

INCOME OPPORTUNITY REALTY INVESTORS INC /TX/

Form 10-Q

November 14, 2006

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## FORM 10-Q

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

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x **QUARTERLY REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**  
FOR THE QUARTER ENDED SEPTEMBER 30, 2006

Or

.. **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**  
FOR THE TRANSITION PERIOD FROM \_\_\_\_\_ TO \_\_\_\_\_

Commission File Number 001-14784

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### INCOME OPPORTUNITY REALTY INVESTORS, INC.

(Exact Name of Registrant as Specified in Its Charter)

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Nevada  
(State or Other Jurisdiction of  
Incorporation or Organization)

1755 Wittington Place, Suite 340

Dallas, Texas 75234

75-2615944  
(I.R.S. Employer

Identification No.)

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(Address of principal executive offices)

(Zip Code)

(469) 522-4200

(Registrant's telephone number, including area code)

(Former name, former address and former fiscal year, if changed since last report)

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Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the Registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  No .

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer or a non-accelerated filer. See definition of accelerated filer in Rule 12b-2 of the Exchange Act (Check one):

Large accelerated filer  Accelerated filer  Non-accelerated filer

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

**APPLICABLE ONLY TO ISSUERS INVOLVED IN BANKRUPTCY PROCEEDINGS DURING THE  
PRECEDING FIVE YEARS:**

Indicate by check mark whether the registrant has filed all documents and reports required to be filed by Sections 12, 13 or 15(d) of the Securities Exchange Act of 1934 subsequent to the distribution of securities under a plan confirmed by a court. 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**  
(Class)

**4,168,035**  
(Outstanding at November 3, 2006)

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**INCOME OPPORTUNITY REALTY INVESTORS, INC.**

**FORM 10-Q**

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**Table of Contents****PART I. FINANCIAL INFORMATION****ITEM 1. FINANCIAL STATEMENTS**

The accompanying Consolidated Financial Statements as of and for the nine months ended September 30, 2006 have not been audited by independent certified public accountants but, in the opinion of the management of Income Opportunity Realty Investors, Inc. ( IORI or the Company ), all adjustments (consisting of normal recurring accruals) necessary for a fair presentation of IORI s consolidated financial position, consolidated results of operations and consolidated cash flows at the dates and for the periods indicated, have been included.

**INCOME OPPORTUNITY REALTY INVESTORS, INC.****CONSOLIDATED BALANCE SHEETS**

	September 30,	December 31,
	2006	2005
	(Unaudited)	
	(dollars in thousands)	
<b>Assets</b>		
Real estate held for investment	\$ 63,230	\$ 35,083
Less accumulated depreciation	(4,867)	(4,311)
	58,363	30,772
Notes and interest receivable	27,368	63,230
Investment in real estate partnerships	657	547
Cash and cash equivalents	57	201
Due from affiliates	17,627	1,853
Other assets	3,954	2,738
	\$ 108,026	\$ 99,341
<b>Liabilities and Stockholders Equity</b>		
Liabilities:		
Notes and interest payable	\$ 60,903	\$ 52,817
Other liabilities	1,473	1,344
	62,376	54,161
Commitments and contingencies		
Minority interest	553	513
Stockholders equity:		
Common Stock, \$.01 par value; authorized, 100,000,000 shares; issued and outstanding 4,168,035 shares at September 30, 2006 and December 31, 2005	42	42
Additional paid-in capital	61,955	61,955
Accumulated deficit	(16,900)	(17,330)
	45,097	44,667
	\$ 108,026	\$ 99,341

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



**Table of Contents****INCOME OPPORTUNITY REALTY INVESTORS, INC.****CONSOLIDATED STATEMENTS OF OPERATIONS****(Unaudited)**

	For the Three Months		For the Nine Months	
	Ended September 30, 2006	2005	Ended September 30, 2006	2005
(dollars in thousands, except per share)				
Property revenue				
Rents and other property revenues	\$ 2,028	\$ 1,688	\$ 5,648	\$ 4,830
Operating expenses				
Property operations	1,196	870	3,032	2,516
Depreciation	191	189	551	539
General and administrative	109	132	391	473
Advisory fees	261	165	678	502
Total operating expenses	1,757	1,356	4,652	4,030
Operating income (loss)	271	332	996	800
Other income (expense):				
Interest income	707	979	2,705	2,937
Mortgage and loan interest	(1,255)	(989)	(3,303)	(2,487)
Net income fee	17	(25)	(38)	(92)
Total other income (expense)	(531)	(35)	(636)	358
Income before equity in earnings of investees and minority interest	(260)	297	360	1,158
Equity in earnings (loss) of investees	29	(17)	110	(45)
Minority interest	2		(40)	
Net income	\$ (229)	\$ 280	\$ 430	\$ 1,113
Earnings per share:				
Net earnings from continuing operations	\$ (0.06)	\$ 0.07	\$ 0.10	\$ 0.27
Weighted average common shares used in computing earnings per share	4,168,035	4,168,035	4,168,035	4,168,035

