

Financial Statements

HOUSE EAR INSTITUTE

June 30, 2004



HENSIEK & CARON

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INDEPENDENT AUDITOR'S REPORT

To The Board of Directors
House Ear Institute

We have audited the accompanying statement of financial position of House Ear Institute (a nonprofit corporation) as of June 30, 2004, and the related statements of activities, changes in net assets, cash flows, and functional expenses for the year then ended. These financial statements are the responsibility of the organization's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with U.S. generally accepted auditing standards, and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statement is free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of House Ear Institute as of June 30, 2004, and the changes in its net assets and its cash flows for the year then ended, in conformity with U.S. generally accepted accounting principles.

In accordance with *Government Auditing Standards*, we have also issued a report dated September 22, 2004, on our consideration of House Ear Institute's internal control structure over financial reporting and our tests of its compliance with certain provisions of laws, regulations, contracts and grants.

September 22, 2004

HOUSE EAR INSTITUTE
STATEMENTS OF FINANCIAL POSITION
JUNE 30, 2004

ASSETS

	2004	2003
Cash, including restricted amounts of \$1,479,515	\$ 3,305,437	\$ 2,903,476
Bequests and other donations receivable	3,189,117	3,268,200
Accounts receivable, net of allowance for uncollectible accounts of \$602,121 in 2004 and \$488,691 in 2003	1,212,293	1,326,329
Educational and research supplies	97,913	100,476
Prepaid expenses and other assets	46,426	58,168
Pledges receivable, net of allowance for uncollectible pledges of \$6,550 in 2004 and \$6,550 in 2003	3,881,546	1,769,160
Notes receivable	140,083	192,275
Investments	32,397,846	31,342,327
Assets of split-interest agreements	2,451,342	2,492,594
Patent development costs	138,211	118,397
Patent costs, net of accumulated amortization of \$46,218 in 2004 and \$38,657 in 2003	89,493	92,685
Deferred bond costs, net of accumulated amortization of \$442,711 in 2004 and \$426,508 in 2003	234,944	251,147
Cash surrender value of life insurance	-	60,456
Facilities and equipment, at cost, net	24,864,954	26,537,138
Total Assets	\$ 72,049,605	\$ 70,512,828

LIABILITIES AND NET ASSETS

Accounts payable and accrued expenses	\$ 1,208,235	\$ 1,261,270
Accrued bond interest payable	14,059	16,584
Note payable	1,434,056	1,621,813
Deferred revenue	1,754,651	1,204,305
Liability to beneficiaries under split-interest agreements	1,110,842	1,178,915
Deferred revenue - pooled income fund	62,658	55,998
Bonds payable	13,695,000	14,180,000
Deferred compensation plan	373,077	254,928
Total Liabilities	19,652,578	19,773,813
Unrestricted Net Assets		
Undesignated fund	17,686,498	20,430,588
Designated by Board of Trustees:		
Adrian Wood Memorial	1,500,000	1,500,000
Bond Retirement	9,372,022	9,571,023
Total Unrestricted Net Assets	28,558,520	31,501,611
Temporarily Restricted Net Assets	10,569,835	7,484,222
Permanently Restricted Net Assets	13,268,672	11,753,182
Total Net Assets	52,397,027	50,739,015
Total Liabilities and Net Assets	\$ 72,049,605	\$ 70,512,828

HOUSE EAR INSTITUTE
STATEMENTS OF ACTIVITIES
FOR THE YEAR ENDED JUNE 30, 2004
WITH SUMMARIZED INFORMATION FOR THE YEAR ENDED JUNE 30, 2003

	2004			2003	
	Unrestricted	Temporarily Restricted	Permanently Restricted	Total	Total
Public Support and Revenue					
Contributions	\$ 4,788,094	\$ 5,126,877	\$ 1,515,490	\$ 11,430,461	\$ 13,670,263
Grants and contracts - direct	5,550,698	-	-	5,550,698	5,177,159
Grants and contracts - indirect	2,641,520	-	-	2,641,520	2,340,378
Educational courses	109,442	-	-	109,442	97,974
Investment returns, net	1,458,965	603,081	-	2,062,046	2,149,011
Building operations	717,389	-	-	717,389	657,678
Clinical services	859,550	-	-	859,550	846,403
Royalties	284,315	-	-	284,315	1,297,124
Other	174,901	-	-	174,901	47,874
Change in value of split-interest agreements	151,800	-	-	151,800	381,289
Net assets released from restrictions	2,644,345	(2,644,345)	-	-	-
Total Public Support and Revenue	19,381,019	3,085,613	1,515,490	23,982,122	26,665,153
Expenses					
Program Services					
Research	13,405,198	-	-	13,405,198	12,623,662
Education	567,205	-	-	567,205	605,596
Total Program Services	13,972,403	-	-	13,972,403	13,229,258
Supporting Services					
Management and general	6,735,728	-	-	6,735,728	6,543,773
Fund raising	1,267,718	-	-	1,267,718	1,217,993
Total Supporting Services	8,003,446	-	-	8,003,446	7,761,766
Total Expenses Before Debt Service Costs	21,975,849	-	-	21,975,849	20,991,024
Change in Net Assets Before Debt Service Costs	(2,594,830)	3,085,613	1,515,490	2,006,273	5,674,129
Debt Service Costs	348,261	-	-	348,261	381,244
Change in Net Assets	\$ (2,943,091)	\$ 3,085,613	\$ 1,515,490	\$ 1,658,012	\$ 5,292,885

