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INTERGROUP CORP
Form 10KSB
October 17, 2005

SECURITIES AND EXCHANGE COMMISSION
Washington, D. C. 20549

FORM 10-KSB

Annual Report under Section 13 or 15(d) of the Securities
Exchange Act of 1934

For the fiscal year ended June 30, 2005

Transition Report under Section 13 or 15(d) of the Securities
Exchange Act of 1934

For the transition period from _____ to _____

Commission file number 1-10324

THE INTERGROUP CORPORATION

(Name of Small Business Issuer in its Charter)

Delaware

13-3293645

(State or Other Jurisdiction of
Incorporation or Organization)

(IRS Employer
Identification No.)

820 Moraga Drive, Los Angeles, California

90049-1632

(Address of Principal Executive Offices)

(Zip Code)

Issuer's Telephone Number: (310) 889-2500

Securities registered under Section 12(b) of the Exchange Act:

Common Stock-\$.01 Par Value

Pacific Exchange, Inc.

Title of Each Class

Name of Each Exchange On Which Registered

Securities registered under Section 12(g) of the Exchange Act:

Common Stock - Par Value \$.01 Per Share

(Title of Class)

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

Check if there is no disclosure of delinquent filers in response to Item
405 of Regulation S-B is not contained in this form, and no disclosure will be
contained, to the best of registrant's knowledge, in definitive proxy or
information statements incorporated by reference in Part III of this Form 10-
KSB or any amendment to this Form 10-KSB.

The issuer's revenues for its most recent fiscal year were \$12,966,000.

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The aggregate market value of the common equity held by non-affiliates of issuer, computed by reference to the price the common equity was sold on September 22, 2005 was \$13,111,853.

The number of shares outstanding of the issuer's Common Stock, \$.01 par value, as of September 22, 2005 was 2,397,241.

Transitional Small Business Disclosure Format (check one): Yes No [X]

DOCUMENTS INCORPORATED BY REFERENCE: None

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PART I

Item 1. Description of Business.

BUSINESS DEVELOPMENT

The InterGroup Corporation ("InterGroup" or the "Company") is a Delaware corporation formed in 1985, as the successor to Mutual Real Estate Investment Trust ("M-REIT"), a New York real estate investment trust created in 1965. The Company has been a publicly-held company since M-REIT's first public offering of shares in 1966 and has been a reporting company pursuant to Section 12(g) of the Securities Exchange Act of 1934 since that time.

The Company was organized to buy, develop, operate, rehabilitate and dispose of real property of various types and descriptions, and to engage in such other business and investment activities as would benefit the Company and its shareholders. The Company was founded upon, and remains committed to, social responsibility. Such social responsibility was originally defined as providing decent and affordable housing to people without regard to race. In 1985, after examining the impact of federal, state and local equal housing laws, the Company determined to broaden its definition of social responsibility. The Company changed its form from a REIT to a corporation so that it could pursue a variety of investments beyond real estate and broaden its social impact to engage in any opportunity which would offer the potential to increase shareholder value within the Company's underlying commitment to social responsibility, which it redefined to encompass investments in any area which can have a socially redeeming value and promote the establishment of a fair, equal and better society.

The Company's principal sources of revenue have been, and continue to be, derived from the operations of its multi-family residential properties, from the sales and disposition of its real property assets, from the operations of its majority owned subsidiary, Santa Fe Financial Corporation ("Santa Fe"), and from the investment of its cash and securities assets. Santa Fe is a public company (OTCBB: SFEF).

BUSINESS OF ISSUER

The Company's principal business is the ownership and management of real estate. Properties include twenty-two apartment complexes, a hotel, two commercial real estate properties, and two single-family houses as a strategic investment. The properties are located throughout the United States, but are concentrated in Texas and Southern California. The Company also has investments in unimproved real property that is held for sale or development. The Company acquires its investments in real estate and other investments utilizing cash, securities or debt, subject to approval or guidelines of the Board of Directors. The Company also invests in income-producing instruments, equity and debt securities and will consider other investments if such investments offer growth or profit potential. See Item 2 for a description of the Company's current investments in real estate and its investment policies concerning real property and marketable securities.

Through its controlling interest in Santa Fe, the Company's business also includes a 565-room hotel located in the Financial District of San Francisco, California. The hotel, commonly known as the Holiday Inn Select Downtown & Spa (the "Hotel") is owned by Justice Investors, a California limited partnership ("Justice" or the "Partnership"), of which Santa Fe's subsidiary, Portsmouth Square Inc. ("Portsmouth") is a 49.8% limited partner and serves as

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one of two general partners. Evon Garage Corporation ("Evon") is the other general partner of Justice and serves as the managing general partner.