Earnings per share reflect a 3-for-1 forward split of the stock in the form of a 200 percent stock dividend declared in May 2005.

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

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

**For the Nine Months Ended September 30, 2006**

**(Dollars in thousands)**

**(Unaudited)**

	Common Stock		Additional	Accumulated	Total
	Shares	Amount	Paid-in Capital	Deficit	Stockholders Equity
Balance, December 31, 2005	4,168,035	\$ 42	\$ 61,955	\$ (17,330)	\$ 44,667
Net income				430	430
Balance, September 30, 2006	4,168,035	\$ 42	\$ 61,955	\$ (16,900)	\$ 45,097

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

**Table of Contents****INCOME OPPORTUNITY REALTY INVESTORS, INC.****CONSOLIDATED STATEMENTS OF CASH FLOWS****(Unaudited)**

	<b>For the Nine Months</b>	
	<b>Ended September 30,</b>	
	<b>2006</b>	<b>2005</b>
	<b>(dollars in thousands)</b>	
<b>CASH FLOWS FROM OPERATING ACTIVITIES</b>		
Net income	\$ 430	\$ 1,113
Reconciliation of net income to net cash used by operating activities		
Adjustments to reconcile net income to net cash used in operating activities		
Depreciation	551	539
Amortization	239	193
Loss (gain) on equity partnerships	(110)	45
Minority interest	40	
Increase in interest receivable	(480)	(966)
Decrease (increase) in other assets	(1,390)	85
Increase (decrease) in interest payable	213	17
Increase (decrease) in other liabilities	273	(1,284)
Net cash provided by (used in) operating activities	(234)	(258)
<b>CASH FLOWS FROM INVESTING ACTIVITIES</b>		
Real estate improvements	(237)	85
Advances from (payments to) advisor and affiliates	(18,024)	(1,657)
Net cash provided by (used in) investing activities	(18,261)	(1,572)
<b>CASH FLOWS FROM FINANCING ACTIVITIES</b>		
Notes payable payments	31,352	(2,110)
Notes payable proceeds	(13,001)	3,612
Net cash provided by financing activities	18,351	1,502
INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	(144)	(328)
CASH AND CASH EQUIVALENTS, beginning of period	201	399
CASH AND CASH EQUIVALENTS, end of period	\$ 57	\$ 71
<b>Supplemental Disclosures of Cash Flow Information</b>		
Cash paid for interest	\$ 2,560	\$ 2,431
Acquisition of real estate in exchange for notes receivable	37,200	
Sale of office building	(12,200)	
Mortgage note payable assumed on acquisition of real estate	(22,802)	

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



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**INCOME OPPORTUNITY REALTY INVESTORS, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**NOTE 1. BASIS OF PRESENTATION**

The accompanying Consolidated Financial Statements have been prepared in accordance with accounting principles generally accepted in the United States of America 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 accounting principles generally accepted in the United States of America for complete financial statements. Dollar amounts in tables are in thousands, except per share amounts. Certain balances for 2005 have been reclassified to conform to the 2006 presentation.

Operating results for the nine-month period ended September 30, 2006, are not necessarily indicative of the results that may be expected for the year ending December 31, 2006. For further information, refer to the Consolidated Financial Statements and notes included in IORI's Annual Report on Form 10-K for the year ended December 31, 2005 (the 2005 Form 10-K).

***Adoption of New Accounting Standards***

*SFAS 123-R.* Effective January 1, 2006 (the Effective Date), the Company adopted SFAS No. 123-R using the modified prospective method. SFAS No. 123-R must be applied not only to newly awarded stock options but also to previously awarded stock options that were not fully vested on the Effective Date. IORI had no fully vested stock-option grants as of the Effective Date. Furthermore, IORI had no outstanding stock-option grants that were modified or settled after the Effective Date; therefore, IORI will recognize no additional compensation costs for previously awarded stock-option grants. In December 2005, the Company's Board of Directors terminated all stock-option plans and has no intent at the present to reinstate any stock-option programs.