HOUSE EAR INSTITUTE
STATEMENTS OF CHANGES IN NET ASSETS
FOR THE YEAR ENDED JUNE 30, 2004

	<u>Unrestricted</u>	<u>Temporarily Restricted</u>	<u>Permanently Restricted</u>	<u>Total</u>
Net Assets, June 30, 2002	\$ 26,991,877	\$ 8,009,556	\$10,444,697	\$ 45,446,130
Change in Net Assets	<u>4,509,734</u>	<u>(525,334)</u>	<u>1,308,485</u>	<u>5,292,885</u>
Net Assets, June 30, 2003	31,501,611	7,484,222	11,753,182	50,739,015
Change in Net Assets	<u>(2,943,091)</u>	<u>3,085,613</u>	<u>1,515,490</u>	<u>1,658,012</u>
Net Assets, June 30, 2004	<u>\$ 28,558,520</u>	<u>\$ 10,569,835</u>	<u>\$ 13,268,672</u>	<u>\$ 52,397,027</u>

**HOUSE EAR INSTITUTE
STATEMENTS OF CASH FLOWS
FOR THE YEAR ENDED JUNE 30, 2004**

	<u>2004</u>	<u>2003</u>
Cash Flows from Operating Activities		
Cash received from service recipients	\$ 10,286,765	\$ 9,539,845
Cash received from donors	7,651,398	9,606,261
Cash received from building operations, net	717,389	657,678
Cash paid to suppliers and employees	(19,513,634)	(18,726,369)
Interest and dividends received	1,060,699	1,138,595
Interest paid	<u>(350,786)</u>	<u>(394,552)</u>
Net Cash Provided by (Used in) Operating Activities	<u>(148,169)</u>	<u>1,821,458</u>
Cash Flows from Investing Activities		
Additions to facilities and equipment	(736,665)	(966,459)
Purchases of investments	(11,710,325)	(1,938,401)
Proceeds from sale of investments	11,747,244	2,014,480
Loans made	(1,000)	(50,000)
Collections on loans	<u>53,191</u>	<u>63,546</u>
Net Cash Used in Investing Activities	<u>(647,555)</u>	<u>(876,834)</u>
Cash Flows from Financing Activities		
Proceeds from donations and investment earnings restricted for:		
Endowment	1,870,442	521,918
Redemption of bonds	(485,000)	(455,000)
Proceeds from line of credit, net	<u>(187,757)</u>	<u>(158,506)</u>
Net Cash Provided by (Used in) Financing Activities	<u>1,197,685</u>	<u>(91,588)</u>
Net Increase in Cash	401,961	853,036
Cash, Beginning	<u>2,903,476</u>	<u>2,050,440</u>
Cash, Ending	<u><u>\$ 3,305,437</u></u>	<u><u>\$ 2,903,476</u></u>

**HOUSE EAR INSTITUTE
STATEMENTS OF CASH FLOWS
FOR THE YEAR ENDED JUNE 30, 2004
(Continued)**

	<u>2003</u>	<u>2002</u>
Reconciliation of the Change in Net Assets		
To Net Cash Provided by (Used in) Operating Activities		
Change in Net Assets	\$ 1,658,012	\$ 5,292,885
Adjustments to reconcile the change in net assets to net cash provided by (used in) operating activities		
Bad debts	113,430	170,113
Change in present value of pledges receivable	524,758	(20,411)
Depreciation and amortization	2,316,828	2,225,356
Loss on disposal of fixed assets	115,786	195,845
Realized and unrealized gains on investments	(1,084,875)	(1,095,522)
Partnership (income) loss	-	(32,373)
Cash surrender value of life insurance	60,456	(10,278)
Donations of noncash assets	(7,563)	(441,258)
(Increase) Decrease in:		
Donations receivable	86,778	(3,268,200)
Accounts receivable	(7,090)	(31,751)
Educational and research supplies	2,563	15,090
Pledges receivable	(2,637,144)	252,000
Assets of split-interest agreements	41,252	164,626
Prepaid expenses and other assets	11,742	17,139
Patent development costs	(19,814)	(35,366)
Patent costs	(4,369)	-
Increase (Decrease) in:		
Accounts payable and accrued expenses	(53,035)	(109,419)
Accrued bond interest payable	(2,525)	(13,308)
Other deferred revenue	550,346	(418,214)
Liability to beneficiaries under split-interest agreements	(61,413)	(612,435)
Deferred compensation plan	118,150	98,857
Donations restricted for long-term purposes:		
Cash donations	<u>(1,870,442)</u>	<u>(521,918)</u>
 Net Cash Provided by (Used in) Operating Activities	 <u><u>\$ (148,169)</u></u>	 <u><u>\$ 1,821,458</u></u>

HOUSE EAR INSTITUTE
STATEMENTS OF FUNCTIONAL EXPENSES
FOR THE YEARS ENDED JUNE 30, 2004
WITH SUMMARIZED INFORMATION FOR JUNE 30, 2003

	2004						2003	
	Program Services			Supporting Services			Total Expenses	
	Research	Education	Total	Management and General	Fund Raising	Total		
Salaries and wages	\$ 7,023,777	\$ 240,513	\$ 7,264,290	\$ 3,066,656	\$ 639,107	\$ 3,705,763	\$ 10,970,053	\$ 10,065,414
Taxes and employee benefits	1,619,824	56,040	1,675,864	584,607	148,912	733,519	2,409,383	2,068,799
Total Personnel Costs	8,643,601	296,553	8,940,154	3,651,263	788,019	4,439,282	13,379,436	12,134,213
Professional fees and contract service payments	959,767	44,847	1,004,614	396,326	146,950	543,276	1,547,890	2,001,370
Occupancy and related expenses	245,509	3,764	249,273	1,215,907	6,254	1,222,161	1,471,434	1,427,704
Travel, conferences, conventions and meetings	200,454	39,187	239,641	128,888	15,816	144,704	384,345	413,055
Special supplies and services	938,220	24,762	962,982	140,451	14,828	155,279	1,118,261	1,051,111
Cost of goods sold	308,003	-	308,003	318	-	318	308,321	276,092
Minor equipment and equipment maintenance	166,193	5,119	171,312	86,101	1,131	87,232	258,544	289,443
Office supplies and services	223,539	106,901	330,440	670,150	213,963	884,113	1,214,553	1,196,630
Total Expenses Before Depreciation	11,685,286	521,133	12,206,419	6,289,404	1,186,961	7,476,365	19,682,784	18,789,618
Depreciation - building	948,871	35,549	984,420	315,266	36,752	352,018	1,336,438	1,358,338
Depreciation - equipment and furniture	771,041	10,523	781,564	131,058	44,005	175,063	956,627	843,068
Total Expenses Before Debt Service Costs	<u>\$ 13,405,198</u>	<u>\$ 567,205</u>	<u>\$ 13,972,403</u>	<u>\$ 6,735,728</u>	<u>\$ 1,267,718</u>	<u>\$ 8,003,446</u>	<u>\$ 21,975,849</u>	<u>\$ 20,991,024</u>

