120 Units	2,986	--	1,423 /(3)
Tiberon Trails/(2)/	Merrillville, IN	376 Units	12,000	--	6,417 /(3)
Shopping Center					
Alta Mesa/(2)/	Ft. Worth, TX	59,933 Sq.Ft.	4,000	--	1,804 /(3)
Land					
Pioneer Crossing	Austin, TX	79.4 Acres	1,165	1,213	--
Willow Springs	Beaumont, CA	20.7 Acres	140	146	--

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- 
- (1) Exchanged with Transcontinental Realty Investors, Inc. ("TCI"), a related party, for the Oaktree Village Shopping Center, Rasor land parcel and Lakeshore Villas land parcel.
  - (2) Property received from Basic Capital Management, Inc. ("BCM"), a related party, for forgiveness of debt.
  - (3) Assumed debt of seller.

In 2001, ARI purchased the following properties:

Property	Location	Units/	Purchase Price	Net Cash Paid	Debt Incurred
Second Quarter					
Apartments					
Glenwood	Addison, TX	168 Units	\$ 6,246	\$ -- / (1) /	\$ 2,549 / (2) /

- 
- (1) 8.88 acres of Hollywood Casino land and 10.5 acres of Vista Ridge land given as consideration. Exchanged with a related party.
  - (2) Assumed debt of seller. Exchanged with a related party.

In 2002, ARI sold the following properties:

Property	Location	Units/ Acres/Sq.Ft.	Sales Price	Net Cash Received	Debt Discharg
First Quarter					
Apartments					
Mallard Lake / (1) /	Greensboro, NC	336 Units	\$ 14,400	\$ --	\$ 7,3
Villas	Plano, TX	208 Units	8,525	3,701	4,0

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AMERICAN REALTY INVESTORS, INC.  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - Continued

NOTE 2. REAL ESTATE (Continued)

Property	Location	Units/ Acres/Sq.Ft.	Sales Price	Net Cash Received	Debt Discharg
First Quarter - Continued					
Land					
Katrina	Palm Desert, CA	2.1 Acres	\$ 1,323	\$ ( 40)	\$ 1,

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Lakeshore Villas/(2)/	Harris County, TX	16.9 Acres	1,499	215	
Rasor/(2)/	Plano, TX	24.5 Acres	1,211	174	
Thompson II	Dallas County, TX	.2 Acres	21	20	
Vista Ridge	Lewisville, TX	10.0 Acres	1,525	130	1,
Shopping Center					
Oaktree Village/(2)/	Lubbock, TX	45,623 Sq.Ft.	2,302	131	1,
Second Quarter					
Apartments					
Oak Hill	Tallahassee, FL	92 Units	3,200	156 / (4) /	2,
Regency	Tampa, FL	78 Units	3,200	851	1,
Stonebridge	Florissant, MO	100 Units	4,340	1,272	2,
Office Building					
Centura	Dallas, TX	410,901 Sq.Ft.	50,000	--	43,
Land					
Hollywood Casino	Farmers Branch, TX	42.8 Acres	16,987	--	6,
Marine Creek	Ft. Worth, TX	54.2 Acres	3,700	--	1,
Mason Goodrich	Houston, TX	7.9 Acres	672	46	
Mason Goodrich	Houston, TX	10.3 Acres	1,444	93	1,
Mason Goodrich	Houston, TX	18.0 Acres	2,790	--	2,
Monterrey	Riverside, CA	61.0 Acres	4,625	--	
Nashville	Nashville, TN	16.6 Acres	1,890	--	
Third Quarter					
Apartments					
Valley Hi	Tallahassee, FL	54 Units	1,452	75	1,
White Pines	Tallahassee, FL	85 Units	764	10	
Woodsong	Smyrna, GA	190 Units	9,200	( 45)	8,

-----

- (1) Exchanged for Governor's Square, Grand Lagoon, Park Avenue, Greenbriar, Regency and Westwood Apartments.
- (2) Exchanged with TCI, a related party, for the Plaza on Bachman Creek Shopping Center.
- (3) Debt assumed by purchaser.
- (4) Represents dividends on and redemption of Innovo Preferred Stock. See NOTE 7. "NOTES PAYABLE."
- (5) Sold to TCI, a related party. Gain deferred until sale to unrelated party.

In 2001, ARI sold the following properties:

Property	Location	Units/ Acres/Sq.Ft.	Sales Price	Net Cash Received	Debt Discharg
-----	-----	-----	-----	-----	-----
First Quarter					
Apartments					
Carriage Park	Tampa, FL	46 Units	\$ 2,005	\$ 757	\$ 1,
Rockborough	Denver, CO	345 Units	16,675	3,654	12,

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## AMERICAN REALTY INVESTORS, INC. NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - Continued

### NOTE 2. REAL ESTATE (Continued)

Property	Location	Units/ Acres/Sq.Ft.	Sales Price	Net Cash Received	De Disch
First Quarter - Continued					
Land					
Frisco Bridges	Collin County, TX	27.8 Acres	\$ 4,500	\$ 4,130	\$
Katrina	Palm Desert, CA	20.0 Acres	2,831	(124)	
Las Colinas	Las Colinas, TX	1.7 Acres	825	233	
Plano Parkway	Plano, TX	11.3 Acres	1,445	312	
Scoggins	Tarrant County, TX	232.8 Acres	2,913	892	1,
Scout	Tarrant County, TX	408.0 Acres	5,087	1,586	3,
Tree Farm	Dallas County, TX	10.4 Acres	2,888	(87)	2,
Shopping Center					
Regency Pointe	Jacksonville, FL	67,063 Sq.Ft.	7,350	5,126	1,
Second Quarter					
Apartments					
Bent Tree	Addison, TX	292 Units	12,050	2,480	8,
Glenwood	Addison, TX	168 Units	6,650	3,166	2,
Kimberly Woods	Tucson, AZ	279 Units	8,450	1,667	6,
Place One	Tulsa, OK	407 Units	12,935	3,310	7,
Shadowood	Addison, TX	184 Units	7,125	1,980	4,
Land					
Katrina	Palm Desert, CA	20.0 Acres	2,940	78	
Mason/Goodrich	Houston, TX	22.1 Acres	4,168	(34)	3,
Plano Parkway	Plano, TX	12.0 Acres	740	672	
Yorktown	Harris County, TX	120.4 Acres	5,239	(160)	4,

- 
- (1) Debt assumed by purchaser.  
(2) Gain deferred until 2002, when ARI-provided financing was collected.

### NOTE 3. NOTES RECEIVABLE

In May 2002, ARI sold its leasehold interests in various oil and gas mineral development properties for \$1.3 million, receiving a note from the buyer for the purchase price. The note bears interest at 10.0% per annum, matures in May 2004 and requires monthly payments of principal and accrued interest. See NOTE 4. "OIL AND GAS OPERATIONS."

In March 2001, ARI sold a 20.0 acre tract of its Katrina land parcel for \$2.8 million, receiving \$700,000 in cash and providing purchase money financing of the remaining \$2.1 million of the sales price. The loan bore interest at 12.0% per annum and matured in July 2001. All principal and interest were due at maturity. In January 2002, \$274,000 in principal and \$226,000 in interest was collected. In March 2002, the note was collected in full, including accrued but unpaid interest.

In November 2001, ARI sold a 12.7 acre tract of its Santa Clarita parcel for

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\$1.9 million, receiving \$1.5 million in cash and providing purchase money financing of the remaining \$437,000 of the sales price. The loan bears interest at 8.0% per annum and matures in November 2002. All principal and accrued but unpaid interest are due at maturity.

