

Financial Statements

HOUSE EAR INSTITUTE

June 30, 2005



HENSIEK & CARON

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INDEPENDENT AUDITOR'S REPORT

To The Board of Directors
House Ear Institute

We have audited the accompanying statements of financial position of House Ear Institute (a nonprofit corporation) as of June 30, 2005 and 2004, and the related statements of activities, changes in net assets, cash flows, and functional expenses for the years 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 audits 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 audits provide 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, 2005 and 2004, and the changes in its net assets and its cash flows for the years then ended, in conformity with U.S. generally accepted accounting principles.

In accordance with *Government Auditing Standards*, we have also issued a report dated October 3, 2005, 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.

October 3, 2005

HOUSE EAR INSTITUTE
STATEMENTS OF FINANCIAL POSITION
JUNE 30, 2005

ASSETS

	2005	2004
Cash, including restricted amounts of \$898,169 in 2005 and \$1,463,455 in 2004	\$ 2,692,748	\$ 3,305,437
Bequests and other donations receivable	686,749	3,189,117
Accounts receivable, net of allowance for uncollectible accounts of \$231,481 in 2005 and \$602,121 in 2004	1,103,623	1,212,293
Educational and research supplies	91,877	97,913
Prepaid expenses and other assets	42,811	46,426
Pledges receivable, net of allowance for uncollectible pledges of \$0 in 2005 and \$6,550 in 2004	9,298,664	3,881,546
Notes receivable	97,177	140,083
Investments	35,220,770	32,397,846
Assets of split-interest agreements	2,376,922	2,451,342
Patent development costs	167,766	138,211
Patent costs, net of accumulated amortization of \$54,217 in 2005 and \$46,218 in 2004	81,494	89,493
Deferred bond costs, net of accumulated amortization of \$458,914 in 2005 and \$442,711 in 2004	218,741	234,944
Facilities and equipment, at cost, net	24,956,437	24,864,954
Total Assets	\$ 77,035,779	\$ 72,049,605

LIABILITIES AND NET ASSETS

Accounts payable and accrued expenses	\$ 1,311,798	\$ 1,208,235
Accrued interest payable	30,064	14,059
Note payable	1,252,454	1,434,056
Deferred revenue	1,251,631	1,754,651
Liability to beneficiaries under split-interest agreements	1,161,647	1,110,842
Deferred revenue - pooled income fund	58,592	62,658
Bonds payable	13,175,000	13,695,000
Deferred compensation plan	-	373,077
Total Liabilities	18,241,186	19,652,578
Unrestricted Net Assets		
Undesignated fund	13,871,229	17,686,498
Designated by Board of Trustees:		
Adrian Wood Memorial	1,500,000	1,500,000
Bond Retirement	9,749,297	9,372,022
Total Unrestricted Net Assets	25,120,526	28,558,520
Temporarily Restricted Net Assets	19,201,223	10,569,835
Permanently Restricted Net Assets	14,472,844	13,268,672
Total Net Assets	58,794,593	52,397,027
Total Liabilities and Net Assets	\$ 77,035,779	\$ 72,049,605

HOUSE EAR INSTITUTE
STATEMENTS OF ACTIVITIES
FOR THE YEAR ENDED JUNE 30, 2005
WITH SUMMARIZED INFORMATION FOR THE YEAR ENDED JUNE 30, 2004