HOUSE EAR INSTITUTE
NOTES TO FINANCIAL STATEMENTS
JUNE 30, 2004

Note 1 - Summary of Significant Accounting Policies

Organization

House Ear Institute (the Institute) is a nonprofit California corporation that was formed in 1946 for the principal purpose of developing conceptually and technically feasible approaches to resolving disorders of hearing and balance through basic and applied research; for testing the practicality of solutions through selective clinical applications; and for communicating the results to hearing health care professionals and the public through educational programs, reports, films and other means.

The Institute was established by Dr. Howard House in 1946 and is dedicated to improving the quality of life for people who have hearing and related disorders through research and education. Since its inception, scientists at the Institute have been engaged in an exploration of the auditory system from the ear canal through the inner ear and into the cortex of the brain and have sought to improve hearing aids and auditory implants and develop innovative treatments and intervention methods.

The Institute's mission continues to be centered around the exploration of the structure of the auditory cellular and molecular mechanisms with a goal of obtaining a better understanding of how a normal ear develops, matures and functions in order to provide greater potential for discovering cures for sensorineural hearing loss and some of the many unsolved causes of deafness and ear disease.

Public Support and Revenue

Donations, including unconditional promises to give (pledges), are recorded as made. All donations are considered to be available for unrestricted use unless specifically restricted by the donor.

Conditional promises to give are recorded when the conditions on which they depend are substantially met. Unconditional promises to give are recorded as verifiable documentation of a promise is received. Promises to give that are due in the next year are recorded as current at their net realizable value; those due in subsequent years are reflected as long-term promises to give and are recorded at the present value of their net realizable value, discounted using low-risk interest rates applicable to the year in which the promise was received. An allowance for uncollectible promises is provided based on management's evaluation of potential uncollectible promises receivable at year end.

Amounts received or promised that are designated for future periods or restricted by the donor for specific purposes are reported as temporarily or permanently restricted support that increases those net asset classes. When a temporary restriction expires, temporarily restricted net assets are reclassified to unrestricted net assets and reported in the statement of activities as net assets released from restriction.

Donated securities and other non-cash donations are recorded as donations at their estimated fair values at the date of donation.

HOUSE EAR INSTITUTE
NOTES TO FINANCIAL STATEMENTS
JUNE 30, 2004

Note 1 - Summary of Significant Accounting Policies (continued)

Public Support and Revenue (continued)

A substantial number of volunteers donate significant amounts of their time to the Institute's programs and other services. However, since no objective basis exists for measuring and valuing these services, they are not reflected in the accompanying financial statements.

Medical and Research Supplies

Inventories of medical and research supplies are stated at the lower of cost or market determined by the first-in first-out method.

Investments

Investments are valued at fair value, with realized and unrealized gains and losses reflected in the statements of activities. The fair value of investments is generally based on quoted market value.

The Institute uses an investment pooling method for accounting for investments. Investment income is allocated to the various classes of net assets on an estimated average annual rate of return on the investment pools.

Facilities and Equipment

Facilities and equipment are recorded at cost at the date of acquisition or at fair market value at the date of donation. Depreciation is provided, using the straight-line method, over the following estimated useful lives:

Medical and research facility	30 years
Equipment and furniture	5 to 10 years

The costs of tenant improvements are depreciated over the term of each lease, including renewal options.

Deferred Revenue

Tuition fees received in advance are reported as deferred revenue until the related seminar is held. Deposits on leases of the building are also classified as deferred revenue.

Comparative Financial Information

The financial statements include certain prior-year summarized comparative information in total but not by net asset class. Such information should be read in conjunction with the Institute's financial statements for the year ended June 30, 2003. Certain reclassifications have been made to June 30, 2003, to be comparative to June 30, 2004.

**HOUSE EAR INSTITUTE
NOTES TO FINANCIAL STATEMENTS
JUNE 30, 2004**

Note 1 - Summary of Significant Accounting Policies (continued)

Statement of Cash Flows

For the purpose of the statement of cash flows, the Institute includes all cash in banks and other financial institutions.

Income Taxes

The Institute is qualified under Section 501(c)(3) of the Internal Revenue Code and is not classified as a private foundation. Nonprofit organizations are not generally liable for taxes on income; therefore, no provision is made for such taxes in the financial statements.

Expense Allocation

The costs of providing various programs and other activities have been summarized on a functional basis in the statement of activities and in the statement of functional expenses. Accordingly, certain costs have been allocated among the programs and supporting services benefited.

Use of Estimates

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Note 2 - Concentration of Credit Risk

The Institute maintains its cash balances at various financial institutions. Cash accounts are insured by the Federal Deposit Insurance Corporation up to \$100,000 per institution. At June 30, 2004, the Institute's uninsured cash balance totaled \$3,005,841.

