

AMERICAN REALTY INVESTORS INC  
Form 10-Q  
August 14, 2006  
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## FORM 10-Q

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

x **QUARTERLY REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**  
FOR THE QUARTER ENDED JUNE 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 001-15663

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# AMERICAN 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)

75-2847135  
(I.R.S. Employer

Identification No.)

1800 Valley View Lane, Suite 300

Dallas, Texas 75234

(Address of principal executive offices)

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(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)

10,895,972  
(Outstanding at June 30, 2006)

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**AMERICAN REALTY INVESTORS, INC.**

**FORM 10-Q**

**FOR THE QUARTER ENDING JUNE 30, 2006**

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**Table of Contents****PART I. FINANCIAL INFORMATION****ITEM 1. FINANCIAL STATEMENTS****AMERICAN REALTY INVESTORS, INC.****CONSOLIDATED BALANCE SHEETS**

(dollars in thousands, except share data)

	June 30, 2006 (Unaudited)	December 31, 2005
<b>Assets</b>		
Real estate held for investment	\$ 1,090,273	\$ 1,025,661
Less accumulated depreciation	(165,934)	(153,597)
	924,339	872,064
Real estate held for sale	137,996	172,303
Real estate subject to sales contract	66,827	68,738
Notes and interest receivable		
Performing (\$29,702 in 2006 and \$44,500 in 2005 from affiliates)	48,256	70,894
Non-performing	12,280	11,546
	60,536	82,440
Less allowance for estimated losses	(1,000)	(1,000)
	59,536	81,440
Restaurant equipment	14,226	13,911
Less accumulated depreciation	(8,137)	(7,528)
	6,089	6,383
Marketable securities, at market value	8,309	7,446
Cash and cash equivalents	16,383	13,904
Investments in equity investees	13,788	13,521
Goodwill	11,858	11,858
Other intangibles, net of accumulated amortization (\$1,300 in 2006 and \$926 in 2005)	1,422	1,449
Other assets (including \$51,066 in 2006 and \$30,441 in 2005 due from affiliate)	111,231	96,689
	\$ 1,357,778	\$ 1,345,795
<b>Liabilities and Stockholders Equity</b>		
Liabilities:		
Notes payable (\$8,389 in 2006 and \$44,848 in 2005 to affiliates)	\$ 840,214	\$ 810,118
Interest payable (\$549 in 2006 and \$682 in 2005 to affiliates)	7,598	7,826
Liabilities related to assets held-for-sale	129,097	144,555
Liabilities subject to sales contract	58,347	59,323
Stock-secured notes payable	22,452	22,549
Accounts payable and other liabilities (\$5,839 in 2006 and \$4,667 in 2005 to affiliates)	90,444	93,842

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	1,148,152	1,138,213
Commitments and contingencies		
Minority interest	69,105	59,185
Stockholders' equity:		
Preferred Stock, \$2.00 par value, authorized 50,000,000 shares, issued and outstanding		
Series A Cumulative Convertible Preferred Stock, 3,390,913 shares in 2006 and 2005 (liquidation preference \$33,909), including 900,000 shares in 2006 and 2005 held by subsidiaries	4,982	4,982
Common Stock, \$.01 par value, authorized 100,000,000 shares; issued 11,592,272 shares	114	114
Treasury stock, at cost	(15,146)	(15,146)
Additional paid-in capital	93,389	93,389
Retained earnings	56,259	64,805
Accumulated other comprehensive income	923	253
	140,521	148,397
	\$ 1,357,778	\$ 1,345,795

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

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

(dollars in thousands, except share data)

	<b>For the Three Months Ended June 30,</b>		<b>For the Six Months Ended June 30,</b>	
	<b>2006</b>	<b>2005</b>	<b>2006</b>	<b>2005</b>
<b>Property revenue:</b>				
Rental and other property revenues (\$517 in 2006 and \$363 in 2005 from affiliates)	\$ 46,461	\$ 42,247	\$ 92,328	\$ 82,371
Restaurant sales	9,388	9,413	18,737	18,033
<b>Total operating revenues</b>	<b>55,849</b>	<b>51,660</b>	<b>111,065</b>	<b>100,404</b>
<b>Expenses:</b>				
Property operating expenses (\$3,976 in 2006 and \$3,306 in 2005 to affiliates)	31,157	29,516	60,827	57,842
Restaurant cost of sales	6,890	7,140	13,805	13,894
Depreciation and amortization	6,891	5,922	13,617	11,696
General and administrative (\$2,550 in 2006 and \$2,284 in 2005 to affiliates)	4,130	4,915	8,022	7,666
Advisory fee to affiliate	3,229	2,732	6,310	5,639
<b>Total operating expenses</b>	<b>52,297</b>	<b>50,225</b>	<b>102,581</b>	<b>96,737</b>
<b>Operating income (loss)</b>	<b>3,552</b>	<b>1,435</b>	<b>8,484</b>	<b>3,667</b>
<b>Other income (expense):</b>				
Interest income from notes receivable (\$828 in 2006 and \$1,685 in 2005 from affiliates)	2,092	1,227	3,238	2,803
Gain on foreign currency transaction	2	228	4	228
Other income (\$2,085 in 2006 and \$1,685 in 2005 from affiliate)	311	885	2,013	1,006
Mortgage and loan interest (\$232 in 2006 and \$1,107 in 2005 to affiliates)	(20,195)	(15,392)	(38,899)	(31,211)
Net income fee to affiliate		658		(819)
Litigation settlement	1,804		1,804	
<b>Total other expense</b>	<b>(15,986)</b>	<b>(12,394)</b>	<b>(31,840)</b>	<b>(27,993)</b>
<b>Loss before gain on land sales, minority interest, and equity in earnings of investees</b>	<b>(12,434)</b>	<b>(10,959)</b>	<b>(23,356)</b>	<b>(24,326)</b>
Gain on land sales	10,668	4,913	13,408	29,091
Minority interest	(798)	174	32	(746)
Equity in income (loss) of investees	86	152	261	212
<b>Income (loss) from continuing operations</b>	<b>(2,478)</b>	<b>(5,720)</b>	<b>(9,655)</b>	<b>4,231</b>
Income (loss) from discontinued operations	3,252	3,002	2,354	13,731
<b>Net income (loss)</b>	<b>774</b>	<b>(2,718)</b>	<b>(7,301)</b>	<b>17,962</b>
Preferred dividend requirement	(631)	(649)	(1,245)	(1,299)
<b>Net income (loss) applicable to Common shares</b>	<b>\$ 143</b>	<b>\$ (3,367)</b>	<b>\$ (8,546)</b>	<b>\$ 16,663</b>

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



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

(dollars in thousands, except per share)

	For the Three Months		For the Six Months	
	Ended June 30, 2006	2005	Ended June 30, 2006	2005
<b>Basic earnings per share:</b>				
Income (loss) from continuing operations	\$ (0.31)	\$ (0.63)	\$ (1.07)	\$ 0.29
Income from discontinued operations	0.32	0.30	0.23	1.35
Net income (loss) applicable to common shares	\$ 0.01	\$ (0.33)	\$ (0.84)	\$ 1.64
<b>Diluted earnings per share:</b>				
Income (loss) from continuing operations	\$ (0.31)	\$ (0.63)	\$ (1.07)	\$ 0.22
Income from discontinued operations	0.32	0.30	0.23	1.04
Net income (loss) applicable to common shares	\$ 0.01	\$ (0.33)	\$ (0.84)	\$ 1.26
<b>Weighted average common shares used in computing earnings per share:</b>				
Basic	10,149,000	10,149,000	10,149,000	10,149,000
Diluted	13,106,924	12,907,309	13,215,097	13,161,501

Series A Cumulative Convertible Preferred Stock (3,390,913 shares of Preferred Stock convertible into common stock estimated to be 2,957,000 common shares) and options to purchase 70,750 shares of ARI's common stock were excluded from the computation of diluted earnings per share for the three and six months ended June 30, 2006, and for the three months ended June 30, 2005, because the effect of their inclusion would be antidilutive.

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



**Table of Contents****AMERICAN REALTY INVESTORS, INC.****CONSOLIDATED STATEMENTS OF STOCKHOLDERS EQUITY****For the Six Months Ended June 30, 2006****(Unaudited)**

(dollars in thousands)

	Preferred Stock		Common Stock		Treasury	Paid-in	Retained	Accumulated Other Comprehensive	Stockholders
	Shares	Amount	Stock	Capital	Stock	Capital	Earnings	Income (Loss)	Equity
Balance, January 1, 2006	3,390,913	\$ 4,982	11,592,272	\$ 114	\$ (15,146)	\$ 93,389	\$ 64,805	\$ 253	\$ 148,397
Comprehensive income:									
Unrealized gain (loss) on foreign currency translation								(194)	(194)
Unrealized gain on marketable securities								864	864
Net income (loss)							(7,301)		(7,301)
Series C Cumulative Convertible Preferred Stock cash dividends (\$7.00 per share per year)							(1,245)		(1,245)
Balance, June 30, 2006	3,390,913	\$ 4,982	11,592,272	\$ 114	\$ (15,146)	\$ 93,389	\$ 56,259	\$ 923	\$ 140,521

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

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

(dollars in thousands)