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### AMERICAN REALTY INVESTORS, INC. NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - Continued

#### NOTE 3. NOTES RECEIVABLE (Continued)

Also in November 2001, ARI sold the Blackhawk Apartments for \$7.1 million, receiving \$1.5 million in cash after the assumption of \$4.0 million of mortgage debt and providing purchase money financing of the remaining \$1.6 million of the sales price. The loan bore interest at 10.0% per annum and matured in May 2002. Monthly principal and interest payments were required. In April 2002, the note was collected in full, including accrued but unpaid interest.

In December 1999, a note with a principal balance of \$1.2 million, secured by a pledge of a partnership interest in a partnership which owns real estate in Addison, Texas, matured. The maturity date was extended to April 2000 in exchange for an increase in the interest rate to 14.0% per annum. All other terms remained the same. In February 2001, the loan amount was increased to \$1.6 million and the maturity date was extended to June 2001. In February 2002, \$1.5 million in principal and \$87,000 in interest was collected. In May 2002, \$10,000 in principal and accrued interest was collected. In July 2002, the note was collected in full, including accrued but unpaid interest.

Related Party. In June 2002, ARI converted \$4.5 million of its receivable from BCM, a related party, to a recourse note receivable. The note bears interest at 10.0% per annum, matures in March 2004 and requires quarterly payments of principal and accrued interest. The first payment is due in December 2002.

In March 2001, ARI funded \$13.6 million of a \$15.0 million unsecured line of credit to One Realco Corporation ("One Realco"), which owns approximately 14.7% of the outstanding shares of ARI's Common Stock. The line of credit bears 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, ARI's advisor. 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 \$15.0 million. All principal and interest are due at maturity. Ronald E. Kimbrough, Executive Vice President and Chief Financial Officer of ARI, is a 10% shareholder of One Realco. Mr. Kimbrough does not participate in day-to-day operations or management of One Realco.

In October 1999, ARI funded a \$4.7 million loan to Realty Advisors, Inc., an affiliate. The loan 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 subordinate pledge of 850,000 shares of ARI Common Stock owned by BCM. The shares are also pledged to a lender on ARI's behalf. The interest

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### AMERICAN REALTY INVESTORS, INC. NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - Continued

#### NOTE 3. NOTES RECEIVABLE (Continued)

rate was changed to 2% over the prime rate, currently 6.75% per annum, and the accrued but unpaid interest of \$984,000 was added to the principal. The new principal balance is \$5.6 million. All principal and accrued interest are due at maturity.

In December 2000, an unsecured loan with a principal balance of \$1.8 million to Warwick of Summit, Inc. ("Warwick") matured. All principal and interest were due at maturity. In February 2002, \$275,000 of interest was received. In May 2002, \$33,000 of principal and \$267,000 of interest was collected. At June 2002, the loan, with a current principal balance of \$1.7 million and \$34,000 of accrued interest, remained unpaid. At August 2002, settlement terms are being negotiated. Richard D. Morgan, a Warwick shareholder, served as a director of ARI until October 2001.

In December 2000, a loan with a principal balance of \$1.6 million to Bordeaux Investments Two, L.L.C. ("Bordeaux"), matured. The loan is 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. At June 2002, the loan, and \$576,000 of accrued interest, remained unpaid. At August 2002, settlement terms are being negotiated. Richard D. Morgan, a Bordeaux member, served as a director of ARI until October 2001.

In March 2000, a loan with a principal balance of \$2.5 million to Lordstown, L.P., matured. The loan 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. At June 2002, the loan, and \$900,000 of accrued interest, remained unpaid. At August 2002, settlement terms are being negotiated. Tara Group, Inc., 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.

#### NOTE 4. OIL AND GAS OPERATIONS

In May 2001, ARI purchased the leasehold interests in 37 oil and gas mineral development properties, which include 131 drilled wells. The total proved reserves were 6.5 million barrels of oil and 3.3 billion cubic feet of natural gas. The total purchase price was \$4.7 million, plus a 40% profit participation. The Operator's Interest was purchased for \$375,000, with \$25,000 cash paid at closing. ARI gave a note payable for the remaining \$350,000. The note bore no interest, and matured in May 2002. Monthly principal payments of \$25,000 were required. The Working Interests were purchased for \$4.3 million, with \$125,000 cash paid at closing. ARI gave a note payable for \$250,000. The note bore no interest, and matured in November 2001. One-half of the principal was paid in August 2001. The remaining \$4.0 million was

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### NOTE 4. OIL AND GAS OPERATIONS (Continued)

paid by issuing 3,968.75 shares of ARI Series F Preferred Stock, which was redeemable quarterly in an amount equal to 20% of net cash flow from the oil and gas operations. The stock had a liquidation value of \$1,000 per share, and paid no dividends.

In May 2002, ARI sold the leasehold interests for \$1.3 million, receiving a note from the buyer for the purchase price. The note bears interest at 10.0% per annum, matures in May 2004 and requires monthly payments of principal and accrued interest. As part of the sale, the notes payable given by ARI for the purchase of the Operator's Interest (\$350,000) and the Working Interests (\$250,000) were canceled. The 3,968.75 shares of ARI Series F Preferred Stock were also returned to ARI and canceled.

### NOTE 5. INVESTMENTS IN EQUITY INVESTEES

Real estate entities. ARI's investment in real estate entities at June 30, 2002, included equity securities of two publicly traded real estate companies, Income Opportunity Realty Investors, Inc. ("IORI") and TCI, and interests in real estate joint venture partnerships. BCM, ARI's advisor, serves as advisor to IORI and TCI.

ARI accounts for its investment in IORI and TCI and the joint venture partnerships using the equity method. The equity securities of IORI and TCI are pledged as collateral for borrowings. See NOTE 8. "MARGIN BORROWINGS."

ARI's investment in real estate entities, accounted for using the equity method, at June 30, 2002 was as follows:

Investee	Percentage of ARI's Ownership at June 30, 2002	Carrying Value of Investment at June 30, 2002	Equivalent Investee Book Value at June 30, 2002	Market V of Investm June 30,
IORI .....	28.49%	\$ 7,981	\$ 11,226	\$ 7,37
TCI .....	49.99	66,329	106,727	80,33
		----- 74,310		----- \$ 87,71 =====
Other .....		6,860		
		----- \$ 81,170 =====		

Management continues to believe that the market value of both IORI and TCI undervalues their assets, and, therefore, ARI may continue to increase its ownership in these entities in 2002, as its liquidity permits. On October 3, 2000, ARI and IORI entered into a stock option agreement which provided IORI and ARI with an option to purchase 1,858,900 shares of TCI common stock from a third party. On October 19, 2000, IORI assigned all of its rights to purchase such shares to ARI. The total cost to purchase the TCI shares was \$30.8 million. In October 2000, ARI paid \$5.6 million of the option price. In April 2001, the



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## AMERICAN REALTY INVESTORS, INC. NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - Continued

### NOTE 5. INVESTMENTS IN EQUITY INVESTEES (Continued)

remainder of the option price was paid and ARI acquired the TCI shares. See ITEM 2. "MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS" for discussion of the proposed acquisition of TCI and IORI by ARI.

Set forth below are summarized results of operations of equity investees for the six months ended June 30, 2002:

Revenues .....	\$ 66,079
Equity in loss of partnerships .....	(2,644)
Property operating expenses .....	50,427
Depreciation .....	10,766
Interest expense .....	20,173
Loss from discontinued operations .....	(1,842)
	-----
Loss before gains on sale of real estate .....	(19,773)
Gain on sale of real estate .....	19,619
	-----
Net loss .....	\$ (154)
	=====

ARI's share of equity investees' loss before gains on the sale of real estate was \$9.2 million for the six months ended June 30, 2002, and its share of equity investees' gains on sale of real estate was \$8.3 million for the six months ended June 30, 2002.