*EITF 06-3.* At its June 2006 meeting, the EITF ratified the consensus regarding Issue No. 06-3 (EITF 06-3), *How Taxes Collected from Customers and Remitted to Governmental Authorities Should be Presented in the Income Statement (That is, Gross versus Net Presentation)*. EITF 06-3 is effective for interim and annual periods beginning after December 15, 2006, with earlier application added, and certain excise taxes. The consensus indicates that gross vs. net income statement classification of those taxes within its scope is an accounting policy decision. In addition, for taxes within its scope, the consensus requires the following disclosures: the accounting policy elected for these taxes and the amounts of the taxes reflected gross (as revenue) in the income statement on an interim and annual basis. We do not believe there will be an impact to our financial condition or results of operations from the adoption of EITF 06-3.

*FIN 48.* On July 13, 2006, the FASB issued Interpretation 48, *Accounting for Uncertainty in Income Taxes - An Interpretation of FASB Statement No. 109*, (FIN 48), which clarifies the accounting for uncertainty in income taxes recognized in a company's financial statements in accordance with SFAS No. 109, *Accounting for Income Taxes*. FIN 48 also prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. The standard also provides guidance on derecognizing, classification, interest, and penalties, accounting in interim periods, disclosure, and transition. The provisions of FIN 48 are effective for fiscal years beginning after December 15, 2006, and are to be applied to all tax positions upon initial adoption of this standard. Only tax positions that meet a more-likely-than-not recognition threshold at the effective date may be recognized or continue to be recognized upon adoption of FIN 48. We are currently evaluating the impact, if any, to our financial condition and results of operations from the adoption of FIN 48.

**Table of Contents****NOTE 2. REAL ESTATE**

On March 31, 2006, IORI acquired a 218-unit apartment complex located in Indianapolis, Indiana (Falcon Point) from Syntek West, Inc. ( SWI, a related party) for \$3,750,000, which includes the assumption of a \$1,500,000 existing mortgage. IORI did not acquire any properties during the nine months ended September 30, 2005.

IORI sold no properties during the nine months ended September 30, 2006 or 2005 other than the properties discussed in NOTE 7.

The following is a list of properties owned by IORI on September 30, 2006:

Property	Location	Units / Sq. Ft. / Acres
<b>Apartments</b>		
Brighton Court	Midland, TX	60 Units / 90,672 Sq. Ft.
Del Mar	Midland, TX	92 Units / 105,348 Sq. Ft.
Enclave	Midland, TX	68 Units / 89,734 Sq. Ft.
Falcon Point	Indianapolis, IN	218 Units / 162,425 Sq. Ft.
Meridian	Midland, TX	280 Units / 264,000 Sq. Ft.
Signature Place	Midland, TX	57 Units / 72,480 Sq Ft.
Sinclair Place	Midland, TX	114 Units / 91,529 Sq. Ft.
<b>Office Buildings</b>		
2010 Valley View	Farmers Branch, TX	40,666 Sq. Ft.
<b>Shopping Centers</b>		
Parkway Center	Dallas, TX	28,374 Sq. Ft.
<b>Industrial Warehouse</b>		
Eagle Crest	Farmers Branch, TX	133,000 Sq. Ft.
<b>Land</b>		
Three Hickory Centre	Farmers Branch, TX	9 Acres
Travelers Land	Farmers Branch, TX	202 Acres

**NOTE 3. NOTES AND INTEREST RECEIVABLE**

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

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

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

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

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

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

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

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

### **NOTE 4. NOTES AND INTEREST PAYABLE**

On March 31, 2006, the Company acquired Falcon Point Apartments and assumed a \$1.5 million note. In September 2006 the Company reduced the principal amount due on the note to \$1.2 million and extended the due date to February 28, 2007. The note bears interest at prime rate plus three percent.