	2005			2004	
	Unrestricted	Temporarily Restricted	Permanently Restricted	Total	Total
Public Support and Revenue					
Contributions	\$ 2,382,480	\$ 15,763,971	\$ 1,204,172	\$ 19,350,623	\$ 11,430,461
Grants and contracts - direct	4,727,345	-	-	4,727,345	5,550,698
Grants and contracts - indirect	2,174,800	-	-	2,174,800	2,641,520
Special events	149,075	378,685	-	527,760	-
Educational courses	94,525	-	-	94,525	109,442
Investment returns, net	1,118,112	298,037	-	1,416,149	2,062,046
Building operations	574,348	-	-	574,348	717,389
Clinical services	907,538	-	-	907,538	859,550
Royalties	282,524	-	-	282,524	284,315
Other	139,255	-	-	139,255	174,901
Change in value of split-interest agreements	-	(177,679)	-	(177,679)	151,800
Net assets released from restrictions	7,631,626	(7,631,626)	-	-	-
Total Public Support and Revenue	<u>20,181,628</u>	<u>8,631,388</u>	<u>1,204,172</u>	<u>30,017,188</u>	<u>23,982,122</u>
Expenses					
Program Services					
Research	13,319,322	-	-	13,319,322	13,405,198
Education	872,258	-	-	872,258	567,205
Total Program Services	<u>14,191,580</u>	<u>-</u>	<u>-</u>	<u>14,191,580</u>	<u>13,972,403</u>
Supporting Services					
Management and general	7,549,710	-	-	7,549,710	6,735,728
Fund raising	1,405,085	-	-	1,405,085	1,267,718
Total Supporting Services	<u>8,954,795</u>	<u>-</u>	<u>-</u>	<u>8,954,795</u>	<u>8,003,446</u>
Total Expenses Before Debt Service Costs	<u>23,146,375</u>	<u>-</u>	<u>-</u>	<u>23,146,375</u>	<u>21,975,849</u>
Change in Net Assets Before Debt Service Costs	(2,964,747)	8,631,388	1,204,172	6,870,813	2,006,273
Debt Service Costs	<u>473,247</u>	<u>-</u>	<u>-</u>	<u>473,247</u>	<u>348,261</u>
Change in Net Assets	<u>\$ (3,437,994)</u>	<u>\$ 8,631,388</u>	<u>\$ 1,204,172</u>	<u>\$ 6,397,566</u>	<u>\$ 1,658,012</u>

**HOUSE EAR INSTITUTE
STATEMENTS OF CHANGES IN NET ASSETS
FOR THE YEAR ENDED JUNE 30, 2005**

	<u>Unrestricted</u>	<u>Temporarily Restricted</u>	<u>Permanently Restricted</u>	<u>Total</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	28,558,520	10,569,835	13,268,672	52,397,027
Change in Net Assets	<u>(3,437,994)</u>	<u>8,631,388</u>	<u>1,204,172</u>	<u>6,397,566</u>
Net Assets, June 30, 2005	<u>\$ 25,120,526</u>	<u>\$ 19,201,223</u>	<u>\$14,472,844</u>	<u>\$ 58,794,593</u>

**HOUSE EAR INSTITUTE
STATEMENTS OF CASH FLOWS
FOR THE YEAR ENDED JUNE 30, 2005**

	<u>2005</u>	<u>2004</u>
Cash Flows from Operating Activities		
Cash received from service recipients	\$ 7,890,152	\$ 10,286,765
Cash received from donors	15,698,489	7,651,398
Cash received from building operations, net	620,286	717,389
Cash paid to suppliers and employees	(21,124,935)	(19,489,451)
Interest and dividends received	766,034	1,060,699
Interest and other debt service costs paid	(457,242)	(350,786)
	<u>3,392,784</u>	<u>(123,986)</u>
Net Cash Provided by (Used in) Operating Activities		
Cash Flows from Investing Activities		
Additions to facilities and equipment	(2,502,772)	(736,665)
Patent costs	(29,555)	(24,183)
Purchases of investments	(28,988,674)	(11,710,325)
Proceeds from sale of investments	26,970,052	11,747,244
Loans made	-	(1,000)
Collections on loans	42,906	53,191
	<u>(4,508,043)</u>	<u>(671,738)</u>
Net Cash Used in Investing Activities		
Cash Flows from Financing Activities		
Proceeds from donations and investment earnings restricted for:		
Endowment	1,204,172	1,870,442
Redemption of bonds	(520,000)	(485,000)
Payments on line of credit, net	(181,602)	(187,757)
	<u>502,570</u>	<u>1,197,685</u>
Net Cash Provided by Financing Activities		
Net (Decrease) Increase in Cash	(612,689)	401,961
Cash, Beginning	<u>3,305,437</u>	<u>2,903,476</u>
Cash, Ending	<u>\$ 2,692,748</u>	<u>\$ 3,305,437</u>

HOUSE EAR INSTITUTE
STATEMENTS OF CASH FLOWS
FOR THE YEAR ENDED JUNE 30, 2005
(Continued)