ARI's cash flow from IORI and TCI is dependent on the ability of each entity to make distributions. In the fourth quarter of 2000, IORI and TCI suspended distributions.

Realty Advisors - Korea. In June 2002, ARI acquired Realty Advisors - Korea from BCM, a related party, for \$6.0 million. ARI's receivable from BCM was reduced by \$6.0 million, and no cash was paid by ARI.

ART Florida Portfolio II, Ltd. In January 2002, Investors Choice Florida Public Funds II, in which ART Florida Portfolio II, Ltd. owned an interest, sold Villas Continental Apartments. ARI received \$1.0 million in cash from the sale. ARI's share of the loss incurred on the sale was \$531,000, which is included in loss on sale of investments in equity investees in the accompanying Consolidated Statements of Operations.

### NOTE 6. MARKETABLE EQUITY SECURITIES - TRADING PORTFOLIO

Since 1994, ARI has been purchasing equity securities of entities other than those of IORI and TCI to diversify and increase the liquidity of its margin accounts. These equity securities are considered a trading portfolio and are carried at market value. In the first six months of 2002, ARI did not purchase or sell any such securities. At June 30, 2002, ARI recognized an unrealized decrease in the market value of its trading portfolio securities of \$7,000. Unrealized and realized gains and losses on trading portfolio securities are included in other income in the accompanying Consolidated Statements of Operations.

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AMERICAN REALTY INVESTORS, INC.  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - Continued

NOTE 7. NOTES PAYABLE

In 2002, ARI financed/refinanced or obtained second mortgage financing on the following:

Property	Location	Units/ Acres/Sq.Ft.	Debt Incurred	Debt Discharged	Net Rece
First Quarter					
Land Walker	Dallas County, TX	90.6 Acres	\$ 8,500	\$ 8,500	\$( 1,
Shopping Center					
Plaza on Bachman Creek	Dallas, TX	80,278 Sq.Ft.	5,000	--	4,
Second Quarter					
Apartments					
Lee Hills	Tallahassee, FL	16 Units	1,750 / (2) /	117	
Valley Hi	Tallahassee, FL	54 Units	-- / (2) /	878	
White Pines	Tallahassee, FL	85 Units	-- / (2) /	--	
Office Buildings					
Four Hickory Centre	Farmers Branch, TX	221,000 Sq.Ft.	12,500 / (3) /	--	3,

Related Party Transactions. In each of the following transactions, except those footnoted as (6), a related party has purchased an entity, which owns the listed property asset, from ARI. ARI has guaranteed that the asset will produce at least a 12% return on the purchase price for a period of three years from the purchase date. If the asset fails to produce the 12% return, ARI will pay the purchaser any shortfall. In addition, if the asset fails to produce the 12% return for a calendar year, the purchaser may require ARI to repurchase the entity for the purchase price. Management has classified these related party transactions as notes payable.

Property	Location	Units/Sq.Ft.	Debt Incurred	Debt Discharged	Net Cas Receive
First Quarter					
Office Building					
Rosedale Towers	Minneapolis, MN	84,798 Sq.Ft.	\$ 5,109	\$ --	\$5,109
Two Hickory Centre	Farmers Branch, TX	96,127 Sq.Ft.	4,448	--	4,448
Second Quarter					
Apartments					
Bay Anchor	Panama City, FL	12 Units	255	--	203
Confederate Point	Jacksonville, FL	206 Units	1,929	--	--
Foxwood	Memphis, TN	220 Units	1,093	--	--
Governor Square	Tallahassee, FL	168 Units	4,480	3,196	611
Grand Lagoon	Panama City, FL	54 Units	2,083	1,209	655

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Oak Hill	Tallahassee, FL	92 Units	2,550	1,875	478
Park Avenue	Tallahassee, FL	121 Units	4,400	2,756	1,341
Seville	Tallahassee, FL	62 Units	1,955	1,263	473
Westwood	Mary Ester, FL	120 Units	3,382	2,327	1,023
Windsor Tower	Ocala, FL	64 Units	1,989	1,128	702
Woodhollow	San Antonio, TX	546 Units	8,160	5,349	2,775
Woodsong	Smyrna, GA	190 Units	2,544	--	--
Office Building					
One Hickory Centre	Farmers Branch, TX	102,615 Sq.Ft.	4,468	--	--

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### AMERICAN REALTY INVESTORS, INC. NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - Continued

#### NOTE 7. NOTES PAYABLE (Continued)

- (1) Variable interest rate.
- (2) Single note with all properties as collateral.
- (3) \$5.5 million funded at June 30, 2002.
- (4) IORI, a related party, purchased 100% of the outstanding common shares of Rosedale Corporation ("Rosedale"), a wholly-owned subsidiary of ARI, for \$5.1 million. Rosedale owns the Rosedale Towers Office Building.
- (5) TCI, a related party, purchased 100% of the common shares of ART Two Hickory Corporation ("Two Hickory"), a wholly-owned subsidiary of ARI, for \$4.4 million. Two Hickory owns the Two Hickory Centre Office Building.
- (6) Properties sold 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, a Director of ARI, controls approximately 11.67% of the outstanding common stock of Innovo. Management has determined to treat this sale as a refinancing transaction. ARI will continue to report the assets and the new debt incurred by Metra on its financial statements. ARI also received \$6.3 million of 8% non-recourse, non-convertible Series A Preferred Stock ("Preferred Shares") of Innovo.

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

The Preferred Shares have a mandatory redemption feature, and are redeemable from the cash proceeds received by Innovo from the operation and sale of the properties. All member distributions that are in excess of current and accrued 8% dividends must be used by Innovo to redeem the Preferred Shares. Since redemption of these shares is subject to the above future events, management has elected to record no basis in the Preferred Shares.

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- (7) TCI, a related party, purchased all of the general and limited partnership interests in Garden Confederate Point, L.P. ("Confederate Point") from ARI for \$1.9 million. Confederate Point owns the Confederate Point Apartments.
- (8) TCI, a related party, purchased all of the general and limited partnership interests in Garden Foxwood, L.P. ("Foxwood") from ARI for \$1.1 million. Foxwood owns the Foxwood Apartments.

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AMERICAN REALTY INVESTORS, INC.  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - Continued

NOTE 7. NOTES PAYABLE (Continued)

- (9) TCI, a related party, purchased all of the general and limited partnership interests in Garden Woodsong, L.P. ("Woodsong") from ARI for \$2.5 million. Woodsong owns the Woodsong Apartments. TCI sold the Woodsong Apartments in July 2002.
- (10) Sold to unrelated buyer in June 2002.
- (11) TCI, a related party, purchased 100% of the common shares of ART One Hickory Corporation ("One Hickory"), a wholly-owned subsidiary of ARI, for \$4.5 million. One Hickory owns the One Hickory Centre Office Building.

In 2001, ARI financed/refinanced or obtained second mortgage financing on the following:

Property	Location	Acres/Rooms Sq.Ft.	Debt Incurred	Debt Discharged	Ne Re
First Quarter					
Land					
Mason/Goodrich	Houston, TX	235.0 Acres	\$ 6,750	\$ --	\$
Pioneer Crossing	Austin, TX	350.1 Acres	7,000	--	
Pioneer Crossing	Austin, TX	14.5 Acres	2,500	--	
Second Quarter					
Land					
Hollywood Casino	Farmers Branch, TX	51.7 Acres	2,500 / (1) /	--	
Valwood	Dallas County, TX	19.4 Acres	-- / (1) /	--	
Katrina	Palm Desert, CA	300.5 Acres	22,000	15,584	
Jeffries Ranch	Oceanside, CA	82.4 Acres	5,250 / (3) /	750	
Willow Springs	Riverside, CA	1,485.7 Acres	-- / (3) /	--	
Hotel					
Williamsburg					
Hospitality House	Williamsburg, VA / (4) /	296 Rooms	10,309	--	
Shopping Center					
Cullman	Cullman, AL	92,486 Sq.Ft.	-- / (3) /	129	

(1) Single note, with both properties as collateral.