In August 2006, IORI and a TCI subsidiary, as co-borrowers, obtained a \$28.7 million loan which if fully subscribed by participating lenders would result in a credit facility for up to \$42.6 million. The initial \$28.7 loan went entirely to IORI. The loan matures in August 2008 and bears interest at a fixed rate of 8.6 percent per annum. The loan requires quarterly interest payments beginning in October 2006. The loan currently is secured by 202 acres of land owned by IORI (known as the Travelers land) located in Dallas, Texas, and is guaranteed by TCI. If and when additional proceeds are made available additional collateral of approximately 99 acres of land located in Dallas, Texas and owned by the TCI subsidiary will be included.

Proceeds received by IORI were used to retire the existing debt on the collateral (including approximately \$11 million of existing debt on the 202 acres pledged by IORI) with the remaining proceeds loaned to affiliated companies at an interest rate equal to Prime + 1%. The loan to affiliated companies will be repaid and the funds used by IORI to invest in additional properties or retire existing debt.

### **NOTE 5. ADVISORY AGREEMENT**

The Company has an Advisory Agreement with Syntek West, Inc. ( SWI ), wherein SWI is responsible for the Company s day-to-day operations. SWI must formulate and submit to IORI s Board of Directors for approval an annual budget and business plan containing a twelve month forecast of operations and cash flow with a general plan for asset sales and purchases, borrowing activity and other investments. SWI reports to the Board quarterly on IORI s performance against the business plan. The Advisory Agreement further places SWI in a fiduciary relationship to IORI s stockholders and contains a broad standard governing SWI s liability for any losses incurred by IORI.

SWI receives, as compensation for its management and advice, monthly advisory fees based on 6 1/2% of IORI s assets annually as well as specific fees for assisting IORI in obtaining financing and completing acquisitions. If IORI s operating expenses exceed limits specified in the Advisory Agreement SWI is obligated to refund a portion of the advisory fees.

Effective July 1, 2005, the Company and SWI entered into a Cash Management Agreement to further define the administration of the Company s day-to-day investment operations, relationship contacts, flow of funds and deposit and borrowing of funds. Under the Cash Management Agreement, all funds of the Company are delivered to SWI which has a deposit liability to the Company and is responsible for investment of all excess funds, which earn interest at the *Wall Street Journal* Prime Rate plus 1 percent per annum, set quarterly on the first day of each calendar quarter. Borrowings for the benefit of the Company bear the same interest rate. The term of the Cash Management Agreement is coterminous with the Advisory Agreement, and is automatically renewed each year unless terminated with the Advisory Agreement.

SWI also receives a Net Income Fee calculated as 7.5% of IORI s net income for the year.

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	For Nine Months	
	Ended September 30,	
	2006	2005
Revenue, fees, interest on cash advances, and cost reimbursements to SWI:		
Fees		
Advisory	\$ 678	\$ 502
Net income	38	92
Cost reimbursements	\$	\$ 36

**NOTE 6. RECEIVABLE FROM AND PAYABLE TO AFFILIATES**

From time to time, IORI and its affiliates and related parties have made unsecured advances to each other. In addition, IORI and its affiliates have entered into transactions involving the purchase, sale, and financing of property. The table below reflects the various transactions between IORI, SWI, and TCI. See NOTE 7. RELATED PARTY TRANSACTIONS.

	SWI	TCI	Total
Balance, December 31, 2005	\$ 1,776	\$ 77	\$ 1,853
Cash received	(3,357)		(3,357)
Cash payments	22,207		22,207
Other additions	(3,786)	(60)	(3,846)
Other repayments	298	472	770
Balance, September 30, 2006	\$ 17,138	\$ 489	\$ 17,627

**NOTE 7. RELATED PARTY TRANSACTIONS**

As described in NOTE 2. REAL ESTATE, on March 31, 2006 IORI acquired a 218 unit apartment complex located in Indianapolis, Indiana from SWI for \$3,750,000, which includes the assumption of a \$1,500,000 existing mortgage. The \$2,250,000 due to the seller was applied to the Due to affiliates balance between IORI and SWI.