	<b>For the Six Months Ended June 30,</b>	
	<b>2006</b>	<b>2005</b>
<b>Cash Flows From Operating Activities:</b>		
Income (loss) from continuing operations	\$ (9,655)	\$ 4,231
Adjustments to reconcile net income to net cash used in operating activities		
Gain on sale of land and real estate	(13,408)	(29,091)
Depreciation and amortization	13,617	11,696
Amortization of deferred borrowing costs	970	3,787
Equity in (income) loss of investees	261	(212)
Unrealized (gain) loss on foreign currency translation	(4)	(228)
(Increase) decrease in accrued interest receivable	(1,932)	1,479
(Increase) decrease in other assets	(2,874)	932
Increase (decrease) in accrued interest payable	(1,403)	(2,303)
Increase (decrease) in minority interest	(3,719)	18
Increase (decrease) in other liabilities	(5,790)	(2,691)
Net cash used in operating activities	(23,937)	(12,382)
<b>Cash Flows From Investing Activities:</b>		
Collections on notes receivable	14,831	3,740
Proceeds from sale of notes receivable	6,749	27,242
Proceeds from sale of restaurant equipment		278
Funding of notes receivable	(2,211)	(2,048)
Acquisition of real estate	(46,855)	(23,633)
Investment in real estate entities		(475)
Real estate improvements	(9,942)	(26,547)
Restaurant equipment purchased	(315)	(476)
Proceeds from sale of real estate	16,342	53,117
Earnest money/escrow deposits	(988)	(4,345)
Distribution from equity investees		313
Net cash provided by (used in) investing activities	(22,389)	27,166
<b>Cash Flows From Financing Activities:</b>		
Proceeds from notes payable	89,623	61,596
Payments on notes payable	(40,179)	(76,108)
Deferred borrowing costs	(2,499)	(2,470)
Net advances from (payments to) affiliates		(24,288)
Margin borrowings (payments), net		3,962
Repurchase of preferred stock		(1)
Preferred dividends paid	(321)	(398)
Net cash (used in) provided by financing activities	46,624	(37,707)
<b>Discontinued Operations:</b>		
Cash used in operating activities	(1,263)	(1,106)
Cash provided by investing activities	3,444	14,314

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Net cash provided (used) by discontinued operations	2,181	13,208
Net increase (decrease) in cash and cash equivalents	2,479	(9,715)
Cash and cash equivalents, beginning of period	13,904	22,401
Cash and cash equivalents, end of period	\$ 16,383	\$ 12,686

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

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

(dollars in thousands)

	<b>For the Six Months Ended June 30,</b>	
	<b>2006</b>	<b>2005</b>
<b>Supplemental Disclosures of Cash Flow Information:</b>		
Cash paid for interest	\$ 32,260	\$ 32,350
<b>Schedule of Non-Cash Investing and Financing Activities:</b>		
Notes payable assumed from buyer upon sale of real estate	\$ 42,156	\$ 6,991
Increase in minority interest related to acquisition of real estate	14,835	
Notes receivable from sale of real estate		27,242
Acquisition of real estate to satisfy note receivable		5,497
Note payable assumed by affiliate	4,000	700
Unrealized foreign currency translation gain (loss)	(194)	
Unrealized gain (loss) on marketable securities	864	
Purchase of subsidiary from affiliate		4,101

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

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**AMERICAN REALTY INVESTORS, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**NOTE 1. BASIS OF PRESENTATION**

The accompanying condensed consolidated financial statements have been prepared in accordance with generally accepted accounting principles in the United States of America for interim financial information and in conjunction with the rules and regulations of the Securities and Exchange Commission and accordingly, do not include all of the information and footnotes required by generally accepted accounting principles in the United States of America for complete financial statements. In the opinion of management of American Realty Investors, Inc. ( ARI ), all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation of ARI 's consolidated financial position, consolidated results of operations and consolidated cash flows have been included. Operating results for the six-month period ended June 30, 2006, are not necessarily indicative of the results that may be expected for the year ended December 31, 2006.

The consolidated balance sheet at December 31, 2005 has been derived from the audited consolidated financial statements at that date but does not include all of the information and footnotes required by generally accepted accounting principles in the United States of America for complete financial statements.

You should read these consolidated financial statements in conjunction with the consolidated financial statements and footnotes thereto in our annual report on Form 10-K for the year ended December 31, 2005. Certain balances for 2005 have been reclassified to conform to the 2006 presentation. Hereafter in this document, American Realty Investors, Inc. is referred to as ARI.

Operating results for the six month period ended June 30, 2006, are not necessarily indicative of the results that may be expected for the year ending December 31, 2006. For further information on the basis of consolidation and accounting policies, 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, 2005 (the 2005 Form 10-K ).

At December 31, 2005 and June 30, 2006, ARI subsidiaries owned 82.2 percent of the outstanding shares of Transcontinental Realty Investors, Inc. ( TCI ). At June 30, 2006, ARI and TCI have the same advisor Prime Income Asset Management, LLC, ( Prime ) and Board of Directors.

At December 31, 2005 and June 30, 2006, ARI subsidiaries owned 20.4 percent of Income Opportunity Realty Investors, Inc. ( IORI ) through TCI 's ownership of 24.9 percent of IORI shares. Two directors of ARI also serve as directors of IORI.

***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. All of TCI 's stock option grants were fully vested as of the Effective Date. Furthermore, TCI had no outstanding stock option grants that were modified or settled after the Effective Date; therefore, TCI 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 04-5*. At its June 2005 meeting, the Emerging Issues Task Force, or EITF, reached a consensus regarding Issue No. 04-5 (EITF 04-5), *Determining Whether a General Partner, or the General Partners as a Group, Controls a Limited Partnership or Similar Entity When the Limited Partners Have Certain Rights*. EITF 04-5 was effective immediately for all newly-formed limited partnerships and for existing limited partnership agreements that are modified. The guidance is effective for existing limited-partnership agreements that are not modified no later than the beginning of the first reporting period in fiscal years beginning after December 15, 2005. The guidance provides a framework for addressing the question of when a general partner, as defined in EITF 04-5, should consolidate a limited partnership. The EITF has concluded that the general partner of a limited partnership should consolidate a limited partnership unless (1) the limited partners possess substantive kick-out rights as defined in paragraph B20 of FIN 46(R), *Consolidation of Variable Interest Entities* , or (2) the limited partners possess substantive participating rights similar to the rights described in Issue 96-16, *Investor 's Accounting for an Investee When the Investor has a Majority of the Voting Interest but the Minority Shareholder or Shareholders have Certain Approval or Veto Rights*. The FASB has amended Statement of Position 78-9, *Accounting for Investments in Real Estate Ventures*, and EITF 96-16, to conform and align with the guidelines set forth in EITF 04-5. There was no impact to our financial condition or results of operations from the adoption of EITF 04-5.



**Table of Contents****AMERICAN REALTY INVESTORS, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

*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 permitted. The scope of EITF 06-3 includes any tax assessed by a governmental authority that is both imposed on and concurrent with a specific revenue-producing transaction between a seller and a customer, and may include, but is not limited to, sales, use, value 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.

**NOTE 2. REAL ESTATE**

In 2006, ARI purchased the following properties:

Property	Location	Sq. Ft./Acres	Purchase Price	Net Cash Paid/ (Received)	Debt Incurred	Interest Rate	Maturity Date
<b>First Quarter</b>							
<b>Land</b>							
Circle C Ranch	Austin, TX	1,092.0 Acres	\$ 25,569	\$	\$ 25,569	8.75% <sup>(1)</sup>	03/08
Southwood 1394	Tallahassee, FL	14.5 Acres	1,150	477	748	8.50 <sup>(1)</sup>	02/08
Valley Ranch 20	Farmers Branch, TX	20.0 Acres	4,673	1,892	3,038	8.50 <sup>(1)</sup>	02/08
Woodmont Fairway Office	Dallas, TX	5.8 Acres	3,833	1,014	3,000	8.25 <sup>(1)</sup>	01/07
Woodmont Merit Drive	Dallas, TX	9.2 Acres	4,560	1,868	2,964	8.00	03/07
<b>Apartments</b>							
Anderson Estates Apts	Oxford, MS	48 Units	1,144 <sup>(3)</sup>	148	996	9.50 <sup>(1)</sup>	12/20
David Jordan Phase II	Greenwood, MS	32 Units	743 <sup>(3)</sup>	98	645	8.50 <sup>(1)</sup>	04/19
David Jordan Phase III	Greenwood, MS	40 Units	812 <sup>(3)</sup>	122	690	8.75 <sup>(1)</sup>	07/22
Leflore Estates / Curtis Moore Apartments	Greenwood, MS	104 Units	2,114 <sup>(3)</sup>	337	1,777	7.00	02/22
Monticello III Estates	Monticello, AR	32 Units	644 <sup>(3)</sup>	96	548	7.00	01/22
Riverwalk Phase I	Greenwood, MS	32 Units	455 <sup>(3)</sup>	99	356	8.50	02/19
Riverwalk Phase II	Greenwood, MS	72 Units	1,584 <sup>(3)</sup>	226	1,358	8.25 <sup>(1)</sup>	02/19
<b>Second Quarter</b>							
<b>Land</b>							
Forney Land	Forney, TX	34.8 Acres	3,945	3,926			
Parc at Clarksville	Clarksville, TN	10.4 Acres	541		547	8.00	08/06
Senlac Hutton	Farmers Branch, TX	5.9 Acres	1,050	949			

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Waco 42	Waco, TX	42.8 Acres	531	112	398	8.00	05/09
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- (1) Variable interest rate.
- (2) Purchased from ARI; purchase price is equal to ARI's cost.
- (3) Net of minority interest and other liabilities assumed.



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In 2005, ARI purchased the following properties:

Property	Location	Units / Sq. Ft./Acres	Purchase Price	Net Cash Paid/ (Received)	Debt Incurred	Interest Rate	Maturity Date
<b>First Quarter</b>							
<b>Land</b>							
Katrina <sup>(1)</sup>	Palm Desert, CA	23.0 Acres	\$ 4,184	\$	\$	%	
Keenan Bridge <sup>(2)</sup>	Farmers Branch, TX	7.5 Acres	510	14			
Mandahl Bay	US Virgin Islands	50.8 Acres	7,000	4,101	3,500	7.00	07/05
Mandahl Bay (Gilmore)	US Virgin Islands	1.0 Acres	96	104			
Mandahl Bay (Chung)	US Virgin Islands	.7 Acres	95	101			
<b>Second Quarter</b>							
<b>Land</b>							
Alliance Airport	Tarrant County, TX	12.7 Acres	850	892			
Mandahl Bay (Marina)	US Virgin Islands	24.0 Acres	2,000	2,101			
Mason Goodrich <sup>(1)</sup>	Houston, TX	13.0 Acres	1,360				
Southwood <sup>(5)</sup>	Tallahassee, FL	12.9 Acres	525	555			
West End <sup>(6)</sup>	Dallas, TX	.2 Acres	49	52			
<b>Apartments</b>							
Mission Oaks <sup>(4)</sup>	San Antonio, TX	228 Units	573	573		5.30	09/46
Parc at Metro Center <sup>(4)</sup>	Nashville, TN	144 Units	817	(378)	817	5.65	09/46
<b>Office Buildings</b>							
Park West	Farmers Branch, TX	243,416 Sq. Ft.	10,000	4,715	6,500	7.50 <sub>(3)</sub>	

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

(2) Exchanged for the Bee Street and 2524 Valley View land parcels.