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- (2) Variable interest rate.
- (3) Single note, with all properties as collateral.
- (4) Also secured by 1,846,000 shares of TCI common stock.

In August 2002, the lender on one of ARI's hotel properties notified ARI that ARI was in default under the provisions of the loan agreement regarding timely payment and debt service coverage ratio. ARI is negotiating with the lender and expects to resolve the issue.

### NOTE 8. MARGIN BORROWINGS

ARI has margin arrangements with various financial institutions and brokerage firms which provide for borrowing of up to 50% of the market

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## AMERICAN REALTY INVESTORS, INC. NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - Continued

### NOTE 8. MARGIN BORROWINGS (Continued)

value of marketable equity securities. The borrowings under such margin arrangements are secured by equity securities of IORI and TCI and ARI's trading portfolio securities and bear interest rates ranging from 5.75% to 24.0%. Margin borrowing totaled \$26.0 million at June 30, 2002.

In April 2000, ARI obtained a security loan in the amount of \$5.0 million from a financial institution. ARI received net cash of \$4.6 million after paying various closing costs. The loan bears interest at 1% over the prime rate, currently 5.75% per annum, requires monthly payments of interest and matures in September 2002. The loan is secured by 1,050,000 shares of ARI Common Stock held by BCM, ARI's advisor.

In March 2001, ARI obtained a security loan in the amount of \$3.5 million from a financial institution. ARI received net cash of \$3.5 million after paying various closing costs. The loan bore interest at 16.0% per annum. In April and May 2001, a total of \$2.0 million in principal paydowns were made. In July 2001, the loan was repaid in full, including accrued but unpaid interest. The loan was secured by 472,000 shares of TCI Common Stock owned by ARI Common Stock and 128,000 shares of ARI owned by One Realco.

In September 2001, ARI obtained a security loan in the amount of \$20.0 million from a financial institution. 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% per annum, while the remaining \$500,000 bears interest at 20% per annum. The loan requires monthly payments of interest only and matures in September 2002. The loan is secured by 2,602,608 shares of TCI common stock held by ARI and 920,507 shares of TCI common stock held by BCM, ARI's advisor.

In October 2001, ARI obtained a security loan in the amount of \$1.0 million from a financial institution. ARI received net cash of \$1.0 million after payment of various closing costs. The loan bears interest at 1% over the prime rate, currently 5.75% per annum, requires monthly payments of interest only and matures in October 2003. The loan is callable upon 60 days prior notice, and is secured by 200,000 shares of ARI Common Stock held by BCM, ARI's advisor.

### NOTE 9. INCOME TAXES

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Financial statement income varies from taxable income principally due to the accounting for income and losses of investees, gains and losses from asset sales, depreciation on owned properties, amortization of discounts on notes receivable and payable and the difference in the allowance for estimated losses. ARI had no taxable income or provision for income taxes in the six months ended June 30, 2002 or 2001.

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### AMERICAN REALTY INVESTORS, INC. NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - Continued

#### NOTE 10. 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, equity in gains on sale of real estate by investees, loss on sale of investments in equity investees and other income which totaled \$( 930,000) and \$( 1.2) million for the three and six months ended June 30, 2002 and \$5.8 million and \$5.8 million for 2001. Expenses that are not reflected in the segments are general and administrative expenses, minority interest, incentive fees, advisory fees, net income fees and discontinued operations, which totaled \$4.9 million and \$11.3 million for the three and six months ended June 30, 2002 and \$9.8 million and \$18.0 million for 2001. Excluded from operating segment assets are assets of \$122.3 million in 2002 and \$122.4 million in 2001, 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, which is located in Bulgaria.

Presented below are ARI's reportable segments operating income for the three and six months ended June 30, 2002 and 2001, and segment assets at June 30, 2002 and 2001.

Three Months Ended June 30, 2002 -----	Commercial Properties -----	Apartments -----	U.S. Hotels -----	Inter- national Hotels -----	Land -----	Pa -----
Operating revenue .....	\$ 8,571	\$ 9,326	\$ 9,144	\$ 1,465	\$ (1)	\$
Interest income .....	--	--	--	--	--	--
Operating expenses .....	5,932	5,866	6,190	748	1,706	--
Operating income (loss) .....	\$ 2,639	\$ 3,460	\$ 2,954	\$ 717	\$ (1,707)	\$
	=====	=====	=====	=====	=====	=====
Depreciation .....	\$ 2,046	\$ 847	\$ 640	\$ 643	\$ --	\$
Interest .....	4,799	3,659	992	--	5,228	--
Capital expenditures .....	5,744	336	197	--	2,271	--
Assets .....	136,639	102,407	66,832	24,091	195,881	--

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Property Sales:	Commercial Properties	Apartments	Land
	-----	-----	-----
Sales price .....	\$ 50,000	\$ 10,740	\$ 15,121
Cost of sale .....	50,000	8,590	13,957
	-----	-----	-----
Gain on sale .....	\$ --	\$ 2,150	\$ 1,164
	=====	=====	=====

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AMERICAN REALTY INVESTORS, INC.  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - Continued

NOTE 10. OPERATING SEGMENTS (Continued)

Six Months Ended June 30, 2002	Commercial Properties	Apartments	U.S. Hotels	Inter- national Hotels	Land	P
-----	-----	-----	-----	-----	-----	-----
Operating revenue .....	\$ 18,990	\$ 19,178	\$ 15,702	\$ 2,468	\$ 61	\$
Interest income .....	-	-	-	-	-	-
Operating expenses .....	11,390	11,465	11,419	1,323	4,080	-
	-----	-----	-----	-----	-----	-----
Operating income (loss) .....	\$ 7,600	\$ 7,713	\$ 4,283	\$ 1,145	\$ (4,019)	\$
	=====	=====	=====	=====	=====	=====
Depreciation .....	\$ 3,614	\$ 1,681	\$ 1,163	\$ 907	\$ -	\$
Interest .....	9,537	6,467	2,123	30	11,396	-
Capital expenditures .....	7,033	548	358	-	2,664	-
Assets .....	136,639	102,407	66,832	24,091	195,881	-

Property Sales:	Commercial Properties	Apartments	Land
	-----	-----	-----
Sales price .....	\$ 52,302	\$ 22,697	\$ 20,701
Cost of sale .....	52,302	14,932	17,338
	-----	-----	-----
Gain on sale .....	\$ -	\$ 7,765	\$ 3,363 / (1)
	=====	=====	=====

(1) Includes \$830,000 gain recognized in 2002 upon collection of note receivable for 2001 land sale.