	2005	2004
Reconciliation of the Change in Net Assets		
To Net Cash Provided by (Used in) Operating Activities		
Change in Net Assets	\$ 6,397,566	\$ 1,658,012
Adjustments to reconcile the change in net assets to net cash provided by (used in) operating activities		
Change in allowance for uncollectible accounts	(370,640)	113,430
Change in present value of pledges receivable	(302,118)	524,758
Depreciation and amortization	2,330,208	2,316,828
Loss on disposal of fixed assets	105,276	115,786
Realized and unrealized gains on investments	(804,296)	(1,084,875)
Change in value of split-interest agreements	121,159	(20,161)
Cash surrender value of life insurance	-	60,456
Donations of noncash assets	-	(7,563)
(Increase) Decrease in:		
Donations receivable	2,497,916	86,778
Accounts receivable	483,763	(7,090)
Educational and research supplies	6,036	2,563
Pledges receivable	(5,115,000)	(2,637,144)
Prepaid expenses and other assets	3,615	11,742
Increase (Decrease) in:		
Accounts payable and accrued expenses	103,563	(53,035)
Accrued bond interest payable	16,005	(2,525)
Other deferred revenue	(503,020)	550,346
Deferred compensation plan	(373,077)	118,150
Donations restricted for long-term purposes:		
Cash donations	(1,204,172)	(1,870,442)
 Net Cash Provided by (Used in) Operating Activities	 \$ 3,392,784	 \$ (123,986)

HOUSE EAR INSTITUTE
STATEMENTS OF FUNCTIONAL EXPENSES
FOR THE YEARS ENDED JUNE 30, 2005
WITH SUMMARIZED INFORMATION FOR JUNE 30, 2004

	2005						2004	
	Program Services			Supporting Services			Total Expenses	
	Research	Education	Total	Management and General	Fund Raising	Total		
Salaries and wages	\$ 6,934,895	\$ 308,131	\$ 7,243,026	\$ 3,247,309	\$ 640,331	\$ 3,887,640	\$ 11,130,666	\$ 10,970,053
Taxes and employee benefits	1,513,167	67,173	1,580,340	815,359	139,592	954,951	2,535,291	2,409,383
Total Personnel Costs	8,448,062	375,304	8,823,366	4,062,668	779,923	4,842,591	13,665,957	13,379,436
Professional fees and contract service payments	903,569	170,204	1,073,773	541,089	224,698	765,787	1,839,560	1,547,890
Occupancy and related expenses	302,219	2,769	304,988	1,166,735	5,760	1,172,495	1,477,483	1,471,434
Travel, conferences, conventions and meetings	201,501	41,717	243,218	489,289	19,322	508,611	751,829	384,345
Special supplies and services	809,593	83,548	893,141	75,541	6,881	82,422	975,563	1,118,261
Cost of goods sold	361,592	2,829	364,421	-	-	-	364,421	308,321
Minor equipment and equipment maintenance	118,061	2,498	120,559	124,886	6,861	131,747	252,306	258,544
Office supplies and services	446,289	146,865	593,154	639,442	280,655	920,097	1,513,251	1,214,553
Total Expenses Before Depreciation	11,590,886	825,734	12,416,620	7,099,650	1,324,100	8,423,750	20,840,370	19,682,784
Depreciation - building	962,970	36,077	999,047	319,950	37,298	357,248	1,356,295	1,336,438
Depreciation - equipment and furniture	765,466	10,447	775,913	130,110	43,687	173,797	949,710	956,627
Total Expenses Before Debt Service Costs	<u>\$ 13,319,322</u>	<u>\$ 872,258</u>	<u>\$ 14,191,580</u>	<u>\$ 7,549,710</u>	<u>\$ 1,405,085</u>	<u>\$ 8,954,795</u>	<u>\$ 23,146,375</u>	<u>\$ 21,975,849</u>

The accompanying notes are an integral part of these statements.

HOUSE EAR INSTITUTE
NOTES TO FINANCIAL STATEMENTS
JUNE 30, 2005

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, 2005

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	3 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, 2004.

HOUSE EAR INSTITUTE
NOTES TO FINANCIAL STATEMENTS
JUNE 30, 2005

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, 2005, the Institute's uninsured cash balance totaled \$2,391,348.