Note 3 - Pledges Receivable

Unconditional promises to give consist of the following:

	<u>2004</u>	<u>2003</u>
Receivable in less than one year	\$ 1,877,550	\$ 978,406
Receivable in one to five years	2,574,152	836,152
Total unconditional promises to give	4,451,702	1,814,558
Less discounts to net present value	(563,606)	(38,848)
Less allowance for uncollectible promises	(6,550)	(6,550)
Net unconditional promises to give	<u>\$ 3,881,546</u>	<u>\$ 1,769,160</u>

HOUSE EAR INSTITUTE
NOTES TO FINANCIAL STATEMENTS
JUNE 30, 2004

Note 3 - Pledges Receivable (continued)

	<u>2004</u>	<u>2003</u>
Restricted for:		
Building maintenance and debt reduction	\$ 548,861	\$ 358,217
Specific research projects	1,972,417	434,105
Endowment	904,652	96,803
Unrestricted	<u>455,616</u>	<u>880,035</u>
Total	<u>\$ 3,881,546</u>	<u>\$ 1,769,160</u>

Note 4 - Investments

As of June 30, 2004 and 2003, investments consist of the following:

<u>2004</u>	<u>Aggregate Fair Value</u>	<u>Cost</u>
Cash & cash equivalents	\$ 411,863	\$ 411,863
Corporate stocks	6,565,297	4,338,844
Mutual funds	15,348,944	14,184,696
United States Treasury notes	9,372,022	6,187,853
Other	<u>699,720</u>	<u>699,711</u>
	<u>\$32,397,846</u>	<u>\$25,822,967</u>
<u>2003</u>	<u>Aggregate Fair Value</u>	<u>Cost</u>
Cash & cash equivalents	\$ 1,637,554	\$ 1,637,554
Corporate stocks	5,802,712	4,512,565
Mutual funds	13,747,384	12,790,677
United States Treasury notes	9,571,023	6,187,853
Other	<u>583,654</u>	<u>643,129</u>
	<u>\$31,342,327</u>	<u>\$25,771,778</u>

Investment returns are summarized as follows:

<u>2004</u>	<u>Unrestricted</u>	<u>Temporarily Restricted</u>	<u>Total</u>
Interest and dividends	\$ 699,111	\$ 288,986	\$ 988,097
Net realized and unrealized gains	818,069	338,159	1,156,228
Investment fees	<u>(58,215)</u>	<u>(24,064)</u>	<u>(82,279)</u>
Total	<u>\$ 1,458,965</u>	<u>\$ 603,081</u>	<u>\$ 2,062,046</u>

HOUSE EAR INSTITUTE
NOTES TO FINANCIAL STATEMENTS
JUNE 30, 2004

Note 4 - Investments (continued)

<u>2003</u>	<u>Unrestricted</u>	<u>Temporarily Restricted</u>	<u>Total</u>
Interest and dividends	\$ 1,033,213	\$ 144,982	\$ 1,178,195
Net realized and unrealized gains	954,376	133,919	1,088,295
Investment fees	(103,023)	(14,456)	(117,479)
Total	<u>\$ 1,884,566</u>	<u>\$ 264,445</u>	<u>\$ 2,149,011</u>

Note 5 - Split-interest Agreements

The Institute administers two types of split-interest agreements:

Charitable remainder trusts provide for the payment of distributions to the grantor or other designated beneficiaries over the trust's term (usually the designated beneficiary's lifetime). At the end of the trust's term, the remaining assets are available for the Institute's use. The portion of the trust attributable to the present value of the future benefits to be received by the Institute is recorded in the statement of activities as a temporarily restricted contribution in the period the trust is established. Assets held in the charitable remainder trusts are reported at fair market value in the Institute's statement of financial position. On an annual basis, the Institute revalues the liability for future distributions to the designated beneficiaries based on actuarial assumptions. The present value of the estimated future payments is calculated using a discount rate of 10% and applicable mortality tables.

Pooled income funds are arrangements whereby many donors' life income gifts are invested and pooled together, and each donor is assigned a relative number of units in the pool. Contribution revenue has been recorded at the fair value of the assets received, discounted at 10% for the estimated time period until each donor's death. The difference between the fair value of the assets received and the revenue recognized as a contribution is recorded as deferred revenue – pooled income fund, representing the amount of discount for future interest. Until a donor's death, the donor is paid the actual income earned on the donor's units in the pooled income fund. Upon a donor's death, the value of the donor's units reverts to the Institute.

Note 6 - Facilities and Equipment

Facilities and Equipment consists of the following:

	<u>2004</u>	<u>2003</u>
Building	\$38,262,544	\$38,152,543
Furniture and equipment	9,663,276	9,115,016
Construction in progress	93,112	284,912
	<u>48,018,932</u>	<u>47,552,471</u>
Less accumulated depreciation	23,153,978	21,015,333
	<u>\$24,864,954</u>	<u>\$26,537,138</u>

HOUSE EAR INSTITUTE
NOTES TO FINANCIAL STATEMENTS
JUNE 30, 2004

Note 7 - Bonds Payable

On May 20, 1993, the Institute issued \$17,685,000 in 1993 Series A Tri-modal Variable Rate Revenue Refunding Certificates of Participation (the Bonds). Proceeds from the Bonds were used to fund the redemption of the Institute's 1988 Series A Insured Health Facility Revenue Bonds, accrued interest thereon, and costs associated with their redemption and the issuance of the new Bonds. The Institute has a letter of credit to guarantee payment of the Bonds in the event of default. The letter of credit is unsecured.

Costs related to the redemption of the old bonds and to the underwriting and issuance of the new bonds have been capitalized and are amortized over the remaining term of the Bonds.

The Bonds carry a variable interest rate, as determined by the remarketing agent on a daily basis until converted to either a weekly variable rate or a fixed rate, at the option of the Institute (subject to certain restrictions). Interest is payable quarterly on March 1, June 1, September 1, and December 1. In addition to the mandatory redemption requirements shown below, the Institute has an early redemption option during any period where the daily or weekly variable rate applies at a price equal to 100% of the Bonds' face value, or during a period where a fixed rate applies at a price not in excess of 102%. The Bonds mature no later than December 1, 2018.