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Three Months Ended June 30, 2001	Commercial Properties	Apartments	U.S. Hotels	Inter- national Hotels	Land	P Pa
Operating revenue .....	\$ 7,479	\$ 9,687	\$ 8,937	\$ 1,032	\$ 42	\$
Interest income .....	-	-	-	-	-	-
Operating expenses .....	5,022	6,398	5,889	3,450	2,625	-
Operating income (loss) .....	\$ 2,457	\$ 3,289	\$ 3,048	\$ ( 2,418)	\$ (2,583)	\$
Depreciation .....	\$ 1,795	\$ 835	\$ 680	\$ 650	\$ -	\$
Interest .....	4,017	2,489	1,006	97	8,078	-
Capital expenditures .....	2,588	23	168	-	251	-
Assets .....	162,933	130,110	68,549	28,394	231,493	-
Property Sales:		Apartments			Land	
Sales price .....		\$ 47,210			\$ 13,087	
Cost of sale .....		21,370			12,163	
Gain on sale .....		\$ 25,840			\$ 924	

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AMERICAN REALTY INVESTORS, INC.  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - Continued

NOTE 10. OPERATING SEGMENTS (Continued)

Six Months Ended June 30, 2001	Commercial Properties	Apartments	U.S. Hotels	Inter- national Hotels	Land	P Pa
Operating revenue .....	\$ 16,278	\$ 19,491	\$ 15,938	\$ 1,726	\$ 105	\$
Interest income .....	-	-	-	-	-	-
Operating expenses .....	10,053	11,945	11,939	3,984	4,544	-
Operating income (loss) .....	\$ 6,225	\$ 7,546	\$ 3,999	\$ (2,258)	\$ (4,439)	\$
Depreciation .....	\$ 3,527	\$ 1,696	\$ 1,309	\$ 650	\$ -	\$
Interest .....	8,297	5,263	2,273	194	13,368	-
Capital expenditures .....	4,806	23	320	1,000	316	-
Assets .....	162,933	130,110	68,549	28,394	231,493	-
Property Sales:	Commercial Properties	Apartments			Land	



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	-----	-----	-----
Sales price .....	\$ 7,350	\$ 65,890	\$ 33,577
Cost of sale .....	5,058	25,916	28,864
	-----	-----	-----
Gain on sale .....	\$ 2,292	\$ 39,974	\$ 4,713
	=====	=====	=====

NOTE 11. DISCONTINUED OPERATIONS

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

For the three and six months ended June 30, 2002 and 2001, income from discontinued operations relates to seven properties that ARI sold during the first six months of 2002 and 18 properties that ARI sold during 2001. The following table summarizes revenue and expense information for these properties sold and held-for-sale.

	For the Three Months Ended June 30,		For the Six Months Ended June 30,	
	2002	2001	2002	2001
	-----	-----	-----	-----
Revenue				
Rental .....	\$ 344	\$ 5,550	\$ 1,558	\$ 12,600
Property operations .....	162	2,157	735	6,000
	-----	-----	-----	-----
	182	3,393	823	5,000
Expenses				
Interest .....	97	3,020	687	5,000
Depreciation .....	71	379	178	600
	-----	-----	-----	-----
	168	3,399	865	5,600
Net income (loss) from discontinued operations ....	14	(6)	(42)	400
Gain of sale of real estate .....	2,150	25,840	7,765	42,000
Equity in gain on sale of real estate from equity investees .....	4,149	9,938	8,280	11,000
	-----	-----	-----	-----
Net income from discontinued operations .....	\$ 6,313	\$ 35,772	\$ 16,003	\$ 52,000
	=====	=====	=====	=====

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### AMERICAN REALTY INVESTORS, INC. NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - Continued

#### NOTE 11. DISCONTINUED OPERATIONS (Continued)

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 12. COMMITMENTS AND CONTINGENCIES

Liquidity. Management expects that cash generated from operations during the remainder of 2002 will not be sufficient to discharge all of ARI's debt obligations as they mature. Therefore, ARI will rely on aggressive land sales, selected income producing property sales and, to the extent necessary, additional borrowings to meet its cash requirements.

Commitments. In March 1999, ARI reached an agreement with the Class A unitholders of Valley Ranch, L.P. to acquire their eight million Class A units for \$1.00 per unit. In 1999, three million units were purchased. Additionally, one million units were purchased in January 2000, two million units were purchased in May 2001 and one million units were purchased in May 2002. The remaining one million units were purchased in August 2002.

Litigation. ARI is involved in various lawsuits arising in the ordinary course of business. In the opinion of ARI's management, the outcome of these lawsuits will not have a material impact on ARI's financial condition, results of operations or liquidity.

#### NOTE 13. GOODWILL AND OTHER INTANGIBLES - ADOPTION OF SFAS 142

In June 2001, the Financial Accounting Standards Board finalized FASB Statement No. 141, "Business Combinations" ("SFAS 141"), and No. 142, "Goodwill and Other Intangible Assets" ("SFAS 142"). SFAS 141 requires the use of the purchase method of accounting and prohibits the use of the pooling-of-interests method of accounting for business combinations initiated after June 30, 2001. SFAS 141 also requires that ARI recognize acquired intangible assets apart from goodwill if the acquired intangible assets meet certain criteria. SFAS 141 applies to all business combinations initiated after June 30, 2001. It also requires, upon adoption of SFAS 142, that ARI reclassify the carrying amounts of intangible assets and goodwill based on the criteria in SFAS 141.

SFAS 142 requires, among other things, that companies no longer amortize goodwill, but instead test goodwill for impairment at least annually. In addition, SFAS 142 requires that ARI identify reporting units in order to assess potential future impairment of goodwill, reassess the useful lives of other existing recognized intangible assets, and cease amortization of intangible assets with an indefinite useful life. SFAS 142 requires that an intangible asset with an indefinite useful life be tested for impairment in accordance with specified guidelines. SFAS 142 is required to be applied in fiscal years beginning after December 15, 2001 to all goodwill and other intangible assets recognized at that date, regardless of when those assets were initially recognized. SFAS

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### NOTE 13. GOODWILL AND OTHER INTANGIBLES - ADOPTION OF SFAS 142 (Continued)

142 required ARI to complete a transitional goodwill impairment test six months from the date of adoption. ARI was also required to reassess the useful lives of other intangible assets within the first interim quarter after adoption of SFAS 142.

The adoption of SFAS 141 did not have a material impact on ARI's results of operations and financial position. ARI adopted SFAS 142 on January 1, 2002, and accordingly ceased amortizing costs in excess of net assets acquired. In connection with the adoption of SFAS 142, ARI completed the first step of the goodwill impairment test during the quarter ended June 30, 2002. Based on the results of this step, ARI believes that the fair value of its reporting unit that carries goodwill exceeds its carrying amount. As the result of the first step of the goodwill impairment test indicates that goodwill is not impaired, the second step of the goodwill impairment test is not necessary.

Transitional Disclosures. Net income (loss) applicable to Common shares and earnings per share, including the after-tax effect of amortization expense related to costs in excess of net assets acquired for the three and six months ended June 30, 2002 and 2001 and the years ended December 31, 2001, 2000 and 1999 are as follows:

	Three Months Ended June 30,		Six Months Ended June 30,		
	2002	2001	2002	2001	
Net income (loss) applicable to					
Common shares .....	\$ (15,227)	\$ 7,927	\$ (24,775)	\$ 9,675	\$
Add back: Amortization of costs in excess of net assets acquired .....	-	85	-	170	
Adjusted net income (loss) applicable to Common shares .....	\$ (15,227)	\$ 8,012	\$ (24,775)	\$ 9,845	\$
Earnings per share:					
Net income (loss) applicable to					
Common shares .....	\$ (1.34)	\$ .78	\$ (2.18)	\$ .96	\$
Amortization of costs in excess of net assets acquired .....	-	.01	-	.01	
Adjusted net income (loss) applicable to Common shares .....	\$ (1.34)	\$ .79	\$ (2.18)	\$ .97	\$

Acquisitions. ARI made no acquisitions resulting in goodwill during the three and six months ended June 30, 2002 and 2001 or the years ended December 2001, 2000 and 1999.