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Since 1998, the Hotel had been leased by Justice to Felcor Lodging Trust, Inc. ("Felcor", NYSE: FCH). Pursuant to a settlement agreement with Felcor, that lease was terminated, effective June 30, 2004, and the Partnership assumed the role of owner/operator with the assistance of a third party management company. Historically, the Partnership's most significant source of income was a lease between Justice and Holiday Inn for the Hotel portion of the property. That lease was amended in 1995, and ultimately assumed by Felcor Lodging Trust, Inc. ("Felcor", NYSE: FCH) in 1998. The lease of the Hotel to Felcor was terminated effective June 30, 2004. The Partnership also derives income from its lease of the garage portion of the property to Evon and the lease of approximately 5,400 square feet on the lobby level of the Hotel to Tru Spa, LLC for the operation of a health and beauty spa. As a general partner, Portsmouth takes an active role in monitoring and overseeing the operations of the Hotel, the lease parking garage and the spa.

DOW HOTEL COMPANY MANAGEMENT AGREEMENT

With the termination of the Hotel Lease, Justice assumed the role of an owner operator of the Hotel on July 1, 2004. To assist with the operations of the Hotel, On May 19, 2004, Justice entered into a third party Management Agreement with Dow Hotel Company, LLC, a Washington limited liability company ("Dow") to operate and manage the Hotel as an agent of the Partnership, effective July 1, 2004. The Management Agreement has an initial term of 10 years, with an option of Justice to extend the original term for another 10 year period. The Management Agreement provides for a base management fee to Dow of up to 2.5% of annual gross operating revenues of the Hotel and incentive fees not to exceed, in the aggregate, 4% of gross operating revenues of the Hotel. The Management Agreement can be terminated by Justice upon at least 60 days written notice, subject to certain termination fees during the first year of the Agreement.

HILTON HOTELS FRANCHISE LICENSE AGREEMENT

With the termination of the Hotel Lease to Felcor, the Partnership was able actively pursue a franchise agreement with a new nationally recognized brand in an effort to move the Hotel up-market and become more competitive. After considering and negotiating with several brands, the Partnership entered into a Franchise License Agreement with Hilton Hotels Corporation (the "Hilton Franchise Agreement") on December 10, 2004 for the right to operate the Hotel as a Hilton brand hotel. The terms of the Hilton Franchise Agreement will commence upon the final approval of the franchise application and the completion of the approved product improvement plan. The commencement date of operation as a Hilton hotel can be no later than June 1, 2006. The term of the Hilton Franchise Agreement is for 15 years commencing on the opening date of the Hotel, with an option to extend the Agreement for another five years, subject to certain conditions. Beginning on the opening date, the Partnership will pay monthly royalty fees of four percent (4%) of the Hotel's gross room revenue for the preceding calendar month. The amount of the monthly fee is subject to change; however, the increase cannot exceed one percent of the Hotel gross room revenue in any calendar year, and the cumulative increases in the monthly fee will not exceed five percent of gross room revenue.

Prior to operating the Hotel as a Hilton hotel, the Partnership is required to make substantial renovations to the Hotel to meet Hilton standards in accordance with a product improvement plan ("PIP") agreed upon by Hilton and

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the Partnership, as well as complying with other brand standards. That project includes a complete renovation and upgrade of all of the Hotel's guestrooms, meeting rooms, common areas and restaurant and bar. The Partnership currently estimates that the cost of the renovation project will be approximately \$34 million. That amount includes approximately \$29 million

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for the actual cost of the renovations and approximately \$5 million for construction interest and estimated carrying costs of operations during the renovation period.

To meet its substantial financial commitments, the Partnership will have to rely on additional borrowings to meet its obligations. The Partnership believes that the value of the Hotel property will be adequate to serve as collateral to secure the necessary financing. That amount of leverage and the associated debt service will create additional risk for the Partnership and its ability to generate cash flows in the future since the Hotel asset has been virtually debt free for many years.

TEMPORARY CLOSURE OF HOTEL FOR RENOVATIONS

On March 15, 2005, the Partnership announced its decision to close down its Hotel operations effective May 31, 2005 to complete the renovations of the Hotel as required by the Hilton Franchise Agreement. The Partnership made this decision because of, among other things, the scope of the work in the common areas, engineering factors and potential environmental and safety issues which made it preferable to temporarily close the Hotel portion of the property. It is anticipated that the Hotel will be closed until the first part of 2006 before it reopens as the "Hilton San Francisco Financial District". The below ground parking garage and Tru Spa located on the lobby level of the Hotel, both of which are lessees of the Partnership, will remain open during the renovation work.