The Bonds are subject to mandatory redemption prior to their stated maturity, on December 1 each year, as follows:

2004	\$ 520,000
2005	555,000
2006	590,000
2007	625,000
2008	665,000
Thereafter, through 2018	<u>10,740,000</u>
	<u><u>\$13,695,000</u></u>

Interest expense incurred in connection with these bonds for the years ended June 30, 2004 and 2003, was \$130,203 and \$174,359, respectively. The effective variable interest rate at June 30, 2004 and 2003 was 1.08% and 1.00%, respectively.

**HOUSE EAR INSTITUTE
NOTES TO FINANCIAL STATEMENTS
JUNE 30, 2004**

Note 8 - Note Payable

The Institute has a promissory note, which is payable in monthly installments of \$21,191 including interest at the banks reference rate plus .25%, due on demand.

If no demand is made, it is due March 15, 2006. Assuming no demand is made, minimum payments are as follows:

2005		\$ 184,044
2006		1,250,012
		\$ 1,434,056

Note 9 - Employee Annuity Plan

The Institute has an employee annuity plan which covers employees with one year of service and who work at least 30 hours per week. The Institute contributes 3% of each employee's eligible salary, and makes matching contributions up to fifty cents for every one dollar an eligible employee contributes. The Institute's total contribution will not exceed 5% for each employee. Employer contributions for the years ended June 30, 2004 and 2003 were \$428,754 and \$396,843, respectively.

Note 10 - Deferred Compensation Plan

The Institute established a deferred compensation plan covering management or other highly compensated employees as defined by ERISA and chosen by the compensation committee of the Board of Directors. The Board of Directors determines the amount of the employer's contribution annually. The employer contributions for the year ended June 30, 2004 and 2003 were \$104,982 and \$46,687, respectively.

Note 11 - Building Operations

The Institute's medical and research facility is comprised of a total of 108,109 square feet. The Institute occupies approximately 73% of the building. The portion of the facility not occupied by the Institute is leased to various medical practitioners, including the House Ear Clinic. All leased space is rented at prevailing market rates. The majority of the lease arrangements are for five-year years with options to renew at the discretion of the Institute, thereby allowing flexibility for growth for the Institute. Future minimum lease payments are as follows:

<u>Years ending June 30,</u>		
2005		\$ 575,470
2006		536,605
2007		514,335
2008		514,335
2009		514,335

HOUSE EAR INSTITUTE
NOTES TO FINANCIAL STATEMENTS
JUNE 30, 2004

Note 12 - Related-Party Transactions

The Institute leases the land on which the medical and research facility is located from St. Vincent Medical Center for \$1 for a 99-year term ending December 31, 2085. Management cannot readily determine the annual fair value of this ground lease, therefore, it is not reflected in the accompanying financial statements.

The House Ear Clinic (the Clinic), an organization of ear specialists in private practice, provides to the Institute (at no cost) patient histories and patient volunteers with specific auditory problems. Drs. John House, Derald Brackmann and Antonio De La Cruz, who are stockholders of the Clinic, are also members of the Institute's Board of Trustees and, with other members of the Clinic, provide the Institute with research, education and fundraising assistance.

During the years ended June 30, 2004 and 2003, the Institute received rental income from the Clinic of \$572,227 and \$427,152, respectively. In addition, at June 30, 2004, the Clinic owed the Institute \$51,937 for current tenant costs. The clinic owed the Institute \$2,410 at June 30, 2003.

One member of the Institute's Board of Trustees currently serves as a principal with a firm providing investment advisory services to the Institute. During the years ended June 30, 2004 and 2003, fees paid to the firm for services provided were \$54,869 and \$79,784, respectively. Another member of the Board of Trustees has acted as a broker in placing various insurance policies; commissions earned from the insurance carriers are not determinable.

ADDITIONAL INFORMATION



HENSIEK & CARON

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BARRY B. HENSIEK, CPA
SUSAN E. CARON, CPA

INDEPENDENT AUDITOR'S REPORT ON ADDITIONAL INFORMATION

To the Board of Directors
House Ear Institute

Our audits of the preceding basic financial statements were made to form an opinion on the basic financial statements taken as a whole. The accompanying schedules of changes in net assets and expenditures of federal awards are presented for purposes of additional analysis and are not a required part of the basic financial statements. Such information has been subjected to the auditing procedures applied in the audits of the basic financial statements and, in our opinion, is fairly stated in all material respects in relation to the basic financial statements taken as a whole.

Hensiek & Caron

September 22, 2004

HOUSE EAR INSTITUTE
SCHEDULE OF CHANGES IN NET ASSETS
FOR THE YEAR ENDED JUNE 30, 2004

	2003	Donations Income and Transfers	Expenditures and Transfers	2004
Unrestricted Net Assets - Board Designated				
Adrienne Wood Memorial	\$ 1,500,000	\$ -	\$ -	\$ 1,500,000
Bond retirement	9,571,023	-	(199,001)	9,372,022
Total Unrestricted Net Assets - Board Designated	\$ 11,071,023	\$ -	\$ (199,001)	\$ 10,872,022
Permanently Restricted Net Assets				
Clair Kos	\$ 54,026	\$ 5,189	\$ (5,189)	\$ 54,026
HPH Chair	1,590,886	152,788	(152,788)	1,590,886
General	1,411,902	328,744	(144,448)	1,596,198
Rupley Fellowship	250,000	24,010	(24,010)	250,000
Library	376,561	36,165	(36,165)	376,561
Electron microscope	500,000	48,020	(48,020)	500,000
Kenneth & Charity Ritter	82,500	7,923	(7,923)	82,500
Permanent capital	2,312,872	222,127	(222,127)	2,312,872
J House	27,598	2,650	(2,650)	27,598
CC Levine Research	1,502,127	144,264	(144,264)	1,502,127
CARE Center	50,000	4,802	(4,802)	50,000
LEID	1,000,000	96,039	(96,039)	1,000,000
Hearst Lab Internship	300,000	238,416	(38,416)	500,000
Lied Children's Center	1,000,000	96,039	(96,039)	1,000,000
Kenneth & Charity Ritter	165,000	26,255	(16,323)	174,932
William Slattery	10,000	480	(10,480)	-
McLoraine	1,000,000	96,039	(96,039)	1,000,000
Capital Campaign 2004-Endowment	-	408,553	(18,720)	389,833
Jack H Skirball Center for Emerging Research	-	515,027	(23,598)	491,429
Elliott & Eleanor Taylor Fund	-	262,005	(12,005)	250,000
Caruso Endowment	119,710	11,497	(11,497)	119,710
Total Permanently Restricted Net Assets	\$ 11,753,182	\$ 2,727,032	\$ (1,211,542)	\$ 13,268,672