Note 3 - Pledges Receivable

Unconditional promises to give consist of the following:

	<u>2005</u>	<u>2004</u>
Receivable in less than one year	\$ 4,595,333	\$ 1,877,550
Receivable in one to five years	4,964,819	2,574,152
Total unconditional promises to give	9,560,152	4,451,702
Less discounts to net present value	(261,488)	(563,606)
Less allowance for uncollectible promises	-	(6,550)
Net unconditional promises to give	<u>\$ 9,298,664</u>	<u>\$ 3,881,546</u>

HOUSE EAR INSTITUTE
NOTES TO FINANCIAL STATEMENTS
JUNE 30, 2005

Note 3 - Pledges Receivable (continued)

	<u>2005</u>	<u>2004</u>
Restricted for:		
Building construction, maintenance and debt reduction	\$ 7,112,574	\$ 548,861
Specific research projects	1,188,119	1,972,417
Endowment	929,355	904,652
Unrestricted	<u>68,616</u>	<u>455,616</u>
Total	<u>\$ 9,298,664</u>	<u>\$ 3,881,546</u>

Note 4 - Investments

As of June 30, 2005 and 2004, investments consist of the following:

<u>2005</u>	<u>Aggregate Fair Value</u>	<u>Cost</u>
Cash & cash equivalents	\$ 3,282,118	\$ 3,282,118
Corporate stocks	5,819,017	3,958,809
Corporate bonds	998,330	994,591
Mutual funds	13,380,108	12,750,399
United States Treasury bonds and notes	<u>11,741,197</u>	<u>7,346,992</u>
	<u>\$35,220,770</u>	<u>\$28,332,908</u>
<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 bonds and notes	<u>10,071,742</u>	<u>6,887,564</u>
	<u>\$32,397,846</u>	<u>\$25,822,967</u>

Investment returns are summarized as follows:

<u>2005</u>	<u>Unrestricted</u>	<u>Temporarily Restricted</u>	<u>Total</u>
Interest and dividends	\$ 605,695	\$ 161,451	\$ 767,146
Net realized and unrealized gains	634,149	169,035	803,184
Investment fees	<u>(121,732)</u>	<u>(32,449)</u>	<u>(154,181)</u>
Total	<u>\$ 1,118,112</u>	<u>\$ 298,037</u>	<u>\$ 1,416,419</u>

HOUSE EAR INSTITUTE
NOTES TO FINANCIAL STATEMENTS
JUNE 30, 2005

Note 4 - Investments (continued)

<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	(58,215)	(24,064)	(82,279)
Total	<u>\$ 1,458,965</u>	<u>\$ 603,081</u>	<u>\$ 2,062,046</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>2005</u>	<u>2004</u>
Building	\$39,156,055	\$38,262,544
Furniture and equipment	9,691,427	9,663,276
Construction in progress	1,276,540	93,112
	<u>50,124,022</u>	<u>48,018,932</u>
Less accumulated depreciation	25,167,585	23,153,978
	<u>\$24,956,437</u>	<u>\$24,864,954</u>

HOUSE EAR INSTITUTE
NOTES TO FINANCIAL STATEMENTS
JUNE 30, 2005

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:

2005	\$ 555,000
2006	590,000
2007	625,000
2008	665,000
2009	710,000
Thereafter, through 2018	<u>10,030,000</u>
	<u><u>\$13,175,000</u></u>

Interest expense incurred in connection with these bonds for the years ended June 30, 2005 and 2004, was \$236,967 and \$130,203, respectively. The effective variable interest rate at June 30, 2005 and 2004 was 2.23% and 1.08%, respectively.

HOUSE EAR INSTITUTE
NOTES TO FINANCIAL STATEMENTS
JUNE 30, 2005

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 or, if no demand is made, on March 15, 2006.

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 4% 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 8% for each employee. Employer contributions for the years ended June 30, 2005 and 2004 were \$546,425 and \$428,754, respectively.

Note 10 - Deferred Compensation Plan

The Institute has maintained a deferred compensation plan covering management and other highly compensated employees as defined by ERISA as selected by the compensation committee of the Board of Directors. The Board of Directors determines the amount of the employer's contribution annually. This plan was terminated during the year ended June 30, 2005; no employer contributions were made for the year. Employer contributions for the year ended June 30, 2004 were \$104,982.