(3) Variable rate.

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

(5) Purchased at 50% interest in this land tract.

(6) Purchased at 37.5% interest in this land tract.

In 2006, ARI sold the following properties:

Property	Location	Units/ Acres/ Sq. Ft.	Sales Price	Net Cash Received/ (Paid)	Debt Discharged	Gain on Sale
<b>First Quarter</b>						
<b>Land</b>						
Hollywood Casino	Farmers Branch, TX	10.5 Acres	\$ 3,225	\$ 1,207	\$	\$ 1,831
Vineyards II	Grapevine, TX	1.5 Acres	1,272	429	745	578

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**Second Quarter**

<b>Land</b>						
Elm Fork	Carrollton, TX	27.6 Acres	3,500	(827)	2,800	1,596
Elm Fork	Carrollton, TX	8.5 Acres	1,674	(755)	1,135	1,030
McKinney Ranch Land	McKinney, TX	123.9 Acres	16,591	6,004	10,051	3,389
McKinney Ranch Land	McKinney, TX	44.5 Acres	10,289	10,031		5,301
Nashville	Nashville, TN	2.4 Acres	462		429	323
Nashville	Nashville, TN	16.4 Acres	2,512		2,416	1,700
Stagliano	Farmers Branch, TX	3.1 Acres	1,373	187		715

**Table of Contents****AMERICAN REALTY INVESTORS, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

Property	Location	Units/ Acres/Sq. Ft.	Sales Price	Net Cash Received/ (Paid)	Debt Discharged	Gain on Sale
<b>Apartments</b>						
Plantation Apartments	Tulsa, OK	138 Units	2,750	638	2,191	432
Willo-Wick Apartments	Pensacola, FL	152 Units	6,500	2,806	2,827	2,860

In 2005, ARI sold the following properties:

Property	Location	Units/ Acres/Sq. Ft.	Sales Price	Net Cash Received/ (Paid)	Debt Discharged	Gain on Sale
<b>First Quarter</b>						
<b>Land</b>						
Granbury Station	Ft. Worth, TX	15.7 Acres	\$ 1,003	\$ 265	\$ 738 <sup>(1)</sup>	\$ 10
Katrina	Palm Desert, CA	9.9 Acres	2,616	574		1,323
Katrina	Palm Desert, CA	13.6 Acres	3,703	591		1,706
Katrina	Palm Desert, CA	5.5 Acres	1,325	1,281		619
Katrina	Palm Desert, CA	6.5 Acres	1,695	340		818
Katrina	Palm Desert, CA	7.4 Acres	2,028	455		1,072
Katrina	Palm Desert, CA	81.2 Acres	19,878	(814)	5,100	9,387
Katrina	Palm Desert, CA	24.8 Acres	6,402	1,027		2,947
Katy	Katy, TX	130.6 Acres	12,400	4,981	6,601	5,630
Nashville	Nashville, TN	1.2 Acres	304	236		226
Vista Ridge	Lewisville, TX	4.4 Acres	950	(92)	914	440
<b>Apartments</b>						
Longwood	Long Beach, MS	200 Units	6,456	9	6,253 <sup>(1)</sup>	56
<b>Office Buildings</b>						
Institute Place	Chicago, IL	144,915 Sq. Ft.	14,460	4,843	7,792 <sup>(1)</sup>	10,603
<b>Industrial Warehouses</b>						
5700 Tulane	Atlanta, GA	67,850 Sq. Ft.	816	738		329
<b>Second Quarter</b>						
<b>Land</b>						
Lemmon Carlisle/ Alamo Springs	Dallas, TX	2.8 Acres	7,674	5,627	1,744	2,729
Vista Ridge	Lewisville, TX	17.9 Acres	4,291	(129)	4,096	2,185
<b>Office Buildings</b>						
9033 Wilshire	Los Angeles, CA	44,253 sq. ft.	12,000	4,366	6,506	2,781
Bay Plaza	Tampa, FL	75,780 sq. ft.	4,681	3,253	951	1,212
Bay Plaza II	Tampa, FL	78,882 sq. ft.	4,719	1,114	3,271	132

(1) Debt assumed by purchaser.

**Table of Contents****AMERICAN REALTY INVESTORS, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

At June 30, 2006, ARI had the following apartment properties under construction:

<b>Property</b>	<b>Location</b>	<b>Units</b>	<b>Amount Expended</b>	<b>Additional Amount to Expend</b>	<b>Construction Loan Funding</b>
Laguna Vista	Farmers Branch, TX	206 Units	\$ 9,376	\$ 11,729	\$ 17,741
Legends of El Paso	El Paso, TX	240 Units	6,318	11,766	16,040
Mission Oaks	San Antonio, TX	228 Units	14,236	3,234	15,636
Parc at Maumelle	Maumelle, AR	240 Units	12,456	6,242	16,829
Parc at Metro Center	Nashville, TN	144 Units	4,022	8,593	11,141
Parc at Rogers	Rogers, AR	152 Units	801	23,391	20,825

**NOTE 3. NOTES AND INTEREST RECEIVABLE**

In February 2005, ARI sold a 9.9 acre tract of its Katrina land parcel for \$2.6 million, receiving \$574,000 after payment of closing costs and providing purchase money financing of \$2.0 million. The loan bore interest at 8.0 percent, required quarterly payments of interest, and matured in February 2008. In March 2005, ARI sold the loan for \$2.0 million, receiving \$2.0 million in cash after payment of closing costs.

In February 2005, ARI sold a 13.6 acre tract of its Katrina land parcel for \$3.7 million, receiving \$591,000 after payment of closing costs and providing purchase money financing of \$2.8 million. The loan bore interest at 8.0 percent, required quarterly payments of interest, and matured in February 2008. In March 2005, ARI sold the loan for \$2.8 million, receiving \$2.8 million in cash after payment of closing costs.

In February 2005, ARI sold a 6.5 acre tract of its Katrina land parcel for \$1.7 million, receiving \$340,000 after payment of closing costs and providing purchase money financing of \$1.3 million. The loan bore interest at 8.0 percent, required quarterly payments of interest, and matured in February 2007. In March 2005, ARI sold the loan for \$1.3 million, receiving \$1.3 million in cash after payment of closing costs.

In February 2005, ARI sold a 7.4 acre tract of its Katrina land parcel for \$2.0 million, receiving \$455,000 after payment of closing costs and providing purchase money financing of \$1.5 million. The loan bore interest at 8.0 percent, required quarterly payments of interest, and matured in February 2007. In March 2005, ARI sold the loan for \$1.5 million, receiving \$1.5 million in cash after payment of closing costs.

In February 2005, ARI sold an 81.2 acre tract of its Katrina land parcel for \$19.9 million, paying \$814,000 after payment of debt and closing costs and providing purchase money financing of \$14.9 million. The loan bore interest at 8.0 percent, required quarterly payments of interest, and matured in February 2007. In March 2005, ARI sold the loan for \$14.9 million, receiving \$14.9 million in cash after payment of closing costs.

In March 2005, ARI sold a 24.8 acre tract of its Katrina land parcel for \$6.4 million, receiving \$1.0 million after payment of closing costs and providing purchase money financing of \$4.8 million. The loan bore interest at 8.0 percent, required quarterly payments of interest, and matured in March 2007. In March 2005, ARI sold the loan for \$4.8 million, receiving \$4.8 million in cash after payment of closing costs.

In March 2004, ARI sold an 8.0 acre tract of its Mason Goodrich land parcel for \$1.0 million, receiving \$251,000 after payment of closing costs and providing purchase money financing of \$523,000. The secured loan bears interest at 10.0 percent per annum, requires monthly payments of accrued interest and matured in March 2006. All principal and accrued but unpaid interest is due at maturity. Through March 2006, \$117,000 in principal has been collected. In March 2006, the purchaser extended the note to March 2007 by paying a 1 percent extension fee and making a 10 percent principal reduction.

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

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extended the note an additional 30 days to April 2005 by paying an extension fee of 0.5 percent of the outstanding principal balance. In the event of a default, the note is also secured by membership rights in the purchaser's entity. The second note was unsecured, bore interest at 8.5 percent per annum, required monthly interest only payments, and matured in January 2005. The Purchaser extended this note to March 2005 by paying 1.0 percent of the outstanding principal balance as an extension fee and then extended the note an additional 30 days to April 2005 by paying an extension fee of 0.5 percent of the outstanding principal balance. Both loans were extended to October 2005 with the payment to ARI of a 2.0 percent extension fee. Both loans were paid in full, including unpaid interest, in October 2005.