HOUSE EAR INSTITUTE
SCHEDULE OF CHANGES IN NET ASSETS
FOR THE YEAR ENDED JUNE 30, 2004
(Continued)

	2003	Donations Income and Transfers	Expenditures and Transfers	2004
Temporarily Restricted Net Assets				
Online Hearing Screening Tests	\$ 1,749	\$ -	\$ (188)	\$ 1,561
Support for clinical fellows-Care Center	-	25,000	-	25,000
Ahmanson Imaging Equipment	8,885	-	-	8,885
Guenther Foundation	142,831	-	-	142,831
Otitis Media Conference	-	10,000	(59)	9,941
Bundy Foundation	118,115	-	-	118,115
Taper Foundation-Children's Program	142,601	-	(132,085)	10,516
Western Lion's Fund	1,159	1,590	(2,240)	509
Caruso (Genetic Hearing Loss)	359,779	11,497	-	371,276
SELDI Equipment	-	161,650	(161,650)	-
Advanced Imaging Facility Fund	-	74,027	-	74,027
Levine - NF2 Research	-	1,201,391	-	1,201,391
Microscope Upkeep	142,138	48,020	(6,296)	183,862
General - Time Restricted	818,344	-	-	818,344
Research Initiative	193,716	15,250	(2,344)	206,622
Rupley Fellows	17,458	24,010	-	41,468
Hearst Lab Interns	17,478	38,416	(22,530)	33,364
Quota Fellows	12,099	-	-	12,099
MIS Digital Imaging	40,088	-	(40,088)	-
Unitrusts & Pooled Income Funds	825,990	-	-	825,990
Jameson Laboratory Fund	3,400	-	-	3,400
Educational Grants	12,700	1,500	-	14,200
Herklotz-Education/Outreach	245,797	-	-	245,797
Building Fund	3,305,876	294,952	(1,129,917)	2,470,911
Graziadio Education/Outreach Program	278,766	-	-	278,766
CARE Operations	142,510	693,090	(543,397)	292,203
CMB Research	-	418,714	(418,714)	-
Family Camp	-	20,790	(20,790)	-
Sound Partners	51,228	50,050	(70,437)	30,841
HEI-TR-Meniere's Disease (Linthicum)	-	1,000	-	1,000
Care Clinic Research	20,000	-	-	20,000
Jan Doak Building Fund	295,593	-	-	295,593
David Lim Fund	4,000	-	-	4,000
Howard House Clinical Studies Lab	138,849	66,457	-	205,306
Ritter Endowment Earnings	8,563	24,247	-	32,810
William Slattery Endowment Earnings	259	42,480	-	42,739
McLoraine Endowment Earnings	25,949	96,039	-	121,988
Hearing Aid Research Fund	750	3,222	-	3,972
Audiovisual Department Fund	4,420	-	-	4,420
Cochlear Implant Fund	3,750	-	-	3,750
Capital Campaign 2004-Building	-	389,833	-	389,833
General Research Fund	61,225	32,500	-	93,725
Jack H Skirball Center for Emerging Research	-	1,515,027	-	1,515,027
Underwriter Fund	26,000	30,000	-	56,000
Public Forum Fund, May 2003	7,000	-	-	7,000
Elliott & Eleanor Taylor Fund	-	439,206	(88,453)	350,753
Egyptian Cultural & Education Bureau	5,157	-	(5,157)	-
Total Temporarily Restricted Net Assets	\$ 7,484,222	\$ 5,729,958	\$ (2,644,345)	\$ 10,569,835