On October 14, 2003, IORI purchased, sold, and conveyed an office building known as One Hickory Centre, and sold 202 acres of unimproved real property known as the Travelers Land in Dallas County, Texas to Encino Executive Plaza, Ltd., an affiliate of ARI. The sales price for One Hickory Centre was \$12,200,000 and Encino Executive Plaza, Ltd. executed a wrap-around promissory note in the amount of \$11,973,025 payable to the order of IORI secured by a Deed of Trust encumbering One Hickory Centre. The remaining difference was a result of pro-rations and various expenses paid by IORI in connection with the closing of the transaction. The note bore interest at 5.49 percent per annum. The sale price for the Travelers Land was \$25,000,000. At closing, Encino Executive Plaza, Ltd. executed an all inclusive wrap-around promissory note payable to IORI in the principal amount of \$22,801,987 secured by a Deed of Trust covering the Travelers Land sold and delivered cash to IORI in the amount of \$1,946,715. As with the prior transaction, the difference between the purchase price and the promissory note represented adjustments for various pro-rations. The note bore interest at 5.49 percent per annum. Subsequently, IORI made a loan to Encino Executive Plaza, Ltd. in the amount of \$1,567,232 payable upon demand or if no demand is made prior thereto on September 30, 2006 with a market rate of interest. Encino Executive Plaza, Ltd. executed and delivered a promissory note payable to the order of IORI in the stated principal amount of \$1,567,232. The note bore interest at 5.49 percent per annum.

On May 12, 2006 Encino Executive Plaza Ltd. transferred One Hickory Center and the 202 acres of unimproved real property known as Travelers land back to IORI in satisfaction of the three notes in the amounts of \$11,973,025, \$22,801,987 and the \$1,567,232 respectively. Further, on May 12, 2006 IORI transferred One Hickory Center to a subsidiary of TCI (a related party) in satisfaction of IORI's debt of \$11,973,025 which was secured by One Hickory Centre.

IORI has not recorded any gain or loss with respect to the above transactions.

**NOTE 8. OPERATING SEGMENTS**

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Significant differences among the accounting policies of the operating segments as compared to the Consolidated Financial Statements principally involve the calculation and allocation of administrative expenses. Management evaluates the performance of each of the operating segments and allocates resources to them based on their operating income and cash flow. There are no intersegment revenues and expenses and IORI conducted all of its business within the United States.

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Presented below is the operating income of each operating segment for the three and nine months ended September 30, 2006 and 2005 and each segment's assets at September 30, 2006 (amounts in thousands).

	Commercial			Total
	Land	Properties	Apartments	
<b>Three Months Ended September 30, 2006</b>				
Rental and other property revenues	\$	\$ 349	\$ 1,679	\$ 2,028
Property operating expenses		204	992	1,196
Depreciation		51	140	191
Interest expense	921	(88)	422	1,255
Segment operating income (loss)	(921)	182	125	(614)
Real estate assets, net of depreciation	24,122	12,815	21,426	58,363
<b>Nine Months Ended September 30, 2006</b>				
Rental and other property revenues	\$ 448	\$ 561	\$ 4,639	\$ 5,648
Property operating expenses		524	2,508	3,032
Depreciation		160	391	551
Interest expense	1,051	1,121	1,131	3,303
Segment operating income (loss)	(603)	(1,244)	609	(1,238)
Real estate assets, net of depreciation	24,122	12,815	21,426	58,363

	Commercial			Total
	Properties	Apartments	Total	
<b>Three Months Ended September 30, 2005</b>				
Rental and other property revenues	\$ 410	\$ 1,278	\$ 1,688	\$ 1,688
Property operating expenses	180	690	870	870
Depreciation	78	111	189	189
Interest expense	571	418	989	989
Segment operating income (loss)	(419)	59	(360)	(360)
Real estate assets, net of depreciation	12,857	17,924	30,781	30,781
<b>Nine Months Ended September 30, 2005</b>				
Rental and other property revenues	\$ 1,106	\$ 3,724	\$ 4,830	\$ 4,830
Property operating expenses	611	1,905	2,516	2,516
Depreciation	205	334	539	539
Interest expense	1,492	995	2,487	2,487
Segment operating income (loss)	(1,202)	490	(712)	(712)
Real estate assets, net of depreciation	12,857	17,924	30,781	30,781

The following table reconciles the segment information to the corresponding amounts in the consolidated statements of operations:

	For the Nine Months	
	Ended September 30, 2006	2005
Segment operating income	\$ (1,238)	\$ (712)
Interest income	2,705	2,937
General and administrative	391	473
Advisory fees	678	502
Net income fee	(38)	(92)
Equity in earnings (loss) of investees	110	(45)
Minority interest	(40)	

Net income	\$ 430	\$ 1,113
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## 9. COMMITMENTS AND CONTINGENCIES

*Liquidity.* Management anticipates that IORI will not generate excess fund from operations in 2006 to be sufficient to discharge all of IORI's debt obligations as they mature. Management may selectively sell income producing assets, refinance real estate, and/or incur additional borrowings against real estate to meet its cash requirements.