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 lease arrangements expire from 2006 to 2010, and generally contain options to renew at the discretion of the Institute, thereby allowing flexibility for growth. Future minimum lease payments for the next five years are as follows:

<u>Years ending June 30,</u>	
2006	\$ 603,671
2007	580,585
2008	572,937
2009	600,297
2010	600,297

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.

HOUSE EAR INSTITUTE
NOTES TO FINANCIAL STATEMENTS
JUNE 30, 2005

Note 12 - Related-Party Transactions (continued)

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, 2005 and 2004, the Institute received rental income from the Clinic of \$514,335 and \$572,227, respectively. In addition, at June 30, 2005, the Clinic owed the Institute \$15,542 for current tenant costs. The clinic owed the Institute \$51,937 for such costs at June 30, 2004.

One member of the Institute's 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

October 3, 2005

HOUSE EAR INSTITUTE
SCHEDULE OF CHANGES IN NET ASSETS
FOR THE YEAR ENDED JUNE 30, 2005

	2004	Donations Income and Transfers	Expenditures and Transfers	2005
Unrestricted Net Assets - Board Designated				
Adrienne Wood Memorial	\$ 1,500,000	\$ -	\$ -	\$ 1,500,000
Bond retirement	9,372,022	377,275	-	9,749,297
Total Unrestricted Net Assets - Board Designated	\$ 10,872,022	\$ 377,275	\$ -	\$ 11,249,297
Permanently Restricted Net Assets				
Clair Kos	\$ 54,026	\$ -	\$ -	\$ 54,026
HPH Chair	1,590,886	-	-	1,590,886
General	1,329,520	54,468	-	1,383,988
Western Lion's	266,678	-	-	266,678
Rupley Fellowship	250,000	-	-	250,000
Library	376,561	-	-	376,561
Electron microscope	500,000	-	-	500,000
Kenneth & Charity Ritter	82,500	-	-	82,500
McLoraine permanent capital	2,312,872	-	-	2,312,872
J House	27,598	-	-	27,598
CC Levine Research	1,502,127	-	-	1,502,127
CARE Center	50,000	-	-	50,000
Lied	1,000,000	-	-	1,000,000
Hearst Lab Internship	500,000	-	-	500,000
Lied Children's Center	1,000,000	-	-	1,000,000
Kenneth & Charity Ritter	174,932	-	-	174,932
McLoraine	1,000,000	-	-	1,000,000
Capital Campaign 2004-Endowment	389,833	110,167	(20,644)	479,356
Jack H Skirball Center for Emerging Research	491,429	8,571	-	500,000
Elliott & Eleanor Taylor Fund	250,000	-	-	250,000
Caruso Endowment	119,710	1,610	-	121,320
Lesley Woods Endowed Care Fund for Professional Actors	-	1,050,000	-	1,050,000
Total Permanently Restricted Net Assets	\$ 13,268,672	\$ 1,224,816	\$ (20,644)	\$ 14,472,844

HOUSE EAR INSTITUTE
SCHEDULE OF CHANGES IN NET ASSETS
FOR THE YEAR ENDED JUNE 30, 2005

(Continued)