**HOUSE EAR INSTITUTE
SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS
FOR THE YEAR ENDED JUNE 30, 2004**

HEI Project Number	Federal Grantor/Pass-through Grantor Program Title	Federal Catalog Number	Agency or Pass- through Number	Contract Period	Expenditures
527	Department of Defense	12.420	DAMD 17-99-1-9491	10/01/99 - 09/30/04	\$ 158,863
569	Department of Defense	12.420	DAMD 17-01-1-0710	01/01/02 - 12/31/04	681,017
506	National Science Foundation	47.075	IIS-9996088	10/15/98 - 09/30/04	191,798
534	National Science Foundation	47.075	BCS-0083865	09/15/00 - 08/31/03	12,811
761	National Science Foundation	47.075	BCS-0214224	08/01/02 - 07/31/04	76,147
786	National Science Foundation	47.070	0312434	07/15/03 - 06/30/06	22,989
790	National Science Foundation	NA	BCS-0350764	08/18/03 - 08/17/05	146,208
Pass-through from National Institute of Health					
501	National Institutes of Health	93.173	RO1 DC003552	08/01/98 - 06/30/06	212,806
524	National Institutes of Health	93.173	RO1 DC004189	08/01/99 - 07/31/04	280,971
528	National Institutes of Health	93.173	RO1 DC04061	09/01/99 - 08/31/04	354,732
529	National Institutes of Health	93.173	RO1 DC03592	04/01/00 - 03/31/04	127,011
532	National Institutes of Health	93.173	RO1 DC04562	07/01/00 - 06/30/05	268,539
538	National Institutes of Health	93.173	RO1 DC04675	03/01/01 - 02/28/06	259,162
539	National Institutes of Health	93.173	RO1 DC04709	01/15/01 - 12/31/05	109,063
555	National Institutes of Health	93.173	RO1 DC04993	07/01/01 - 05/31/06	264,044
556	National Institutes of Health	93.173	RO1 DC05025	09/01/01 - 08/31/04	225,457
558	National Institutes of Health	93.173	F32 DC05282	09/01/01 - 08/31/05	46,554
559	National Institutes of Health	93.173	RO1 DC04796	09/28/01 - 08/31/06	354,807
560	National Institutes of Health	93.176	RO3 DC04759	02/09/01 - 01/31/04	56,769
572	National Institutes of Health	93.173	RO1 DC04856	05/01/01 - 04/30/06	229,260
574	National Institutes of Health	93.173	R21DC04876	05/01/01 - 04/30/04	49,324
597	National Institutes of Health	93.173	RO1 DC04792	05/01/01 - 04/30/06	294,101
701	National Institutes of Health	93.173	U13 DC006653	04/01/04 - 03/31/05	114
750	National Institutes of Health	93.173	RO3 DC05566	03/01/02 - 02/28/05	75,318
751	National Institutes of Health	93.173	RO1 DC04786	04/01/02 - 03/31/07	204,350
753	National Institutes of Health	93.173	RO1 DC01526	04/15/02 - 03/31/07	256,303
758	National Institutes of Health	93.173	RO1 DC05220	07/01/02 - 06/30/05	317,410
759	National Institutes of Health	93.173	RO3 DC05335	07/05/02 - 06/30/05	75,940
762	National Institutes of Health	93.173	RO1 DC05213	08/01/02 - 06/30/07	114,024
763	National Institutes of Health	93.173	RO1 DC05843	09/20/02 - 08/31/07	462,094
767	National Institutes of Health	93.173	F32 DC006154	01/01/03 - 12/31/05	20,360
773	National Institutes of Health	93.838	RO1 HL070293	04/01/03 - 03/31/07	267,902
774	National Institutes of Health	93.173	R21 DC006139	04/01/03 - 03/31/05	136,758
778	National Institutes of Health	93.173	RO1 DC006185	05/15/03 - 04/30/07	202,699
780	National Institutes of Health	93.173	R13 DC006256	08/01/03 - 07/31/04	29,898
785	National Institutes of Health	93.173	RO1 DC006238	07/15/03 - 06/30/08	195,414
787	National Institutes of Health	93.173	R21 DC006035	07/18/03 - 06/30/05	42,527
788	National Institutes of Health	93.173	P30 DC006276	08/01/03 - 05/31/08	47,116
789	National Institutes of Health	93.173	P30 DC006276	08/01/03 - 05/31/08	66,904
Pass-through from Huntington Medical Research Institutes - A Cochlear					
557	Nucleus Auditory Prosthesis Based on Microstimulation	93.173	N01-DC-1-2105	06/30/01 - 06/29/04	109,577
Pass-through from Biologic Systems Corp. - Screening Devise for Detecting					
568	Small Acoustic Tumors	93.173	R44 DC04141	09/20/01 - 08/31/04	93,568
Pass-through from University of California at Los Angeles - Auditory					
599	Development in Early Amplified Children	93.173	1712GCB979	01/01/02 - 08/31/05	157,441
Pass-through from Indiana University - Comparison of Sensory Aids in Deaf					
634	Children	93.173	RO1 DC000064	04/01/01 - 03/31/05	28,990
Pass-through from Johns Hopkins University - Childhood Development after					
754	Cochlear Implantation	93.173	8206 00394	05/01/02 - 04/30/07	194,803
Pass-through from Massachusetts General Hospital - Genotype Phenotype					
769	Relationship in Neurofibromatosis 2	93.853	RO1 NS40527	09/20/02 - 07/31/06	32,946
Pass-through from Jackson Laboratory - Genetics of Age Related Hearing					
779	Loss	93.173	RO1 DC005827	05/05/03 - 04/30/06	38,151
Pass-through from Advanced Bionics Corp. - Binaural Assessment Instrument					
791	for Cochlear Implants	93.173	R43 DC005759	09/15/03 - 09/14/04	50,928
752	Veterans Administration		M020822401	08/21/02 - 07/31/03	1,656
					<u>\$ 7,645,621</u>

**HOUSE EAR INSTITUTE
NOTES TO THE SCHEDULE OF FEDERAL FINANCIAL ASSISTANCE
FOR THE YEAR ENDED JUNE 30, 2004**

Note 1 - Significant Accounting Policies

Basis of Presentation

The accompanying Schedule of Federal Financial Assistance includes all federal grants to House Ear Institute (Institute) which had activity during fiscal 2004. The schedule has been prepared on the accrual basis of accounting. Grant revenues are recorded for financial reporting purposes when the Institute has met the qualifications for the respective grants.

Note 2 - Scope of the Audit Pursuant to OMB Circular A-133

All federal grant operations of the Institute are included in the scope of the Circular A-133 audit (Single Audit). The Single Audit was performed in accordance with the provisions of the Office of Management and Budget's Compliance Supplement for Audits of Institutions of Higher Learning and Other Nonprofit Institutions. Compliance testing of all general requirements, as described in the Compliance Supplement, was performed for the Institute.

Note 3 - Reconciliation of Schedule of Federal Assistance

The Institute is currently receiving several grants through other nonprofit organizations as a subrecipient. These grants are not included in the Schedule of Federal Financial Assistance. Below is the reconciliation of the reportable Schedule of Financial Assistance to the Institute's audited financial statements.