**Table of Contents****AMERICAN REALTY INVESTORS, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

In March 2005, ARI entered into an agreement to advance a third party \$3.2 million for development costs relating to single-family residential lots in Austin, Texas. These advances are secured by membership interests in the borrower and a second lien on 1,092 acres of undeveloped land. The secured note bears interest at 10 percent, requires semi-annual interest payments, and matures in March 2008. In September 2005 the total amount authorized under this advance was increased to \$5.0 million. As of March 31, 2006, ARI had advanced \$3.2 million to the borrower. ARI also guaranteed an \$18 million bank loan for the borrower which is secured by a first lien on the 1,092 acres of undeveloped land. In June 2005, ARI purchased the subsidiary of a related party for \$4.1 million that holds two notes receivable from this third party totaling \$3.0 and \$1.0 million, respectively. These notes are secured by approximately 142 acres of undeveloped land and membership interests in the borrowers. The secured notes bear interest at 12.0 percent, have an interest reserve for payments that is added to the principal balance on a monthly basis, and matured in June 2005. Both loans were extended to September 2005 and upon maturity, both loan balances were paid under the advance referred to at the beginning of this paragraph. In March 2006, ARI acquired all of the interests in the borrower, including ownership of the Austin, Texas land. The land is secured by the \$18 million first mortgage and a \$3 million subordinated loan. In March 2006, ARI secured a development loan of \$31.2 million (secured by the Austin, Texas land), of which \$18 million was used to pay the existing first mortgage. The development loan matures in March 2008 and bears interest at Prime + 1 percent. As of June 30, 2006, \$20.0 million was outstanding on the development loan. The Company intends to develop the land for sale to single-family residential builders.

In December 2005, ARI sold 27.2 acres and 3.73 acres to a third party for \$10.1 million and \$1.4 million, and provided \$7.6 million and \$1.0 million of seller financing, respectively. Both notes bear interest at 8.0 percent per annum, require monthly interest only payments, and mature in December 2008. In January 2006, ARI sold both notes to a financial institution for full face value less closing costs, plus accrued interest. The financial institution has a Put Option that would require ARI to purchase both notes back under the following conditions: (1) failure to construct agreed upon roads on the property by December 2006; (2) there occurs any event of default by the buyer; (3) certain escrow deposits for the road completion are not sufficient to cover the cost of the road construction; (4) any amendment, modification or assignment of certain development and escrow agreements between ARI and the buyer; and (5) failure of ARI to deliver certain documents to the financial institution within a timely manner. ARI and other related parties have also guaranteed the full payment of the note balances, including any outstanding interest and costs incurred by the financial institution.

In December 2004, ARI sold the Centura Tower office building to a partnership and retained a 1 percent non-controlling general partner interest and a 4 percent limited partner interest. ARI has certain obligations to fund the partnership for rent abatements, tenant improvements, leasing commissions and other cash shortfalls. Through March 31, 2006, ARI has funded \$1.7 million of these obligations, and has recorded a note receivable from the partnership. This note has no maturity date, requires no payments, and bears interest at a fixed rate of 7.0 percent per annum. The note will be paid out of excess cash flow or from sales proceeds, but only after certain partner preferred returns are paid.

In March 2002, ARI sold the 174,513 Sq. Ft. Hartford Office Building in Dallas, Texas, for \$4.0 million, providing \$4.0 million in seller financing as well as an additional \$1.4 million line of credit for leasehold improvements all in the form of a first lien mortgage note. The note bears interest at a variable interest rate, currently 7.5 percent per annum, requires monthly interest only payments and matures in March 2007. As of June 2006, ARI has funded \$896,000 of the \$1.4 million line of credit. ARI determined during the third quarter of 2005 that it would classify this note as non-performing due to the lack of debt payments received and the probability that no debt payments would be received in the future. Effective for the quarter ended September 30, 2005, ARI no longer accrues interest on this note. The loan is not considered impaired due to management's opinion that the fair value of the collateral is sufficient to cover the current loan balance and accrued interest at June 2006.

In July 2002, ARI entered into an agreement to fund up to \$300,000 under a revolving line of credit secured by 100 percent interest in a partnership of the borrower. The line of credit bears interest at 12.0 percent per annum, requires monthly interest only payments, and matured in June 2005. This loan was extended to June 2006 in the second quarter of 2005 and was subsequently modified in the fourth quarter of 2005. This second modification extends the loan maturity to October 2007 and limits any advances under the line of credit to \$25,000 per month. As of March 2006, the borrower had \$211,000 of available credit under the credit limit.

In September 1999, in conjunction with the sale of two apartments in Austin, Texas, \$2.1 million in purchase money financing was provided, secured by limited partnership interests in two limited partnerships owned by the buyer. In March 2000, the borrower made a \$1.1 million payment. The borrower executed a replacement promissory note for the remaining note balance of \$1.0 million, which was unsecured, non-interest bearing and matured in April 2003. In 2004, ARI initiated legal action to collect the note. In August 2005, a settlement agreement was reached. The note was replaced with a new promissory note, also non-interest bearing, which is secured by a \$1.5 million Agreed Judgment. The note calls for 36 monthly payments beginning in January 2006, with a balloon payment of \$460,000 due in January 2009. ARI will continue

to classify this note as non-performing even though payments have been received in 2006.

**Table of Contents****AMERICAN REALTY INVESTORS, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

In February 2003, ARI sold an 89.3 acre tract of its Katrina land parcel for \$8.5 million, paying \$410,000 after payment of closing costs and debt pay down and providing purchase money financing of \$5.6 million. The note bears interest at 8.0 percent per annum and matures three years after the recording of the Deed of Trust. Interest was to begin accruing after improvements to the site were completed by ARI. The costs to ARI to complete the improvements, estimated to be \$2.5 million, were accrued in 2002. By 2005 a portion of the improvements had been completed and the remaining accrual is \$1.2 million at June 30, 2006. At March 2006, negotiations with the buyer to settle the obligations were underway. The remaining improvements were not expected to be completed before the settlement. In April 2006 a proposal was made to a bank to sell the note at a discount, but still in excess of the note receivable balance less accrued development costs. The proposed bank note will be guaranteed by ARI and other related parties. The note is classified as non-performing at June 30, 2006.

In December 2002, ARI sold a 238.0 acre tract of its Desert Wells land parcel for \$23.8 million, receiving \$321,000 after payment of closing costs and debt paydown and providing purchase money financing of \$21.4 million. The first lien financing of \$17.8 million bore interest at 8.0 percent per annum, matured in December 2004, and required payments beginning in March 2003. In March 2003, the note was sold to an unrelated party for \$17.1 million plus accrued and unpaid interest. The buyer of the note has limited recourse against a 53 acre parcel of ARI's Katrina land, in event of default by the borrower. ARI recognized a previously deferred gain of \$15.0 million upon completion of the sale of the note. The second lien financing of \$3.6 million bore interest at 8.0 percent per annum and matured on June 30, 2003. All principal and interest were due at maturity. In February 2005, the note was exchanged for 23.0 acres of land in Palm Desert, California. See NOTE 2. REAL ESTATE.

*Related Parties.* In March 2004, ARI sold a K-Mart in Cary, North Carolina to Basic Capital Management, Inc. ( BCM ) for \$3.2 million, including the assumption of debt. ARI also provided \$1.5 million of the purchase price as seller financing. The unsecured note bears interest at 2.0 percent over the prime rate, currently 9.0 percent and matures in April 2008.

In March 2004, ARI sold the Texstar Warehouse in Arlington, Texas to BCM for \$2.4 million, including the assumption of debt. ARI also provided \$1.3 million of the purchase price as seller financing. The unsecured note bears interest at 2.0 percent over the prime rate, currently 9.0 percent and matures in April 2008.

In October 2003, IORI sold the One Hickory office building in Farmers Branch, Texas with 202 acres of undeveloped land also located in Farmers Branch to an affiliate of ARI, as replacement property to accommodate a tax-deferred exchange for the ARI affiliate, for a total sales price of \$37.2 million. IORI financed \$36.1 million of the sales price with a note bearing interest at the rate of 5.49 percent per annum and maturing in June 2006. The \$37.2 million sales price approximated IORI's initial cost of acquiring the properties. Before the ARI affiliate was effectively dissolved in May 2006, the ARI affiliate sold One Hickory and the undeveloped land back to IORI for \$37.2 million, effectively discharging IORI's \$36.1 million note receivable from ARI. The ARI affiliate paid interest to IORI monthly.

**NOTE 4. INVESTMENTS IN UNCONSOLIDATED REAL ESTATE ENTITIES**

ARI's investment in real estate entities at June 30, 2006, was as follows:

Investee	Percentage of ARI's Ownership	Carrying Value of Investment	Market Value of Investment
IORI	24.9%	\$ 6,345	\$ 7,260
Garden Centura, L.P.	5.0%	6,098	
Other		1,345	\$ 7,260
		\$ 13,788	





**Table of Contents****AMERICAN REALTY INVESTORS, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

Set forth below are summarized results of operations of IORI and Garden Centura for the six months ended June 30, 2006 and 2005:

	<b>2006</b>	<b>2005</b>
Revenues	\$ 66,802	\$ 83,768
Equity in loss of partnership	81	(28)
Property operating expenses	(52,499)	(49,903)
Depreciation	(5,341)	(4,209)
Interest	(16,474)	(14,223)
Income before gain on sale of real estate	(7,431)	15,405
Gain on sale of real estate	4,314	72
Net income	\$ (3,117)	\$ 15,477

ARI's share of equity investees' income before gains on the sale of discontinued operations was \$175,000 for the six months ended June 30, 2006. ARI did not recognize any gain on equity investees' sale of real estate for the six months ended June 30, 2006.

ARI's cash flow from IORI is dependent on IORI making distributions. In the fourth quarter of 2000, IORI suspended distributions.

**NOTE 5. MARKETABLE EQUITY SECURITIES**

ARI owns equity securities of Realty Korea CR-REIT Co., Ltd. No. 1 representing approximately a 9.2 percent ownership interest. This investment is considered an available-for-sale security. Due to increase in market price, ARI recognized an unrealized gain of \$490,000 and \$869,000 for the three and six month period ending June 30, 2006, respectively.