Temporarily Restricted Net Assets	2004	Donations Income and Transfers	Expenditures and Transfers	2005
Online Hearing Screening Tests	\$ 1,561	\$ -	\$ -	\$ 1,561
Support for clinical fellows-Care Center	25,000	40,000	-	65,000
Ahmanson Imaging Equipment	8,885	-	-	8,885
Guenther Foundation	142,831	-	-	142,831
Otitis Media Conference	9,941	-	(5,336)	4,605
Bundy Foundation	118,115	-	-	118,115
Taper Foundation-Children's Program	10,516	-	-	10,516
Western Lion's Fund	509	16,645	(1,083)	16,071
Caruso (Genetic Hearing Loss)	371,276	40,856	-	412,132
Advanced Imaging Facility Fund	74,027	25,857	-	99,884
Levine - NF2 Research	1,201,391	439,800	-	1,641,191
Microscope Upkeep	183,862	25,000	(42,001)	166,861
General - Time Restricted	818,344	-	(818,344)	-
Research Initiative	206,622	150	(25,798)	180,974
Rupley Fellows	41,468	12,500	-	53,968
Hearst Lab Interns	33,364	25,000	(17,102)	41,262
Quota Fellows	12,099	-	-	12,099
Unitrusts & Pooled Income Funds	825,990	454,076	(177,679)	1,102,387
Jameson Laboratory Fund	3,400	-	-	3,400
Educational Grants	14,200	4,200	(18,400)	-
Herklotz-Education/Outreach	245,797	5,000	-	250,797
Building Fund	2,470,911	119,768	(679,418)	1,911,261
Graziadio Education/Outreach Program	278,766	-	-	278,766
CARE Operations	292,203	284,398	(576,601)	-
CMB Research	-	118,174	(118,174)	-
Family Camp	-	45,492	(18,695)	26,797
Sound Partners	30,841	448,232	(453,757)	25,316
HEI-TR-Meniere's Disease (Linthicum)	1,000	50	-	1,050
Care Clinic Research	20,000	10,860	-	30,860
Jan Doak Building Fund	295,593	-	(295,593)	-
David Lim Fund	4,000	10,350	(4,476)	9,874
Howard House Clinical Studies Lab	205,306	31	-	205,337
Ritter Endowment Earnings	32,810	12,872	-	45,682
William Slattery Endowment Earnings	42,739	10,550	-	53,289
McLoraine Endowment Earnings	121,988	-	(121,988)	-
Hearing Aid Research Fund	3,972	1,830	-	5,802
Audiovisual Department Fund	4,420	-	-	4,420
Cochlear Implant Fund	3,750	200,100	-	203,850
Capital Campaign 2004-Building	389,833	12,124,947	(2,454,794)	10,059,986
Capital Campaign 2004-Programs	-	1,837,446	(853,164)	984,282
General Research Fund	93,725	9,971	(103,696)	-
Jack H Skirball Center for Emerging Research	1,515,027	-	(1,515,027)	-
Underwriter Fund	56,000	55,000	-	111,000
Public Forum Fund, May 2003	7,000	-	-	7,000
Elliott & Eleanor Taylor Fund	350,753	4,400	(134,326)	220,827
Daniel's Fund for CARE Center	-	88,405	(3,370)	85,035
Lesley Woods Care Fund	-	136,250	-	136,250
Lesley Woods Outreach Fund	-	350,000	-	350,000
Medtronic / Midas Rex Course	-	7,500	(7,500)	-
William Luxford Pediatric Hearing Fund	-	2,000	-	2,000
Otis Media Research	-	110,000	-	110,000
Total Temporarily Restricted Net Assets	\$ 10,569,835	\$ 17,077,710	\$ (8,446,322)	\$ 19,201,223