Intangible Assets not Subject to Amortization. The carrying value of ARI's costs in excess of net assets acquired is as follows:

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	June 30, 2002	2001	December 31, 2000
Costs in excess of net assets acquired, net of accumulated amortization of \$1,763 in 2002 and 2001, \$1,420 in 2000 and \$1,079 in 1999 .....	\$ 11,858 =====	\$ 11,858 =====	\$ 12,201 =====

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

#### Introduction

ARI's predecessor 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, TCI, and 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. In February 2002, the court granted final approval of the proposed settlement. Under the proposal, ARI will acquire all of the outstanding common shares of IORI and TCI not currently owned by ARI for a cash payment or shares of ARI preferred stock. ARI will pay \$17.50 cash per TCI share and \$19.00 cash per IORI share for the stock held by non-affiliated stockholders. ARI will issue one share of Series G Preferred Stock with a liquidation value of \$20.00 per share for each share of TCI Common Stock for stockholders who affirmatively elect to receive ARI Preferred Stock in lieu of cash. ARI will issue one share of Series H Preferred Stock with a liquidation value of \$21.50 per share for each share of IORI Common Stock for stockholders who affirmatively elect to receive ARI Preferred Stock in lieu of cash. All affiliated stockholders will receive ARI Preferred Stock. Each share of Series G Preferred Stock will be convertible into 2.5 shares of ARI Common Stock, and each share of Series H Preferred Stock will be convertible into 2.25 shares of ARI Common Stock during a 75-day period that commences fifteen days after the date of the first ARI Form 10-Q filing that occurs after the closing of the merger transaction. Upon the acquisition of IORI and TCI shares, TCI and IORI would become wholly-owned subsidiaries of ARI. The transaction is subject to the negotiation of a definitive merger agreement and a vote of the shareholders of all three entities. ARI has the same advisor as TCI and IORI, and TCI and IORI have the same board of directors. Earl D. Cecil, a Director of ARI, is also a Director of TCI and IORI.

#### 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 judgements. 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

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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

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### ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)

#### Critical Accounting Policies (Continued)

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.

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 the information such 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.

#### Liquidity and Capital Resources

General. Cash and cash equivalents at June 30, 2002, totaled \$2.6 million, compared with \$709,000 at December 31, 2001. Although ARI anticipates that during the remainder of 2002 it will generate cash from operations, as discussed below, such excess cash is not sufficient to discharge all of ARI's debt obligations as they mature. ARI will therefore again rely on externally generated funds, including aggressive land sales, selected sales of income producing properties, borrowings against its investments in various real estate entities, refinancing of properties, and, to the extent necessary, borrowings to meet its debt service obligations, pay taxes, interest and other non-property related expenses.

At December 31, 2001, notes payable totaling \$267.5 million had either scheduled maturities or required principal reduction payments during 2002. During the first six months of 2002, ARI either extended, refinanced, paid down, paid off or received commitments from lenders to extend or refinance \$89.0 million of the debt scheduled to mature in 2002.

Net cash used in operating activities decreased to \$21.2 million in the six months ended June 30, 2002, from \$31.0 million in the six months ended June 30, 2001. Fluctuations in the components of cash flow from operations are discussed in the following paragraphs.

Net cash from property operations (rents collected less payments for expenses applicable to rental income) increased to \$18.6 million in the

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)

Liquidity and Capital Resources (Continued)

six months ended June 30, 2002 from \$9.1 million in 2001. The increase is primarily attributable to a decline in the payments for operating expenses in 2002 from an elevated level in 2001, when there was a significant paydown of accounts payable. ARI expects a decrease in cash flow from property operations during the remainder of 2002. Such decrease is expected to result from the continued selective sale of income producing properties.

Net cash from pizza operations (sales less cost of sales) increased to \$3.2 million in the six months ended June 30, 2002, from \$2.9 million in the six months ended June 30, 2001. The increase is primarily attributable to the opening of three new stores in 2001.

Interest collected increased to \$966,000 in the six months ended June 30, 2002, from \$300,000 in 2001. The increase was primarily attributable to the collection of \$542,000 in past due interest.

Interest paid of \$30.3 million in the six months ended June 30, 2002, approximated the \$31.2 million in 2001.

Advisory fees paid of \$3.3 million in the six months ended June 30, 2002, approximated the \$3.5 million in 2001.

General and administrative expenses paid increased to \$6.5 million in the six months ended June 30, 2002 from \$4.5 million in 2001. The increase is primarily attributable to an increase in legal fees and cost reimbursements paid to the advisor.

ARI's cash flow from its investments in IORI and TCI is dependent on the ability of each of the entities to make distributions. In the fourth quarter of 2000, IORI and TCI suspended distributions. Accordingly, ARI received no current distributions in the first six months of 2002 and 2001. However, in May 2001, ARI received \$53,000 in accumulated dividends on shares of Continental Mortgage and Equity Trust that should have been exchanged for TCI Common Stock in 1999.

Other cash used in operating activities of \$2.4 million in the six months ended June 30, 2002, approximated the use of \$2.5 million in 2001.

In the first six months of 2002, ARI received a total of \$5.3 million on the collection of two mortgage notes receivable and partial paydown of four mortgage notes receivable.

In 2002, ARI purchased the following property:

Property	Location	Units/ Sq.Ft./Acres	Purchase Price	Net Cash Paid	Debt Incurred	Inte Ra
First Quarter						
Shopping Center						
Plaza on Bachman						

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Creek/(1)/ Dallas, TX 80,278 Sq.Ft. \$3,103 \$ -- \$ --

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ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)

Liquidity and Capital Resources (Continued)

Property	Location	Units/ Sq.Ft./Acres	Purchase Price	Net Cash Paid	Debt Incurred	Inter Ra
Second Quarter						
Apartments						
Pinecrest/(2)/	North Augusta, SC	120 Units	\$ 2,986	\$ --	\$ 1,423/(3)/	8.
Tiberon Trails/(2)/	Merrillville, IN	376 Units	12,000	--	6,417/(3)/	9.
Shopping Center						
Alta Mesa/(2)/	Ft. Worth, TX	59,933 Sq.Ft.	4,000	--	1,804/(3)/	10.
Land						
Pioneer Crossing	Austin, TX	79.4 Acres	1,165	1,213	--	
Willow Springs	Beaumont, CA	20.7 Acres	140	146	--	

- (1) Exchanged with TCI, a related party, for the Oaktree Village Shopping Center, Razor land parcel and Lakeshore Villas land parcel.  
(2) Property received from BCM, a related party, for forgiveness of debt.  
(3) Assumed debt of seller.

In 2002, ARI sold the following properties:

Property	Location	Units/ Acres/Sq.Ft.	Sales Price	Net Cash Received	D
First Quarter					
Apartments					
Mallard Lake/(1)/	Greensboro, NC	336 Units	\$ 14,400	\$ --	
Villas	Plano, TX	208 Units	8,525	3,701	
Land					
Katrina	Palm Desert, CA	2.1 Acres	1,323	(40)	
Lakeshore Villas/(2)/	Harris County, TX	16.9 Acres	1,499	215	
Razor/(2)/	Plano, TX	24.5 Acres	1,211	174	
Thompson II	Dallas County, TX	.2 Acres	21	20	
Vista Ridge	Lewisville, TX	10.0 Acres	1,525	130	
Shopping Center					
Oaktree Village/(2)/	Lubbock, TX	45,623 Sq.Ft.	2,302	131	
Second Quarter					
Apartments					
Oak Hill	Tallahassee, FL	92 Units	3,200	156 / (4)/	

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Regency	Tampa, FL	78 Units	3,200	851
Stonebridge	Florissant, MO	100 Units	4,340	1,272
Office Building				
Centura	Dallas, TX	410,901 Sq.Ft.	50,000	--
Land				
Hollywood Casino	Farmers Branch, TX	42.8 Acres	16,987	--
Marine Creek	Ft. Worth, TX	54.2 Acres	3,700	--
Mason Goodrich	Houston, TX	7.9 Acres	672	46
Mason Goodrich	Houston, TX	10.3 Acres	1,444	93
Mason Goodrich	Houston, TX	18.0 Acres	2,790	--
Monterrey	Riverside, CA	61.0 Acres	4,625	--
Nashville	Nashville, TN	16.6 Acres	1,890	--