**NOTE 6. NOTES PAYABLE**

In July 2005, ARI secured a line of credit for \$10.0 million for the acquisition and financing of land tracts. The line of credit bears interest at the prime rate plus 1.0 percent, which is currently 8.0 percent, requires interest only payments, and matures in three years. Each land tract funding has a \$2.0 million limit on the loan amount, requires interest only payments at the line of credit's variable rate, and has a maturity date of 18 months. The current amount available for use under the line of credit is \$2.5 million.

In February 2005, ARI received a loan in the amount of \$5.0 million. The note bears interest at 8.0 percent per annum, requires semi-annual interest payments, and matures in July 2006. The loan is collateralized by certain partnership interests that hold apartments owned by ARI. Anytime before maturity, the lender has the option to convert the outstanding loan balance into general and limited partnership units in each of the partnerships, subject to HUD approval.

In 2006, ARI refinanced the following properties:

Property	Location	Sq. Ft./Rooms/ Units/Acres	Debt		Net Cash Received	Interest Rate	Maturity Date
			Debt Incurred	Debt Discharged			
<i>First Quarter</i>							
Land							

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Nashville	Nashville, TN	100.9 Acres	\$ 2,500	\$	\$ 2,500 <sup>(2)</sup>	12.50%	05/06
Palmer Lane	Austin, TX	367.4 Acres	14,000	14,300	(893)	8.50 <sup>(1)</sup>	08/07
Pioneer Crossing	Austin, TX	235.0 Acres	11,750 <sup>(3)</sup>	4,000		12.50	04/07
West End	Dallas, TX	5.3 Acres	9,000	2,000	6,079	8.00 <sup>(1)</sup>	03/07
<b>Apartments</b>							
Hunters Glen	Midland, TX	212 Units	2,475	1,804	421	7.23 <sup>(1)</sup>	02/09
<b>Second Quarter</b>							
<b>Land</b>							
Nashville Land	Nashville, TN	82.2 Acres	6,500	2,776	3,561	7.50	07/08
<b>Office Buildings</b>							
University Square	Anchorage, AK	20,215 Sq. Ft.	1,360	1,079	257	8.25	05/16

**Table of Contents****AMERICAN REALTY INVESTORS, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

Property	Location	Sq. Ft./Rooms/ Units/Acres	Debt		Net Cash Received	Interest Rate	Maturity Date
			Debt Incurred	Debt Discharged			
<b>Shopping Centers</b>							
Cross County Mall	Mattoon, IL	307,266 Sq. Ft.	9,500	4,399	4,773	7.18	07/11

(1) Variable rate.

(2) Cash received by affiliate, increasing ARI's affiliate receivable.

(3) Various affiliate notes extended and collateralized by ARI, increasing ARI affiliate receivable.

In 2005, ARI refinanced the following properties:

Property	Location	Sq. Ft./Rooms/ Units/Acres	Debt		Net Cash Received	Interest Rate	Maturity Date
			Debt Incurred	Debt Discharged			
<b>Land</b>							
Nashville	Nashville, TN	109.6 Acres	\$ 7,000	\$	\$ 6,341	7.50%	02/07
<b>Shopping Centers</b>							
Bridgeview Plaza	LaCrosse, WI	116,008 Sq. Ft.	7,197	6,304	649	7.25 <sup>(1)</sup>	03/10
Dunes Plaza	Michigan City, IN	223,869 Sq. Ft.	3,750	2,685	658	7.50 <sup>(1)</sup>	01/10
<b>Second Quarter</b>							
<b>Apartments</b>							
Autumn Chase	Midland, TX	64 Units	1,166	797	317	5.88 <sup>(1)</sup>	05/35
Courtyard	Midland, TX	133 Units	1,342	966	266	5.88 <sup>(1)</sup>	05/35
Southgate	Odessa, TX	180 Units	1,879	1,712	61	5.88 <sup>(1)</sup>	05/35
<b>Hotels</b>							
The Majestic	Chicago, IL	55 Rooms	3,225		3,066	6.40	06/10

(1) Variable rate.

**NOTE 7. STOCK-SECURED NOTES PAYABLE**

ARI has margin arrangements with various financial institutions and brokerage firms, which provide for borrowings of up to 50.0 percent of the market value of marketable equity securities. ARI also has other notes payable secured by stock. The borrowings under such margin arrangements and notes are secured by the equity securities of IORI and TCI, and ARI's trading portfolio securities and bear interest rates ranging from 9.5 percent to 24.0 percent per annum. Stock-secured notes payable and margin borrowings totaled \$22.5 million at June 30, 2006 and \$22.5 million at December 31, 2005.

*Sunset Management LLC.* At June 30, 2006 and December 31, 2005, ARI's stock-secured notes payable include \$5.0 million payable to Sunset Management LLC. On May 16, 2005, the United States District Court for the Northern District of Texas, Dallas Division, entered its Memorandum Opinion and Order and Judgment dismissing a purported stockholders' derivative action filed October 5, 2004, by Sunset Management LLC against a number of entities, including the Company, as Case No. 3:04-CV-02162-B styled *Sunset Management LLC, derivatively on behalf of Transcontinental Realty Investors, Inc. v. American Realty Investors, Inc., et al.* The Court's Judgment granted a Motion to Dismiss filed by the Defendants, including the Company, and ordered that Plaintiff Sunset Management LLC take nothing by its suit. No appeal was timely filed, and the dismissal of the action is now final. The Sunset Complaint in this case contained many of the same allegations raised by Sunset Management LLC in four other cases which, as rulings have occurred, have resulted in a denial of Sunset Management LLC's requested relief. The dismissed action was the fifth in a continuing series of actions involving Sunset Management LLC, certain subsidiaries of

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the Company and TCI resulting from a loan in September 2001 to BCM and three subsidiaries of the Company in the original amount of \$30 million (\$19.5 million of which bore interest at 24 percent per annum, while the remaining \$10.5 million of which bore interest at 20 percent). In September 2002, \$15 million in principal was repaid leaving a \$15 million aggregate balance, which Sunset Management LLC orally agreed to extend the maturity date and accept substitute collateral, an arrangement which Sunset Management LLC did not honor, resulting in the original litigation filed in Texas State Court during October 2002 as Cause No. 02-09433-I in the 162nd Judicial District Court of Dallas County, Texas, originally styled American Realty Trust, Inc., ART Williamsburg, Inc., Basic Capital Management, Inc. and EQK Holdings, Inc. v. Sunset Management LLC (the Texas Litigation ). The Texas Litigation alleged breach of contract,

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**AMERICAN REALTY INVESTORS, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

misrepresentation, breach of duty of good faith and fair dealing and slander of title by Sunset Management LLC and sought certain declaratory relief against Sunset Management LLC, as well as temporary and permanent anti-suit injunctions against Sunset Management LLC. The Texas Litigation has been removed to the United States Bankruptcy Court for the Eastern District of Texas, Sherman Division, as Adversary Proceeding No. 03-04256 styled American Realty Trust, Inc., et al. v. Sunset Management LLC, et al. This Adversary Proceeding is associated with the case styled In Re: ART Williamsburg, Inc., Debtor, pending in the United States Bankruptcy Court for the Eastern District of Texas, Sherman Division, Case No. 4:03-43909-BTR-11, filed August 22, 2003.

The Company is also a defendant in related litigation with Sunset Management LLC in the case styled Sunset Management LLC, et al. v. American Realty Investors, Inc., et al., now pending in the United States District Court for the Eastern District of Texas, Tyler Division, as Case No. 4:06-CV-18. In this case, Sunset Management LLC originally sought to require a conveyance by ARI and/or its subsidiaries of certain pledged shares back to the pledgors, BCM and certain subsidiaries of ARI. Sunset Management LLC has filed a Motion for Summary Judgment claiming that transfer of the ownership of the shares among the Company and its affiliates violates the pledge agreements. ARI has responded to the Motion, which it believes is without merit because the transfer of the shares harmed no one, did not affect the validity of the pledge agreements, and in fact, benefited not only ARI but also probably Sunset Management LLC because it substantially reduced the taxes payable on a consolidated basis for ARI and TCI, thereby potentially increasing the value of the collateral pledged. The Company expects this case to eventually be consolidated with the primary discussed in the preceding paragraph when that case is transferred to the district court.

The Company, American Realty Trust, Inc. ( ART ), and a subsidiary of ART are also three of four plaintiffs in an action filed July 19, 2006 against Sunset Management LLC and John Baldwin in the case styled *American Realty Trust, Inc., et al. v. Sunset Management LLC and John Baldwin* now pending in the United States District Court for the Eastern District of Texas, Tyler Division, as Case No. 6:06CV315. In this case, plaintiffs seek actual and exemplary damages against Sunset Management LLC and John Baldwin individually for alleged violations of federal and state securities laws and rules promulgated thereunder, including an unlawful and concealed plan to use a late fee provision in a note to obtain title to securities by manufacturing a default and purporting to foreclose on certain securities as a scheme, artifice and device to defraud the plaintiffs, and the filing by Sunset Management LLC of a false and misleading Schedule 13D with the Securities and Exchange Commission.

*Other stock-secured notes payable.* In September 2003, ARI obtained a security loan in the amount of \$13.5 million from a financial institution. The loan bears interest at 12.0 percent over the 30-day LIBOR rate, currently 16.8 percent requires monthly payments of interest only and matured in September 2004. The loan is secured by 1,656,537 shares of TCI common stock and 250,000 shares of IORI common stock held by TCI. In September 2004, the maturity date was extended to December 2004. In December 2004, the maturity date was extended to March 2005. In March 2005, the maturity date was extended to March 2006. In March 2006, the maturity date was extended to March 2007.

**NOTE 8. RELATED PARTY TRANSACTIONS**

In March 2006, ARI, through one of its subsidiary companies, borrowed \$11.75 million secured by approximately 235 acres of land in Austin, Texas. The loan is guaranteed by ARI, Prime and certain other affiliated companies. The loan bears interest at an annual rate of 12.5 percent and matured in April 2006. The loan is currently being extended.

In January 2005, an affiliate made a \$700,000 note payment on ARI's behalf, reducing ARI's affiliate receivable.