SINGLE AUDIT

**HOUSE EAR INSTITUTE
SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS
FOR THE YEAR ENDED JUNE 30, 2005**

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	\$ 15,692
569	Department of Defense	12.420	DAMD 17-01-1-0710	01/01/02 - 12/31/04	785,699
506	National Science Foundation	47.075	IIS-9996088	10/15/98 - 09/30/04	65,506
761	National Science Foundation	47.075	BCS-0214224	08/01/02 - 07/31/04	81
786	National Science Foundation	47.070	0312434	07/15/03 - 06/30/06	399
790	National Science Foundation	NA	BCS-0350764	08/18/03 - 08/17/05	166,614
Pass-through from National Institute of Health					
501	National Institutes of Health	93.173	RO1 DC003552	08/01/98 - 06/30/06	161,394
524	National Institutes of Health	93.173	RO1 DC004189	08/01/99 - 07/31/04	227,528
528	National Institutes of Health	93.173	RO1 DC04061	09/01/99 - 08/31/04	119,338
529	National Institutes of Health	93.173	RO1 DC03592	04/01/00 - 03/31/04	88,484
532	National Institutes of Health	93.173	RO1 DC04562	07/01/00 - 06/30/05	357,228
538	National Institutes of Health	93.173	RO1 DC04675	03/01/01 - 02/28/06	266,635
555	National Institutes of Health	93.173	RO1 DC04993	07/01/01 - 05/31/06	264,186
556	National Institutes of Health	93.173	RO1 DC05025	09/01/01 - 08/31/04	202,242
558	National Institutes of Health	93.173	F32 DC05282	09/01/01 - 08/31/05	31,508
559	National Institutes of Health	93.173	RO1 DC04796	09/28/01 - 08/31/06	288,016
572	National Institutes of Health	93.173	RO1 DC04856	05/01/01 - 04/30/06	43,564
597	National Institutes of Health	93.173	RO1 DC04792	05/01/01 - 04/30/06	247,804
701	National Institutes of Health	93.173	U13 DC006653	04/01/04 - 03/31/05	44,766
704	National Institutes of Health	93.173	R13 DC007326	04/01/05 - 03/31/06	10,611
750	National Institutes of Health	93.173	RO3 DC05566	03/01/02 - 02/28/05	40,036
751	National Institutes of Health	93.173	RO1 DC04786	04/01/02 - 03/31/07	48,051
753	National Institutes of Health	93.173	RO1 DC01526	04/15/02 - 03/31/07	125,582
758	National Institutes of Health	93.173	RO1 DC05220	07/01/02 - 06/30/05	157,430
759	National Institutes of Health	93.173	RO3 DC05335	07/05/02 - 06/30/05	349,093
762	National Institutes of Health	93.173	RO1 DC05213	08/01/02 - 06/30/07	79,703
763	National Institutes of Health	93.173	RO1 DC05843	09/20/02 - 08/31/07	363,922
767	National Institutes of Health	93.173	F32 DC006154	01/01/03 - 12/31/05	281,079
773	National Institutes of Health	93.838	RO1 HL070293	04/01/03 - 03/31/07	106,506
774	National Institutes of Health	93.173	R21 DC006139	04/01/03 - 03/31/05	30,000
778	National Institutes of Health	93.173	RO1 DC006185	05/15/03 - 04/30/07	317,397
780	National Institutes of Health	93.173	R13 DC006256	08/01/03 - 07/31/04	102
785	National Institutes of Health	93.173	RO1 DC006238	07/15/03 - 06/30/08	228,556
787	National Institutes of Health	93.173	R21 DC006035	07/18/03 - 06/30/05	3,727
788	National Institutes of Health	93.173	P30 DC006276	08/01/03 - 05/31/08	48,454
789	National Institutes of Health	93.173	P30 DC006276	08/01/03 - 05/31/08	109,183
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	154,468
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	140,412
Pass-through from Indiana University - Comparison of Sensory Aids in Deaf					
634	Children	93.173	RO1 DC000064	04/01/01 - 03/31/05	28,113
Pass-through from Johns Hopkins University - Childhood Development after					
754	Cochlear Implantation	93.173	8206 00394	05/01/02 - 04/30/07	201,914
Pass-through from Massachusetts General Hospital - Genotype Phenotype					
769	Relationship in Neurofibromatosis 2	93.853	RO1 NS40527	09/20/02 - 07/31/06	14,707
Pass-through from Jackson Laboratory - Genetics of Age Related Hearing					
779	Loss	93.173	RO1 DC005827	05/05/03 - 04/30/06	52,405
					<u>\$ 6,268,135</u>

**HOUSE EAR INSTITUTE
NOTES TO THE SCHEDULE OF FEDERAL FINANCIAL ASSISTANCE
FOR THE YEAR ENDED JUNE 30, 2005**

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 2005. 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	\$ 6,268,135
Other Grants	
National Organization for Hearing Research Foundation	264,610
American Otological Society	34,013
Cochlear Americans	85,268
Howard Leight Industries.	36,838
Deafness Research Foundation	8,324
Entific	53,839
Advance Bionics	62,118
Implanted Acoustics	67,840
Novartis Phara AG	13,820
Miscellaneous consulting	<u>7,340</u>
Total Grants and Contracts Revenue per Audited Financial Statements	<u><u>\$ 6,902,145</u></u>



**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, 2005, and have issued our report thereon dated October 3, 2005. 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.

October 3, 2005



**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, 2005. 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, 2005.

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, 2005, and have issued our report thereon dated October 3, 2005. 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.

Wenzel & Caron

October 3, 2005

**HOUSE EAR INSTITUTE
STATUS OF FINDINGS AND QUESTIONED COSTS
JUNE 30, 2005**

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 low-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, 2005**

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

None