Total Grant Expenditures per Schedule of Federal Financial Assistance	\$ 7,645,621
Other Grants	
National Organization for Hearing Research Foundation	170,847
Medical Research Products	154,687
Cochlear Americans	80,000
Cochlear Corp.	18,000
Deafness Research Foundation	21,452
Entific	22,250
Advance Bionics	15,515
Canadian Coast Guard/University of Ottawa	35,444
Miscellaneous consulting	<u>28,402</u>
Total Grants and Contracts Revenue per Audited Financial Statements	<u><u>\$ 8,192,218</u></u>

SINGLE AUDIT



**REPORT ON COMPLIANCE AND ON INTERNAL CONTROL OVER FINANCIAL
REPORTING BASED ON AN AUDIT OF FINANCIAL STATEMENTS PERFORMED
IN ACCORDANCE WITH GOVERNMENT AUDITING STANDARDS**

To the Board of Directors
House Ear Institute

We have audited the financial statements of House Ear Institute as of and for the year ended June 30, 2004, and have issued our report thereon dated September 22, 2004. We conducted our audit in accordance with generally accepted auditing standards and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

Compliance

As part of obtaining reasonable assurance about whether the House Ear Institute's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts and grants, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit and, accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance that are required to be reported under *Government Auditing Standards*.

Internal Control Over Financial Reporting

In planning and performing our audit, we considered the House Ear Institute's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide assurance on the internal control over financial reporting. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control over financial reporting that might be material weaknesses. A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We noted no matters involving the internal control over financial reporting and its operation that we consider to be material weaknesses.

This report is intended for the information of the audit committee, management, federal awarding agencies and pass-through entities. However, this report is a matter of public record and its distribution is not limited.

September 22, 2004



**REPORT ON COMPLIANCE WITH REQUIREMENTS APPLICABLE TO EACH
MAJOR PROGRAM AND INTERNAL CONTROL OVER COMPLIANCE IN
ACCORDANCE WITH OMB CIRCULAR A-133**

To the Board of Directors
House Ear Institute

Compliance

We have audited the compliance of House Ear Institute with the types of compliance requirements described in the *U.S. Office of Management and Budget (OMB) Circular A-133 Compliance Supplement* that are applicable to each of its major federal programs for the year ended June 30, 2004. House Ear Institute's major federal programs are identified in the summary of auditor's results section of the accompanying schedule of findings and questioned costs. Compliance with the requirements of laws, regulations, contracts and grants applicable to each of its major federal programs is the responsibility of House Ear Institute's management. Our responsibility is to express an opinion on House Ear Institute's compliance based on our audit.

We conducted our audit of compliance in accordance with U. S. generally accepted auditing standards; the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; and OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*. Those standards and OMB Circular A-133 require that we plan and perform the audit to obtain reasonable assurance about whether noncompliance with the types of compliance requirements referred to above that could have a direct and material effect on a major federal program occurred. An audit includes examining, on a test basis, evidence about House Ear Institute's compliance with those requirements and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion. Our audit does not provide a legal determination on House Ear Institute's compliance with those requirements.

In our opinion, House Ear Institute complied, in all material respects, with the requirements referred to above that are applicable to each of its major federal programs for the year ended June 30, 2004.

Internal Control Over Compliance

The management of House Ear Institute is responsible for establishing and maintaining effective internal control over compliance with requirements of laws, regulations, contracts and grants applicable to federal programs. In planning and performing our audit, we considered House Ear Institute's internal control over compliance with requirements that could have a direct and material effect on a major federal program in order to determine our auditing procedures for the purpose of expressing our opinion on compliance and to test and report on internal control over compliance in accordance with OMB Circular A-133.

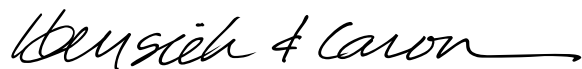
Our consideration of the internal control over compliance would not necessarily disclose all matters in the internal control that might be material weaknesses. A material weakness is a condition in which the

design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that noncompliance with applicable requirements of laws, regulations, contracts and grants that would be material in relation to a major federal program being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We noted no matters involving the internal control over compliance and its operation that we consider to be material weaknesses.

Schedule of Expenditures of State and Federal Awards

We have audited the basic financial statements of House Ear Institute as of and for the year ended June 30, 2004, and have issued our report thereon dated September 22, 2004. Our audit was performed for the purpose of forming an opinion on the basic financial statements taken as a whole. The accompanying Schedule of Expenditures of State and Federal Awards is presented for purposes of additional analysis as required by OMB Circular A-133 and is not a required part of the basic financial statements. Such information has been subjected to the auditing procedures applied in the audit of the basic financial statements and, in our opinion, is fairly stated, in all material respects, in relation to the basic financial statements taken as a whole.

This report is intended for the information of the audit committee, management, federal awarding agencies and pass-through entities. However, this report is a matter of public record and its distribution is not limited.



September 22, 2004

**HOUSE EAR INSTITUTE
STATUS OF FINDINGS AND QUESTIONED COSTS
JUNE 30, 2004**

A. SUMMARY OF AUDIT RESULTS

1. The auditor's report expresses an unqualified opinion on the basic financial statements of the House Ear Institute
2. No reportable conditions were disclosed during the audit of the financial statements.
3. No instances of noncompliance material to the financial statements of House Ear Institute were disclosed during the audit.
4. The auditor's report on compliance for the major federal award programs for House Ear Institute expresses an unqualified opinion.
5. The programs tested as major programs included:

<u>Name of Program</u>	<u>CFDA Number</u>
Department of Defense	12.420
National Science Foundation	47.075
Research and Development Cluster	93.173

6. The threshold for distinguishing type A and B programs was \$300,000.
7. House Ear Institute was determined to be a high-risk auditee.

B. FINDINGS – FINANCIAL STATEMENTS AUDIT

None

C. FINDINGS AND QUESTIONED COSTS – MAJOR FEDERAL AWARD PROGRAMS AUDIT

None

**HOUSE EAR INSTITUTE
SCHEDULE OF PRIOR YEAR FINDINGS AND QUESTIONED COSTS
FOR THE YEAR ENDED JUNE 30, 2004**

**1. PRIOR YEAR FINDINGS AND QUESTIONED COSTS – MAJOR FEDERAL AWARD
PROGRAMS AUDIT**

None