Cash advances either to or from ARI, through its advisor, Prime Income Asset Management LLC ( Prime ) are unsecured, generally do not have specific repayment terms and have been reflected in ARI's financial statements as other assets or other liabilities. Effective July 1, 2005, ARI and Prime agreed to charge interest on the outstanding balance of funds advanced to or from ARI. The interest rate, set at the beginning of each quarter, is the prime rate plus 1 percent on the average daily cash balances advanced.

The following table reconciles the beginning and ending balances of accounts receivable from and (accounts payable to) affiliates as of June 30, 2006.

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	<b>PRIME</b>
Balance, December 31, 2005	\$ 29,702
Cash transfers to affiliates	107,650
Cash transfers from affiliates	(98,659)
Advances through receipt of financing proceeds	10,250
Construction fees payable to affiliate	(2,518)
Balance, June 30, 2006	\$ 46,425

**Table of Contents****AMERICAN REALTY INVESTORS, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

At June 30, 2006, ARI's other assets include \$1.2 million due from affiliates for rent and interest. Also at June 30, 2006, ARI owed \$711,000 million to Regis Property Management for management fees and sales commissions.

*Returns on Metra Properties.* In April 2002, ARI, TCI, and IORI sold 28 apartment properties to partnerships controlled by Metra Capital, LLC (Metra). Innovo Group, Inc. (Innovo) is a limited partner in the partnerships that purchased the properties. Joseph Mizrachi, then a director of ARI, controlled approximately 11.67 percent of the outstanding common stock of Innovo. Management determined to treat the sales as financing transactions, and ARI and TCI continued to report the assets and the new debt incurred by Metra on their financial statements. The partnership agreements for each of these partnerships stated that the Metra Partners, as defined, receive cash flow distributions at least quarterly in an amount sufficient to provide them with a 15 percent cumulative compounded annual rate of return on their invested capital, as well as a cumulative compounded annual amount of 0.50 percent of the average outstanding balance of the mortgage indebtedness secured by any of these properties. These distributions to the Metra Partners had priority over distributions to any other partners. In August 2004, ARI, TCI, and IORI instituted an action in Texas State District Court regarding the transaction. During April 2005, resolution of the litigation occurred, settling all liabilities remaining from the original partnership arrangements which included a return of investor equity, a cessation of any preferential return, prospective asset management fees and miscellaneous fees and transactions costs from the Plaintiffs as a prepayment of a preferred return, along with a delegation of management and corresponding payment of management fees to Prime, and a motion to dismiss the action as a part of the resolution. Of the prepayment, ARI recognized expense of \$525,000 and a reduction in liabilities of \$3.2 million during the second quarter of 2005.

**NOTE 9. 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 and other 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. Excluded from operating segment assets are assets of \$134.7 million in 2006 and \$137.7 million in 2005, 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 Akademia (Poland), which began operations in 2002.

Presented below are ARI's reportable segments' operating income for the three and six months ended June 30, 2006 and 2005, and segment assets at June 30, 2006 and 2005.

For the Three Months Ended June 30, 2006	Commercial					Receivables/		Total
	Properties	Apartments	Hotels	Land	Restaurants	Other		
Operating revenue	\$ 13,236	\$ 23,005	\$ 9,812	\$ 185	\$ 9,388	\$ 223	\$ 55,849	
Operating expenses	8,771	13,493	7,111	1,784	6,872	16	38,047	
Depreciation	2,999	2,866	688		335	3	6,891	
Mortgage and loan interest	3,731	8,798	984	4,873	319	1,490	20,195	
Interest income						2,092	2,092	
Gain on sales				10,668			10,668	
Segment operating income (loss)	\$ (2,265)	\$ (2,152)	\$ 1,029	\$ 4,196	\$ 1,862	\$ 806	\$ 3,476	
Capital expenditures	\$ 4,056	\$ 2,413	\$ 99	\$ 1,655	\$ 342		\$ 8,565	
Assets	224,741	535,074	123,940	245,418	19,299	63,212	1,211,684	
<b>Property Sales:</b>								
Sales price	\$	\$	\$	\$ 60,351	\$	\$	\$ 60,351	
Cost of sale				46,347			46,347	



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Deferred current gain				3,336				3,336
Recognized prior deferred gain								

Gain on sale	\$	\$	\$	\$ 10,668	\$	\$	\$	\$ 10,668
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For the Three Months Ended June 30, 2005	Commercial				Receivables/			Total
	Properties	Apartments	Hotels	Land	Restaurants	Other		
Operating revenue	\$ 10,115	\$ 21,011	\$ 10,941	\$ 157	\$ 9,413	\$ 23	\$ 51,660	
Operating expenses	7,462	13,400	7,271	1,355	7,140	28	36,656	
Depreciation	2,622	2,294	693		317	(4)	5,922	
Mortgage and loan interest	2,926	7,801	1,187	2,094	342	1,042	15,392	
Interest income						1,227	1,227	

**Table of Contents****AMERICAN REALTY INVESTORS, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

For the Three Months Ended June 30, 2005						Receivables/		Total
	Commercial Properties	Apartments	Hotels	Land	Restaurants	Other		
Gain on sales				4,913				4,913
Segment operating income (loss)	\$ (2,895)	\$ (2,484)	\$ 1,790	\$ 1,621	\$ 1,614	\$ 184		\$ (170)
Capital expenditures	\$ 695	\$ 8,011	\$ 142	\$ 1,356	\$ 411			\$ 10,615
Assets	167,669	502,063	81,905	215,898	20,135	71,610		1,059,280
For the Three Months Ended June 30, 2005						Receivables/		Total
Property Sales:	Commercial Properties	Apartments	Hotels	Land	Restaurants	Other		
Sales price	\$	\$	\$	\$ 11,965	\$	\$		\$ 11,965
Cost of sale				7,052				7,052
Deferred current gain								
Recognized prior deferred gain								
Gain on sale	\$	\$	\$	\$ 4,913	\$	\$		\$ 4,913
For the Six Months Ended June 30, 2006						Receivables/		Total
	Commercial Properties	Apartments	Hotels	Land	Restaurants	Other		
Operating revenue	\$ 29,047	\$ 44,850	\$ 17,604	\$ 350	\$ 18,736	\$ 478		\$ 111,065
Operating expenses	17,669	26,972	13,698	2,617	13,786	(110)		74,632
Depreciation	5,590	5,817	1,538		667	5		13,617
Mortgage and loan interest	8,305	16,044	2,232	9,100	645	2,573		38,899
Interest income						3,238		3,238
Gain on sales				13,408				13,408
Segment operating income (loss)	\$ (2,517)	\$ (3,983)	\$ 136	\$ 2,041	\$ 3,638	\$ 1,248		\$ 563
Capital expenditures	\$ 6,209	\$ 4,159	\$ 349	\$ 2,000	\$ 411			\$ 13,128
Assets	155,110	551,882	78,359	330,601	19,299	63,212		1,198,463
Property Sales:	Commercial Properties	Apartments	Hotels	Land	Restaurants	Other	Total	
Sales price	\$	\$	\$	\$ 65,462	\$	\$		\$ 65,462
Cost of sale				50,549				50,549
Deferred current gain				3,336				3,336
Recognized prior deferred gain				1,831				1,831
Gain on sale	\$	\$	\$	\$ 13,408	\$	\$		\$ 13,408
For the Six Months Ended June 30, 2005						Receivables/		Total
	Commercial Properties	Apartments	Hotels	Land	Restaurants	Other		
Operating revenue	\$ 22,529	\$ 40,913	\$ 18,540	\$ 355	\$ 18,033	\$ 34		\$ 100,404
Operating expenses	14,518	25,994	14,063	3,254	13,894	13		71,736
Depreciation	5,219	4,466	1,389		620	2		11,696
Mortgage and loan interest	5,714	14,680	2,808	5,181	690	2,138		31,211
Interest income						2,803		2,803

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Gain on sales				29,091				29,091
Segment operating income (loss)	\$ (2,922)	\$ (4,227)	\$ 280	\$ 21,011	\$ 2,829	\$ 684	\$ 17,655	
Capital expenditures	\$ 2,911	\$ 21,832	\$ 265	\$ 1,539	\$ 476	\$	\$ 27,023	
Assets	167,669	502,063	81,905	215,898	20,135	71,610	1,059,280	
<b>Property Sales:</b>								
Sales price	\$	\$	\$	\$ 64,270	\$	\$	\$ 64,270	
Cost of sale				35,179			35,179	
Deferred current gain								
Recognized prior deferred gain								
Gain on sale	\$	\$	\$	\$ 29,091	\$	\$	\$ 29,091	

**Table of Contents****AMERICAN REALTY INVESTORS, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

The following table reconciles the segment information to the corresponding amounts in the Consolidated Statements of Operations:

	<b>For the Six Months Ended June 30,</b>	
	<b>2006</b>	<b>2005</b>
Segment operating income (loss)	\$ 563	\$ 17,655
Other non-segment items of income/(expense):		
General and administrative	(8,022)	(7,666)
Advisory fee	(6,310)	(5,639)
Gain/(loss) on foreign currency transaction	4	228
Other income (expense)	2,013	1,006
Net income fee		(819)
Litigation settlement	1,804	
Equity in income (loss) of investees	261	212
Minority interest	32	(746)
<b>Income (loss) from continuing operations</b>	<b>\$ (9,655)</b>	<b>\$ 4,231</b>

**NOTE 10. DISCONTINUED OPERATIONS**

For the three and six months ended June 30, 2006 and 2005, income from discontinued operations relates to 18 properties ARI sold during 2005 and 7 properties ARI sold or held-for-sale in 2006. The following table summarizes revenue and expense information for these properties sold and held-for-sale.