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

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

#### ***WARNING CONCERNING FORWARD LOOKING STATEMENTS***

The following discussion should be read in conjunction with the financial statements and notes thereto appearing elsewhere in this report.

This Report on Form 10-Q may contain forward-looking statements within the meaning of the federal securities laws, principally, but not only, under the caption Management's Discussion and Analysis of Financial Condition and Results of Operations. We caution investors that any forward-looking statements in this report, or which management may make orally or in writing from time to time, are based on management's beliefs and on assumptions made by, and information currently available to, management. When used, the words anticipate, believe, expect, intend, may, might, plan, estimate, project, should, will, result and similar expressions which do not relate solely to historical matters are intended to identify forward-looking statements. These statements are subject to risks, uncertainties, and assumptions and are not guarantees of future performance, which may be affected by known and unknown risks, trends, uncertainties, and factors, that are beyond our control. Should one or more of these risks or uncertainties materialize, or should underlying assumptions prove incorrect, actual results may vary materially from those anticipated, estimated, or projected. We caution you that, while forward-looking statements reflect our good faith beliefs when we make them, they are not guarantees of future performance and are impacted by actual events when they occur after we make such statements. We expressly disclaim any responsibility to update our forward-looking statements, whether as a result of new information, future events or otherwise. Accordingly, investors should use caution in relying on past forward-looking statements, which are based on results and trends at the time they are made, to anticipate future results or trends.

Some of the risks and uncertainties that may cause our actual results, performance, or achievements to differ materially from those expressed or implied by forward-looking statements include, among others, the factors listed and described at Item 1A. Risk Factors in the Company's Annual Report on Form 10-K, which investors should review. There have been no changes from the risk factors previously described in the Company's Form 10-K for the fiscal year ended December 31, 2005.

Other sections of this report may also include suggested factors that could adversely affect our business and financial performance. Moreover, we operate in a very competitive and rapidly changing environment. New risks emerge from time to time and it is not possible for management to predict all such matters; nor can we assess the impact of all such matters on our business or the extent to which any factor, or combination of factors, may cause actual results to differ materially from those contained in any forward-looking statements. Given these uncertainties, investors should not place undue reliance on forward-looking statements as a prediction of actual results. Investors should also refer to our quarterly reports on Form 10-Q for future periods and current reports on Form 8-K as we file them with the SEC, and to other materials we may furnish to the public from time to time through Forms 8-K or otherwise.

#### ***Overview***

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

#### ***Critical Accounting Policies***

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America, or GAAP, requires management to use judgment in the application of accounting policies, including making estimates and assumptions. We base our estimates on historical experience and on various other assumptions believed to be reasonable under the circumstances. These judgments affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the dates of the financial statements and the reported amounts of revenue and expenses during the reporting periods. If our judgment or interpretation of the facts and circumstances relating to various transactions had been different, it is possible that different accounting policies would have been applied resulting in a different presentation of our financial statements. From time-to-time, we evaluate our estimates and assumptions. In the event estimates or assumptions prove to be different from actual results, adjustments are made in subsequent periods to reflect more current information. Below is a discussion of accounting policies that we consider critical in that they may require complex judgment in their application or require estimates about matters that are inherently uncertain.



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### ***Real Estate Held for Investment***

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***

IORI 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.

### ***Recognition of Rental Income***

Rental income for commercial property leases is recognized on a straight-line basis over the respective lease terms. Rental income for residential property leases is recorded when due from residents and is recognized monthly as earned, which is not materially different than on a straight-line basis as lease terms are generally for periods of one year or less. For hotel properties, revenues for room sales and guest services are recognized as rooms are occupied and services are rendered.

### ***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 the deposit, installment, cost recovery or financing method, whichever is appropriate. When IORI provides seller financing, gain is not recognized at the time of sale unless the buyer's initial investment and continuing investment are deemed to be adequate as determined by SFAS 66 guidelines.

### ***Non-performing Notes Receivable***

IORI 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.

### ***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.

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### ***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.