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ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)

Liquidity and Capital Resources (Continued)

Property	Location	Units/ Acres/Sq.Ft.	Sales Price	Net Cash Received	D
Third Quarter					
Apartments					
Valley Hi	Tallahassee, FL	54 Units	\$ 1,452	\$ 75	\$
White Pines	Tallahassee, FL	85 Units	764	10	
Woodsong	Smyrna, GA	190 Units	9,200	(45)	

- 
- (1) Exchanged for Governor's Square, Grand Lagoon, Park Avenue, Greenbriar, Regency and Westwood Apartments.
  - (2) Exchanged with TCI, a related party, for the Plaza on Bachman Creek Shopping Center.
  - (3) Debt assumed by purchaser.
  - (4) Represents dividends on and redemption of Innovo Preferred Stock. See NOTE 7. "NOTES PAYABLE."
  - (5) Sold to TCI, a related party. Gain deferred until sale to unrelated party.

In 2002, ARI financed/refinanced or obtained second mortgage financing on the following:

Property	Location	Units/ Acres/Sq.Ft.	Debt Incurred	Debt Discharged
-----				



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First Quarter					
Land					
Walker	Dallas County, TX	90.6 Acres	\$ 8,500	\$	8,500
Shopping Center					
Plaza on Bachman Creek	Dallas, TX	80,278 Sq.Ft.	5,000		--
Second Quarter					
Apartments					
Lee Hills	Tallahassee, FL	16 Units	1,750 / (2) /		117
Valley Hi	Tallahassee, FL	54 Units	-- / (2) /		878
White Pines	Tallahassee, FL	85 Units	-- / (2) /		--
Office Buildings					
Four Hickory Centre	Farmers Branch, TX	221,000 Sq.Ft.	12,500 / (3) /		--

Related Party Transactions. In each of the following transactions, except those footnoted as (6), a related party has purchased an entity, which owns the listed property asset, from ARI. ARI has guaranteed that the asset will produce at least a 12% return on the purchase price for a period of three years from the purchase date. If the asset fails to produce the 12% return, ARI will pay the purchaser any shortfall. In addition, if the asset fails to produce the 12% return for a calendar

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ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)

Liquidity and Capital Resources (Continued)

year, the purchaser may require ARI to repurchase the entity for the purchase price. Management has classified these related party transactions as notes payable.

Property	Location	Units/Sq.Ft.	Debt Incurred	Debt Discharged	Net Rece
First Quarter					
Office Building					
Rosedale Towers	Minneapolis, MN	84,798 Sq.Ft.	\$ 5,109	\$ --	\$ 5,
Two Hickory Centre	Farmers Branch, TX	96,127 Sq.Ft.	4,448	--	4,
Second Quarter					
Apartments					
Bay Anchor	Panama City, FL	12 Units	255	--	
Confederate Point	Jacksonville, FL	206 Units	\$ 1,929	\$ --	\$
Foxwood	Memphis, TN	220 Units	1,093	--	
Governor Square	Tallahassee, FL	168 Units	4,480	3,196	
Grand Lagoon	Panama City, FL	54 Units	2,083	1,209	
Oak Hill	Tallahassee, FL	92 Units	2,550	1,875	
Park Avenue	Tallahassee, FL	121 Units	4,400	2,756	1,
Seville	Tallahassee, FL	62 Units	1,955	1,263	
Westwood	Mary Ester, FL	120 Units	3,382	2,327	1,

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Windsor Tower	Ocala, FL	64 Units	1,989	1,128
Woodhollow	San Antonio, TX	546 Units	8,160	5,349
Woodsong	Smyrna, GA	190 Units	2,544	--
Office Building				
One Hickory Centre	Farmers Branch, TX	102,615 Sq.Ft.	4,468	--

- 
- (1) Variable interest rate.
  - (2) Single note with all properties as collateral.
  - (3) \$5.5 million funded at June 30, 2002.
  - (4) IORI, a related party, purchased 100% of the outstanding common shares of Rosedale Corporation ("Rosedale"), a wholly-owned subsidiary of ARI, for \$5.1 million. Rosedale owns the Rosedale Towers Office Building.
  - (5) TCI, a related party, purchased 100% of the common shares of ART Two Hickory Corporation ("Two Hickory"), a wholly-owned subsidiary of ARI, for \$4.4 million. Two Hickory owns the Two Hickory Centre Office Building.
  - (6) Properties sold 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, a Director of ARI, controls approximately 11.67% of the outstanding common stock of Innovo. Management has determined to treat this sale as a refinancing transaction. ARI will continue to report the assets and the new debt incurred by Metra on its

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ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION  
AND RESULTS OF OPERATIONS (Continued)

Liquidity and Capital Resources (Continued)

financial statements. ARI also received \$6.3 million of 8% non-recourse, non-convertible Series A Preferred Stock ("Preferred Shares") of Innovo.

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

The Preferred Shares have a mandatory redemption feature, and are redeemable from the cash proceeds received by Innovo from the operation and sale of the properties. All member distributions that are in excess of current and accrued 8% dividends must be used by Innovo to redeem the Preferred Shares. Since redemption of these shares is subject to the above future events, management has elected to record no basis in the Preferred Shares.

- (7) TCI, a related party, purchased all of the general and limited partnership interests in Garden Confederate Point, L.P. ("Confederate Point") from ARI for \$1.9 million. Confederate Point owns the Confederate Point Apartments.
- (8) TCI, a related party, purchased all of the general and limited partnership

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interests in Garden Foxwood, L.P. ("Foxwood") from ARI for \$1.1 million. Foxwood owns the Foxwood Apartments.

- (9) TCI, a related party, purchased all of the general and limited partnership interests in Garden Woodsong, L.P. ("Woodsong") from ARI for \$2.5 million. Woodsong owns the Woodsong Apartments. TCI sold the Woodsong Apartments in July 2002.
- (10) Sold to unrelated buyer in June 2002.
- (11) TCI, a related party, purchased 100% of the common shares of ART One Hickory Corporation ("One Hickory"), a wholly-owned subsidiary of ARI, for \$4.5 million. One Hickory owns the One Hickory Centre Office Building.

ARI has margin arrangements with various financial institutions and brokerage firms which provide for borrowing up to 50% of the market value of ARI's marketable equity securities. The borrowings under such margin arrangements are secured by equity securities of IORI and TCI and ARI's trading portfolio and bear interest rates ranging from 5.75% to 24.0%. Margin borrowing totaled \$26.0 million at June 30, 2002.

Management expects that it will be necessary for ARI to sell \$102.0 million, \$34.1 million and \$1.2 million of its land holdings during each of the next three years to satisfy the debt on such land as it matures. If ARI is unable to sell at least the minimum amount of land to satisfy

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### ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)

#### Liquidity and Capital Resources (Continued)

the debt obligations on such land as it matures, or, if it was not able to extend such debt, ARI would either sell other of its assets to pay such debt or transfer the property to the lender.

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 property securing each note. The mortgage note receivable review includes an evaluation of the collateral property securing such 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 and Contingencies

In March 1999, an agreement was reached with the Class A unitholders of Valley Ranch, L.P. to acquire their eight million Class A units for \$1.00 per unit. In 1999, three million units were purchased. Additionally, one million units were purchased in January 2000, two million units were purchased in May 2001 and one

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million units were purchased in May 2002. The remaining one million units were purchased in August 2002.