	<b>For the Three Months Ended June 30,</b>		<b>For the Six Months Ended June 30,</b>	
	<b>2006</b>	<b>2005</b>	<b>2006</b>	<b>2005</b>
<b>Revenue:</b>				
Rental	\$ 2,051	\$ 3,685	\$ 4,596	\$ 7,577
Property operations	1,226	2,749	3,216	5,428
	825	936	1,380	2,149
<b>Expenses:</b>				
Interest	981	1,870	2,242	3,255
Depreciation	73	189	265	275
	1,054	2,059	2,507	3,530
<b>Loss from discontinued operations</b>	<b>(229)</b>	<b>(1,123)</b>	<b>(1,127)</b>	<b>(1,381)</b>
Gain on sale of real estate	3,481	4,125	3,481	15,112
Equity in gain on sale of real estate by equity investees				
<b>Net income from discontinued operations</b>	<b>\$ 3,252</b>	<b>\$ 3,002</b>	<b>\$ 2,354</b>	<b>\$ 13,731</b>

**NOTE 11. COMMITMENTS AND CONTINGENCIES**

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*Liquidity.* ARI's principal liquidity needs are funding normal recurring expenses, meeting debt service requirements, funding capital expenditures, funding development costs not otherwise covered by construction loans and funding new property acquisitions not otherwise covered by acquisition financing. In 2006, ARI will rely on aggressive land sales, selected income producing property sales and, to the extent necessary, additional borrowings to meet its cash requirement.

*Partnership Obligations.* ARI is the limited partner in 11 partnerships that are currently constructing residential properties. As permitted in the respective partnership agreements, ARI presently intends to purchase the interests of the general and any other limited partners in these partnerships subsequent to the final completion of these construction projects. The amounts paid to buyout the non-affiliated partners are limited to development fees earned by the non-affiliated partners, and are set forth in the respective partnership agreements. The total amount of the expected buyouts as of June 30, 2006 is approximately \$2.3 million. ARI is a non-controlling general and limited partner in a real estate partnership and is obligated to fund approximately \$1.9 million through September 30, 2006, for certain partnership obligations.

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**AMERICAN REALTY INVESTORS, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

*Commitments.* During 2002, Milano, then a wholly-owned subsidiary of ARI, sold two restaurants to a corporation owned in part by an officer of Milano. In conjunction with the sale of these restaurants, Milano guaranteed the bank debt incurred by the related party. The guaranty applies to all current debt and to all future debt of the related party until such time as the guaranty is terminated by Milano. The amount of the debt outstanding that is subject to the guaranty is \$788,000. In July 2003, ARI sold its interest in Milano to Gruppa for \$18.5 million, receiving \$7.4 million in cash after debt assumption and providing purchase money financing of \$2.3 million. ARI owns 20.0 percent of Gruppa, thereby retaining a 20.0 percent interest in Milano. ARI remained the guarantor of \$8.7 million of assumed debt and was one of the guarantors of \$7.5 million in new debt obtained by Gruppa. The total remaining debt guaranteed is \$13.0 million. Due to the debt guarantees and ARI's continuing ownership interest in Milano, management has determined that this should be accounted for as a financing transaction.

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

**NOTE 12. SUBSEQUENT EVENTS**

In August 2006, a TCI subsidiary and IORI, as co-borrowers, obtained a loan commitment of up to \$42.6 million loan from Metropolitan National Bank. The loan matures in August 2008 and bears interest at the rate of 8.6 percent per annum. The loan requires quarterly interest payments beginning in October 2006. The loan is secured by a) approximately 99 acres of land located in Dallas, Texas and owned by the TCI subsidiary (which the TCI subsidiary purchased from ARI in August 2006) and b) 202 acres of land located in Dallas, Texas which is owned by IORI. The loan is also guaranteed by TCI. Proceeds of the new loan will be used to retire the existing debt on the collateral and to fund additional investments for TCI and IORI.

Other events occurring after the date of these financial statements are included within each note, as appropriate.

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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 (the Form 10-K).

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***

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

Today, ARI is an externally advised real estate investment company that owns a diverse portfolio of residential apartment communities, office buildings, hotels and other commercial properties. ARI has a preeminent track record as a developer, completing the construction of 19 apartment properties comprising 4,300 units over the last three years. In addition, ARI owns a high-quality portfolio of land held for future development and continues to invest in well-located land tracts in high-growth markets primarily in Texas. The Company is an active buyer and seller and during 2006 acquired over \$49 million and sold over \$56 million of land and income-producing properties. As of June 30, 2006, the Company owned approximately 13,570 units in 69 residential apartment communities, 29 commercial properties comprising almost five million rentable square feet and 11 hotels containing a total of 1,531 rooms. In addition, at June 30, 2006 ARI owned 7,254 acres of land held for development and had almost 1,200 apartment units in six projects under construction. The Company currently owns income-producing properties and land in 21 states as well as in Poland and the U.S. Virgin Islands. Prime Income Asset Management, LLC (Prime) is the Company's external advisor. Regis Property Management, LLC, an affiliate of Prime, manages the Company's commercial properties. Regis Hotel I, LLC, another Prime affiliate, manages the Company's hotel investments. ARI engages various third-party companies to lease and manage its apartment properties.





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**Table of Contents*****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.

***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***

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

***Recognition of Rental Income***

Rental income for commercial and residential property leases is recognized on a straight-line basis. 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 ARI 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.

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

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

### ***Interest Recognition on Notes Receivable***

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

### ***Allowance for Estimated Losses***

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

### ***Fair Value of Financial Instruments***

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

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

ARI reported a net loss of \$8.7 million for the six months ended June 30, 2006, which included the following non-cash charges and credits: depreciation and amortization from real estate held for investment of \$13.6 million, amortization of deferred borrowing cost of \$1.3 million, gain on sale of real estate of \$13.2 million, equity in income of equity investees of \$103,000, and gain on foreign currency transaction of \$2,000. Net cash used in operating activities amounted to \$22 million for the six months ended June 30, 2006, interest receivable increased by \$1.9 million primarily due to fewer payments received, other assets decreased by \$6.2 million primarily due to decreases in prepaid expenses and deposit accounts, interest payable decreased by \$3.3 million due to an increase of cash payments on ARI's notes payable, and other liabilities increased by \$1.7 million primarily due to an increase in accrued expenses.

Net cash used in investing activities of \$26.4 million was primarily due to real estate improvements of \$10.3 million, acquisitions of real estate of \$46.8 million, earnest money deposits of \$988,000, funding of notes receivable of \$5.8 million and purchases of restaurant equipment of \$315,000. These outflows for investing activities were offset by the collection of \$6.7 million on notes receivable and \$16.3 million from the sale of real estate.

Net cash provided by financing activities of \$45.7 million was comprised of proceeds received from the funding or refinancing of notes payable of \$89.6 million offset by cash payments of \$40.2 million to paydown existing notes payable.

In the first six months of 2006, ARI purchased seven apartment developments, and ten parcels of unimproved land for a total of \$49.3 million. ARI paid \$11.9 million in cash, including various closing costs, and incurred \$39.5 million in debt. ARI also expended \$23.9 million on property construction. For the remainder of 2006, ARI expects to spend an additional \$64.9 million on property construction projects, of which \$33.3 million will be funded by debt.

In the first six months of 2006, ARI sold 12 land parcels for a total of \$284.5 million, receiving \$18.8 million in cash.

In the first six months of 2006, ARI financed or refinanced five land parcels, one office building, one shopping center and one apartment for a total of \$57.1 million, discharging \$30.3 million in debt and receiving \$16.7 million in cash.



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ARI has margin arrangements with various financial institutions and brokerage firms which provide for borrowing up to 50 percent 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 9.0 percent to 24.0 percent. Margin borrowing totaled \$22.4 million at June 30, 2006.

Management expects that it may be necessary for ARI to sell land holdings during the remainder of 2006 to satisfy the debt on such land as it matures. If ARI is unable to sell sufficient land to satisfy the debt obligations on such land as it matures, or, if it is not able to extend such debt, ARI intends to sell other of its assets, specifically income producing properties, to pay the debt.

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.

**Related Party Transactions**

In March 2006, ARI, through one of its subsidiary companies, borrowed \$11.75 million secured by approximately 235 acres of land in Austin, Texas. The loan is guaranteed by ARI, Prime and certain other affiliated companies. The loan bears interest at an annual rate of 12.5 percent and matured in April 2006. The loan is month-to-month bearing interest at 12.5 percent.

In January 2005, an affiliate made a \$700,000 note payment on ARI's behalf, reducing ARI's affiliate receivable.

**Commitments and Contingencies**

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

**Results of Operations**

For the three and six months ended June 30, 2006, ARI reported a net loss of \$2.4 million and \$9.6 million, respectively, as compared to net loss of \$5.7 million and a net income of \$4.2 million for the three and six months ended June 30, 2005, respectively. The primary factors contributing to ARI's net income are discussed in the following paragraphs.

Rents (dollars in thousands)

	For the Three Months		For the Six Months	
	Ended June 30,		Ended June 30,	
	2006	2005	2006	2005
Commercial	\$ 13,236	\$ 10,115	\$ 29,047	\$ 22,529
Apartments	23,005	21,011	44,850	40,913
Hotels	9,812	10,941	17,604	18,540
Land	185	157	350	355
Restaurants	9,388	9,413	18,736	18,033
Other	223	23	478	34
	\$ 55,849	\$ 51,660	\$ 111,065	\$ 100,404

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The increase in commercial rents of \$3.1 million and \$6.5 million for the three and six months ended June 30, 2006, respectively, is due to the completion of several construction projects and an increase in occupancy. The increase in apartment rents of \$3.1 million and \$6.5 million for the three and six months ended June 30, 2006, respectively, is due to the completion of several new apartment complexes. Rental income is anticipated to continue to increase as new construction is completed.