### ***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 IORI'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.

### ***Liquidity and Capital Resources***

Cash and cash equivalents at September 30, 2006 were \$57,000 compared to \$201,000 at December 31, 2005. IORI's principal sources of cash have been and will continue to be property operations, proceeds from asset sales, interest earned on notes receivable, financings and refinancings and partnership distributions. Management anticipates that IORI will generate excess cash from operations in 2006 due to increased rental receipts at its properties. However, such excess may not be sufficient to discharge all of IORI's debt obligations as they mature. Management may selectively sell income producing assets, refinance real estate, and/or incur additional borrowings against real estate to meet its cash requirements.

The Company reported net income of \$430,000 for the nine months ended September 30, 2006, which included the following items for the period: depreciation and amortization of \$551,000, an increase in other assets of \$1.4 million, a decrease in notes and interest receivable of \$480,000, an increase in notes and interest payable of \$208,000, an increase in other liabilities of \$273,000 and minority interest of \$40,000. Net cash used in operating activities totaled \$234,000 for the nine months ended September 30, 2006. During the nine months ended September 30, 2006 net cash used in investing activities was \$18.3 million, which is almost entirely advances to the Company's Advisor under the terms of the Cash Management Agreement. See Note 5. Cash Management Agreement. Net cash provided by financing activities was \$18.4 million which is the net funds received from refinancing of properties.

Management reviews the carrying values of IORI's properties at least annually or 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. If impairment is found to exist, a provision for loss is recorded by a charge against earnings. The property review generally includes selective property inspections, discussions with the manager of the property, visits to selected properties in the area and a review of the following: (1) the property's current rents compared to market rents, (2) the property's expenses, (3) the property's maintenance requirements and (4) the property's cash flows.

### ***Results of Operations***

IORI had net income (loss) of (\$229,000) and \$430,000 for the three and nine months ended September 30, 2006 as compared to net income of \$280,000 and \$1.1 million for the corresponding periods in 2005. Fluctuations in components of revenue and expense between 2006 and the corresponding periods in 2005 are discussed below.

Rental incomes for the three and nine months ended September 30, 2006 were \$2.0 million and \$5.6 million as compared to \$1.7 million and \$4.8 million in the corresponding periods in 2005. The increase is primarily due to revenue from the Falcon Point Apartments which was acquired on March 31, 2006.

Property operating expense for the three and nine months ended September 30, 2006 was \$1.2 million and \$3.0 million as compared to \$870,000 and \$2.5 million for the corresponding periods in 2005. The increase is primarily due to operating expenses from the Falcon Point Apartments.

Interest income for the three and nine months ended September 30, 2006 was \$707,000 and \$2.7 million compared to \$979,000 million and \$2.9 million for the corresponding periods in 2005. Decreases were due to the overall reduction in notes receivable held by the Company.



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As more fully discussed in Note 7. RELATED PARTY TRANSACTIONS, on May 12, 2006 Encino Executive Plaza Ltd. transferred One Hickory Center and the 202 acres of unimproved real property known as Travelers land back to IORI in satisfaction of the three notes in the amounts of \$11,973,025, \$22,801,987 and \$1,567,232 respectively. Interest income received by IORI on the Encino Notes through May 12, 2006 was \$720,000. Interest income on the Encino Notes for the nine months ended September 31, 2005 was \$1,496,000.

The overall loss of interest income was partially offset by interest income from a \$6,700,000 loan to TCI on September 30, 2005. Interest income on this note for the nine months ended September 30, 2006 was \$512,000 compared to zero for 2005.

Interest expense for the three and nine months ended September 30, 2006 was \$1.3 million and \$3.3 million compared to \$989,000 and \$2.5 million for the corresponding periods in 2005. The increase was primarily due to the additional debt incurred by IORI during 2005 and 2006 due to new loans, refinancings and the acquisition of Falcon Point. The increase was also due to increased interest rates for IORI's variable interest rate debt.

The overall increase in interest expense was partially offset by the elimination of interest expense on the debt to TCI, which was cancelled when One Hickory Center was transferred to TCI.

Depreciation expense for the three and nine months ended September 30, 2006 was \$191,000 and \$551,000 compared to \$189,000 and \$539,000 for the corresponding periods in 2005.

Advisory fees to affiliate for the three and nine months ended September 30, 2006 were \$261,000 and \$678,000 compared to \$165,000 and \$502,000 for the corresponding periods in 2005. The increase was due to a net increase in gross assets which is the basis of the advisory fee. The increase was also due to fees for refinancing certain mortgage obligations. These increases were offset by interest paid by the advisor to IORI under a cash management agreement between the advisor and IORI. See NOTE 5. ADVISORY AGREEMENT.