### Results of Operations

For the six months ended June 30, 2002, ARI reported a net loss of \$23.6 million, compared to net income of \$10.9 million for the six months ended June 30, 2001. The primary factors contributing to ARI's net loss are discussed in the following paragraphs.

Rents increased to \$28.7 million and \$56.8 million in the three and six months ended June 30, 2002, from \$27.3 million and \$53.8 million in 2001. Rents from commercial properties increased to \$19.0 million for the six months ended June 30, 2002, from \$16.3 million in 2001, rent from hotels increased to \$18.2 million in the six months ended June 30, 2002, from \$17.7 million in 2001 and rent from apartments of \$19.2 million in the six months ended June 30, 2002 approximated the \$19.4 million in 2001. The increase in commercial property rents was primarily attributable to increased occupancy, and the increase in hotel property rents was primarily attributable to the opening of the Hotel Sofia in 2001. Rental income is expected to decrease in the remainder of 2002 as a result of continued property sales.

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### ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)

#### Results of Operations (Continued)

Property operations expense decreased to \$20.5 million and \$39.8 million in the three and six months ended June 30, 2002, from \$23.5 million and \$42.5 million in 2001. Property operations expense for commercial properties increased to \$11.4 million in the six months ended June 30, 2002, from \$10.1 million in 2001. For hotels, property operations expense decreased to \$12.7 million in the six months ended June 30, 2002, from \$15.9 million in 2001. For land, property operations expense of \$4.1 million in the six months ended June 30, 2002 approximated the \$4.5 million in 2001. For apartments, property operations expense of \$11.5 million in the six months ended June 30, 2002, approximated the \$11.9 million in 2001. The increase in commercial property operations expense was primarily attributable to the acquisition of Plaza on Bachman Creek in 2002. The decrease in hotel property operations expense was primarily due to the over estimation of expenses at Hotel Sofia in 2001. Property operations expense is expected to decrease in the remainder of 2002 as a result of continued property sales.

Pizza parlor sales and cost of sales increased to \$9.7 million and \$7.8 million, respectively, in the three months ended June 30, 2002 and \$18.3 million and \$14.7 million for the six months ended June 30, 2002 from \$8.7 million and \$7.1 million, respectively, for the three months ended June 30, 2001 and \$16.6 million and \$13.6 million for the six months ended June 30, 2001. The increase was primarily attributable to the opening of three new stores in 2001, plus an increase of 10.4% in same- store sales.

Interest income from notes receivable of \$785,000 and \$1.4 million in the three and six months ended June 30, 2002 approximated the \$776,000 and \$1.2 million in 2001.

Other income increased to \$142,000 and \$326,000 in the three and six months ended June 30, 2002 from \$44,000 and \$77,000 in the three and six months ended June 30, 2001. The increase was primarily due to service fee income and

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dividends on and redemption of Innovo Preferred Stock. See NOTE 2. "REAL ESTATE" and NOTE 7. "NOTES PAYABLE."

Interest expense increased to \$18.0 million and \$36.2 million in the three and six months ended June 30, 2002 from \$16.1 million and \$31.5 million in 2001. The increase was primarily attributable to higher balances payable on stock loans, at higher interest rates.

Depreciation and amortization expense of \$4.5 million and \$7.9 million in the three and six months ended June 30, 2002, approximated the \$4.2 million and \$7.8 million in 2001.

General and administrative expenses increased to \$3.2 million and \$6.5 million in the three and six months ended June 30, 2002, from \$1.6 million and \$4.5 million in 2001. The increase is primarily attributable to increased legal fees and increased cost reimbursements paid to the advisor.

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### ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)

#### Results of Operations (Continued)

Advisory fees decreased to \$1.5 million and \$3.3 million in the three and six months ended June 30, 2002 from \$2.3 million and \$3.5 million in 2001. The decrease is due to the reduction in the total assets of ARI, which is the basis for the fee.

There was no net income fee to affiliate in the three and six months ended June 30, 2002 compared to \$1.8 million in the three and six months ended June 30, 2001. The income fee payable to ARI's advisor is 10% of the annualized net income for the year, in excess of a 10% return on shareholders' equity. At June 30, 2002, ARI's annualized net income is below the 10% return threshold.

There was no incentive fee to affiliate in the three and six months ended June 30, 2002 compared to \$4.3 million and \$5.8 million in the three and six months ended June 30, 2001. The incentive fee is only due if ARI is also subject to the net income fee. At June 2002, the net income fee requirements are not met; therefore, no incentive fee is due. This fee represents 10% of the excess of net capital gains over net capital losses from sales of operating properties. The amount of this fee for the remainder of 2002 will be dependent on the number of operating properties sold, the net capital gains realized and whether the net income fee is due.

Minority interest increased to \$773,000 and \$1.6 million in the three and six months ended June 30, 2002, from \$(95,000) and \$1.5 million in 2001. The three month increase is due to corrections made in the second quarter of 2001 that effectively eliminated the expense for the quarter.

Equity in loss of investees decreased to \$(5.2) million and \$(9.2) million in the three and six months ended June 30, 2002, from \$(3.8) million and \$(5.3) million in 2001. The decrease was primarily attributable to increased net losses for TCI and IORI in 2002.

Loss on the sale of investments in equity investees increased to \$531,000 for the six months ended June 30, 2002 from \$387,000 in the three and six months ended June 30, 2001. See NOTE 5. "INVESTMENTS IN EQUITY INVESTEES."

Equity in gain on sale of real estate by equity investees decreased to \$4.1

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million and \$8.3 million in the three and six months ended June 30, 2002, from \$9.9 million and \$11.4 million in 2001. The decrease is primarily attributable to reduced profit margin on property sales by TCI and IORI.

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

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)

Environmental Matters (Continued)

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 apartment operations fluctuate proportionately with inflationary increases and decreases in housing costs. Fluctuations in the rate of 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 borrowings as well as the cost of variable interest rate debt will be affected.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISKS

At June 30, 2002, ARI's exposure to a change in interest rates on its debt is as follows:

	Balance	Weighted Average Interest Rate	Effect of 1% Increase In Base Rates
	-----	-----	-----
Notes payable:			
Variable rate .....	\$ 81,124	10.715%	\$ 811
	=====		=====
Total decrease in ARI's annual net income .....			\$ 811
			=====
Per share .....			\$ .07
			=====

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PART II. OTHER INFORMATION

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

The annual meeting was held on July 8, 2002, at which stockholders were asked to consider and vote upon the election of Directors. At the meeting, stockholders elected the following individuals as Directors:

Director	Shares Voting	
	For	Withheld Authority
Earl D. Cecil .....	7,511,832	31,978
Collene C. Currie .....	7,512,484	31,326
Richard W. Humphrey .....	7,507,077	36,733
Joseph Mizrachi .....	7,512,654	31,156

There were no abstentions or broker non-votes on the election of Directors.

ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K

(a) Exhibits:

Exhibit Number	Description
3.0	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).
99.1	Certification Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, filed herewith.
99.2	Certification Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002, filed herewith.

(b) Reports on Form 8-K as follows:

None.

SIGNATURE PAGE

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the

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undersigned thereunto duly authorized.

AMERICAN REALTY INVESTORS, INC.

Date: October 11, 2002  
-----

By: /s/ Ronald E. Kimbrough  
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Ronald E. Kimbrough  
Executive Vice President and Chief  
Financial Officer (Principal  
Financial and Accounting Officer and  
Acting Principal Executive Officer)

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AMERICAN REALTY INVESTORS, INC.

EXHIBITS TO

QUARTERLY REPORT ON FORM 10-Q

For the Quarter ended June 30, 2002

Exhibit Number	Description	Page Number
99.1	Certification Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.	40
99.2	Certification Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.	41

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