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## Property Operations Expenses (dollars in thousands)

	For the Three Months		For the Six Months	
	Ended June 30,		Ended June 30,	
	2006	2005	2006	2005
Commercial	\$ 8,771	\$ 7,462	\$ 17,669	\$ 14,518
Apartments	13,493	13,400	26,972	25,994
Hotels	7,111	7,271	13,698	14,063
Land	1,784	1,355	2,617	3,254
Restaurants	6,872	7,140	13,786	13,894
Other	16	28	(110)	13
	\$ 38,047	\$ 36,656	\$ 74,632	\$ 71,736

The increase in commercial operations expense of \$1.3 million and \$3.1 million for the three and six months ended June 30, 2006 from 2005, respectively, is due to the completion of several construction projects and the associated management expense.

## Depreciation and Amortization (dollars in thousands)

	For the Three Months		For the Six Months	
	Ended June 30,		Ended June 30,	
	2006	2005	2006	2005
Commercial	\$ 2,999	\$ 2,622	\$ 5,590	\$ 5,219
Apartments	2,866	2,294	5,817	4,466
Hotels	688	693	1,538	1,389
Restaurants	335	317	667	620
Other	3	(4)	5	2
	\$ 6,891	\$ 5,922	\$ 13,617	\$ 11,696

The increase in apartment depreciation expense of \$572,000 and \$1.3 million for the three and six months ended June 30, 2006 from 2005, respectively, is due to the completion of seven new apartment complexes.

## Mortgage and Loan Interest Expense (dollars in thousands)

	For the Three Months		For the Six Months	
	Ended June 30,		Ended June 30,	
	2006	2005	2006	2005
Commercial	\$ 3,731	\$ 2,926	\$ 8,305	\$ 5,714
Apartments	8,798	7,801	16,044	14,680
Hotels	984	1,187	2,232	2,808
Land	4,873	2,094	9,100	5,181
Restaurants	319	342	645	690
Other	1,490	1,042	2,573	2,138
	\$ 20,195	\$ 15,392	\$ 38,899	\$ 31,211

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The increase in commercial interest expense of \$805,000 and \$2.5 million for the three and six months ended June 30, 2006 from 2005, respectively, is due to the new debt incurred from the completion of construction projects. The increased interest expense on the apartments of \$997,000 and \$1.3 million for the three and six months ended June 30, 2006 from 2005, respectively, is due to the completion and purchase of apartment complexes. The increase in land interest expense of \$2.7 million and \$3.9 million for the three and six months ended June 30, 2006 from 2005, respectively, is due to the debt incurred with the purchase of land.

Other income increased for the six months ended June 30, 2006 from 2005 by \$1.0 million due to the increased receivable from an affiliated party.

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Gain on sales increase by \$5.7 million and decreased by \$15.6 million for the three and six months ended June 30, 2006 from 2005, respectively. The increase for the three months ended from the prior period was due to higher gains in the first quarter and lower gains in the second quarter, as the overall activity remained constant.

	For the Three Months Ended June 30,		For the Six Months Ended June 30,	
	2006	2005	2006	2005
Revenue:				
Rental	\$ 2,051	\$ 3,685	\$ 4,596	\$ 7,577
Property operations	1,226	2,749	3,216	5,428
	825	936	1,380	2,149
Expenses:				
Interest	981	1,870	2,242	3,255
Depreciation	73	189	265	275
	1,054	2,059	2,507	3,530
Loss from discontinued operations	(229)	(1,123)	(1,127)	(1,381)
Gain on sale of real estate	3,481	4,125	3,481	15,112
Write-down of assets held-for-sale				
Equity in gain on sale of real estate by equity investees				
Income (loss) from discontinued operations	\$ 3,252	\$ 3,002	\$ 2,354	\$ 13,731

The \$11.1 million decrease in discontinued operations for the six months ended June 30, 2006 from 2005 is due to the gain on the sale of two apartment complexes.

***Tax Matters***

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 a loss for federal income tax purposes, after the use of net operating loss carryforwards, in the first six months of 2006 and the first six months of 2005; therefore, it recorded no provision for income taxes.

At June 30, 2006, ARI had a net deferred tax asset of \$105.8 million due to tax deductions available to it in future years. However, as management cannot determine that it is more likely than not that ARI will realize the benefit of the deferred tax assets, a 100% valuation allowance has been established.

***Environmental Matters***

Under various federal, state and local environmental laws, ordinances and regulations, ARI may be potentially liable for removal or remediation costs, as well as certain other potential costs relating to hazardous or toxic substances (including governmental fines and injuries to persons and property) where property-level managers have arranged for the removal, disposal or treatment of hazardous or toxic substances. In addition, certain environmental laws impose liability for release of asbestos-containing materials into the air, and third parties may seek recovery for personal injury associated with such materials. Management is not aware of any environmental liability relating to the above matters that would have a material adverse effect on ARI's business, assets, or results of operations.

***Inflation***

The effects of inflation on ARI's operations are not quantifiable. Revenues from 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.





**Table of Contents****ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISKS**

At June 30, 2006, ARI's exposure to a change in interest rates on its debt is as follows (dollars in thousands except per share):

	Balance	Weighted Average Interest Rate	Effect of 1 percent Increase In Base Rates
Notes payable:			
Variable rate	\$ 246,189	8.15%	\$ 2,461
Total decrease in ARI's annual net income			\$ 2,461
Per share			\$ 0.24

**ITEM 4. CONTROLS AND PROCEDURES**

As of the end of the period covered by this report, ARI carried out an evaluation, under the supervision and with the participation of ARI's Acting Principal Executive Officer and principal accounting officer, of ARI's disclosure controls and procedures pursuant to Exchange Act Rules 13a-15 and 15d-15. Based upon that evaluation, ARI's Acting Principal Executive Officer and principal accounting officer concluded that ARI's disclosure controls and procedures are effective.

There have been no changes in ARI's internal controls over financial reporting during the quarter ending June 30, 2006, that have materially affected, or are reasonably likely to materially affect, ARI's internal control 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 this report, American Realty Investors, Inc. did not repurchase any of its equity securities. The following table sets forth a summary by month for the quarter indicating no repurchases were made, and that at the end of the period covered by this report, a specified number of shares may yet be purchased under the programs specified below:

<b>Period</b>	<b>Total Number of Shares Purchased</b>	<b>Average Price Paid per Share</b>	<b>Total Number of Shares Purchased as Part of Publicly Announced Program</b>	<b>Maximum Number of Shares that May Yet be Purchased Under the Program<sup>(1)</sup></b>
April 2006		\$		129,493
May 2006				129,493
June 2006				129,493
Total		\$		

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

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**ITEM 6. EXHIBITS**

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

**Exhibit**

<b>Number</b>	<b>Description of Exhibit</b>
3.0	Certificate of Restatement of Articles of Incorporation of American Realty Investors, Inc. dated August 3, 2000 (incorporated by reference to Exhibit 3.0 to the Registrant's Quarterly Report on Form 10-Q for the quarter ended September 30, 2000).
3.1	Certificate of Correction of Restated Articles of Incorporation of American Realty Investors, Inc. dated August 29, 2000 (incorporated by reference to Exhibit 3.1 to Registrant's Quarterly Report on Form 10-Q dated September 30, 2000).
3.2	Articles of Amendment to the Restated Articles of Incorporation of American Realty Investors, Inc. decreasing the number of authorized shares of and eliminating Series B Cumulative Convertible Preferred Stock dated August 23, 2003 (incorporated by reference to Exhibit 3.3 to Registrant's Quarterly Report on Form 10-Q for the quarter ended September 30, 2003).
3.3	Articles of Amendment to the Restated Articles of Incorporation of American Realty Investors, Inc., decreasing the number of authorized shares of and eliminating Series I Cumulative Preferred Stock dated October 1, 2003 (incorporated by reference to Exhibit 3.4 to Registrant's Quarterly Report on Form 10-Q for the quarter ended September 30, 2003).
3.4	Bylaws of American Realty Investors, Inc. (incorporated by reference to Exhibit 3.2 to Registrant's Registration Statement on Form S-4 filed December 30, 1999).
4.1	Certificate of Designations, Preferences and Relative Participating or Optional or Other Special Rights, and Qualifications, Limitations or Restrictions Thereof of Series F Redeemable Preferred Stock of American Realty Investors, Inc., dated June 11, 2001 (incorporated by reference to Exhibit 4.1 to the Registrant's Annual Report on Form 10-K for the year ended December 31, 2001).
4.2	Certificate of Withdrawal of Preferred Stock, Decreasing the Number of Authorized Shares of and Eliminating Series F Redeemable Preferred Stock, dated June 18, 2002 (incorporated by reference to Exhibit 3.0 to the Registrant's Quarterly Report on Form 10-Q for the quarter ended June 30, 2002).
4.3	Certificate of Designation, Preferences and Rights of the Series I Cumulative Preferred Stock of American Realty Investors, Inc., dated February 3, 2003 (incorporated by reference to Exhibit 4.3 to the Registrant's Annual Report on Form 10-K for the year ended December 31, 2002).
4.4	Certificate of Designation for Nevada Profit Corporations designating the Series J 8 percent Cumulative Convertible Preferred Stock as filed with the Secretary of State of Nevada on March 16, 2006 (incorporated by reference to Registrant current report on Form 8-K for event of March 16, 2006).
10.1	Advisory Agreement between American Realty Investors, Inc. and Prime Income Asset Management, LLC, dated October 1, 2003 (incorporated by reference to Exhibit 10.0 to the Registrant's Current Report on Form 8-K, dated October 1, 2003).
10.2	Second Amendment to Modification of Stipulation of Settlement dated October 17, 2001 (incorporated by reference to Exhibit 10.1 to the Registrant's Registration Statement on Form S-4, dated February 24, 2002).
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. 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.

AMERICAN REALTY INVESTORS, INC.

Date: August 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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**AMERICAN REALTY INVESTORS, INC.**  
**EXHIBITS TO**  
**QUARTERLY REPORT ON FORM 10-Q**  
**FOR THE QUARTER ENDED JUNE 30, 2006**

**Exhibit**

<b>Number</b>	<b>Description of Exhibits</b>
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. 1350.

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\* Filed herewith