The net income fee to affiliates for the three and nine months ended September 30, 2006 was (\$17,000) and \$38,000 as compared to \$25,000 and \$92,000 for the corresponding periods in 2005. The net income fee is based on 7 1/2 percent of IORI's net income. See NOTE 5. ADVISORY AGREEMENT.

General and administrative expenses for the three and nine months ended September 30, 2006 was \$109,000 and \$391,000 as compared to \$132,000 and \$473,000 for the corresponding periods in 2005.

### ***Related Party Transactions***

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

### **Taxes**

Financial statement income varies from taxable income principally due to the accounting for income and losses of investees, gains and losses from asset sales, depreciation on owned properties, amortization of discounts on notes receivable and payable and the difference in the allowance for estimated losses. IORI had taxable loss for the first nine months of 2006 and for the first nine months of 2005; therefore, it recorded no provision for income taxes.

At September 30, 2006, IORI had a net deferred tax asset of approximately \$1.0 million due to tax deductions available to it in future years. However, as management cannot determine that it is more likely than not that IORI will realize the benefit of the deferred tax asset, a 100% valuation allowance has been established.

### ***Inflation***

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



**Table of Contents*****Environmental Matters***

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

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

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

At September 30, 2006 IORI's exposure to a change in interest rates on its debt was as follows:

	<b>Weighted</b>	<b>Effect of 1%</b>
	<b>Average</b>	<b>Increase In</b>
	<b>Balance</b>	<b>Base Rates</b>
Notes payable:		
Variable rate	\$ 7,000,000	10.25% \$ 70,000
<b>Total decrease in IORI's annual net income</b>		<b>70,000</b>
Per share		\$ .02

**ITEM 4. CONTROLS AND PROCEDURES**

Based upon their most recent evaluation, which was completed as of the end of the period covered by this Report, the Acting Principal Executive Officer and Chief Financial Officer concluded that the Company's disclosure controls and procedures were effective at September 30, 2006 to ensure that information required to be disclosed in reports that the Company files or submits under the Securities Exchange Act of 1934, is recorded, processed, summarized and reported within the time period specified in Securities and Exchange Commission rules and forms. There were no changes in the Company's internal controls over financial reporting during the quarter ended September 30, 2006 that have materially affected or are reasonably likely to materially affect the Company's internal controls over financial reporting.

**Table of Contents****PART II. OTHER INFORMATION****ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS**

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

Period	Total Number of Shares Purchased	Average Price Paid per Share	Total Number of	Maximum Number of
			Shares Purchased	Shares that May
			as Part of Publicly	Yet be Purchased
	Shares Purchased	Paid per Share	Announced Program	Under the Program <sup>(a)</sup>
Balance as of June 30, 2006				219,090
July 1-31, 2006	\$	\$		219,090
August 1-31, 2006				219,090
September 1-30, 2006				219,090
Total	\$	\$		

- (a) On June 23, 2000, the IORI Board of Directors approved a share repurchase program for up to 1,409,000 shares of our common stock. This repurchase program has no termination date.

**ITEM 6. EXHIBITS**

The following documents are filed herewith as exhibits or incorporated by reference as indicated:

**Exhibit**

Number	Description
3.0	Articles of Incorporation of Income Opportunity Realty Investors, Inc., (incorporated by reference to Appendix C to the Registrant's Registration Statement on Form S-4, dated February 12, 1996).
3.1	Bylaws of Income Opportunity Realty Investors, Inc. (incorporated by reference to Appendix D to the Registrant's Registration Statement on Forms S-4 dated February 12, 1996).
10.0	Advisory Agreement dated as of July 1, 2003 between Income Opportunity Realty Investors, Inc. and Syntek West, Inc. (incorporated by reference to Exhibit 10.0 to the registrant's current on Form 10-Q for event of July 1, 2003).
31.1*	Certification Pursuant to Rule 13a-14 and 15d-14 under the Securities Exchange Act of 1934, as amended.
32.1*	Certification pursuant to 18 U.S.C. Section 1350.

\* filed herewith

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**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 undersigned thereunto duly authorized.

INCOME OPPORTUNITY REALTY INVESTORS, INC.

Date: November 14, 2006

By: /s/ Steven A. Abney  
Steven A. Abney  
Executive Vice President and Chief Financial Officer  
(Principal Financial and Accounting Officer and  
Acting Principal Executive Officer)

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