RECENT DEVELOPMENTS - NEW FINANCING

On July 27, 2005, Justice entered into a first mortgage loan (the "Prudential Loan") with The Prudential Insurance Company of America in a principal amount of \$30,000,000. The term of the Loan is for 120 months at a fixed interest rate of 5.22% per annum. The Loan calls for monthly installments of principal and interest in the amount of approximately \$165,100, calculated on a 360 month amortization schedule. The Loan is secured by a first deed of trust on the Partnership's Hotel property, including all improvements and personal property thereon and an assignment of all present and future leases and rents. The Loan is without recourse to the limited and general partners of Justice.

On July 27, 2005, Justice also obtained a \$10,000,000 Revolving Line of Credit ("LOC") from United Commercial Bank. The term of the LOC is for 60 months at an annual interest rate equal to either The Wall Street Journal Prime Rate or LIBOR + 2%, as selected by Justice, and is secured by a second deed of trust on the Hotel property. Interest only is payable monthly with principal and accrued interest due at maturity.

From the proceeds of the Prudential Loan, the Partnership retired its existing line of credit in the approximate amount of \$7,436,000, including accrued interest, and paid off a short term unsecured line of credit from United Commercial Bank in the amount of \$2,007,000, including accrued interest.

Justice believes that the Prudential Loan and the LOC will provide sufficient financial resources for the Partnership to complete the substantial renovations to the Hotel required by its Franchise License Agreement with

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Hilton. Justice also believes that it will be able to meet its debt service and operating capital needs through the reopening of the Hotel in the early part of 2006.

For further information see Item 2 Description of Properties and Item 6 Management's Discussion and Analysis of Financial Condition and Results of Operations and Notes to Consolidated Financial Statements.

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COMPETITION

All of the properties owned by the Company are in areas where there is substantial competition. However, management believes that its apartments, hotel, and commercial properties are generally in a competitive position in their respective communities. The Company intends to continue upgrading and improving the physical condition of its existing properties and will consider selling existing properties, which the Company believes have realized their potential, and re-investing in properties that may require renovation but that offer greater appreciation potential.

The hotel had traditionally enjoyed a favorable year-round occupancy rate, but both occupancy and average daily room rates have suffered since fiscal year ended June 30, 2001. Newer and more upscale properties have opened in or near the Financial District, which provide greater amenities to its guests, making it difficult for the Hotel to compete. These competitors are now better positioned to attract both the business traveler and tourists.

Management believes that the Hotel could not continue to be competitive under the conditions it operated under while a Holiday Inn Select brand hotel. By terminating the Hotel Lease with Felcor, and taking over the operations of the Hotel, the Partnership now has greater ability to direct the future of the Hotel. The Hotel property is now approximately 25 years old, with no major renovations having been made to the Hotel property during that time. As discussed above, the Partnership is committed to make substantial improvements to almost every area of the Hotel before it reopens in the early part of 2006 as the Hilton San Francisco Financial District. The newly renovated Hotel will feature among other amenities: totally new guest rooms and suites; a new concierge lounge and common areas; modern and expanded meeting rooms; a new ballroom; an exciting, new restaurant and bar; a new fitness center; and the existing Tru Spa. The Partnership believes that this renovation project, coupled with the strength of the Hilton brand and reservation system, along with the hotel management expertise of Dow, will allow the Hotel to compete in the top levels of its market segment.

EMPLOYEES

As of June 30, 2005, the Company had a total of 12 full-time employees in its corporate office. Effective July 2002, the Company entered into a client service agreement with Administaff Companies II, L.P. ("Administaff"), a professional employer organization serving as an off-site, full service human resource department for its corporate office. Administaff personnel management services are delivered by entering into a co-employment relationship with the Company's employees. There are also approximately 34 employees at the Company's properties outside of the State of California that are subject to similar co-employment relationships with Administaff. The employees and the Company are not party to any collective bargaining agreement, and the Company believes that its employee relations are satisfactory.

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Item 2. Description of Properties.

PROPERTIES

At June 30, 2005, the Company's investment in real estate consisted of properties located throughout the United States, but which are concentrated in Texas and Southern California. These properties include twenty two apartment complexes, two single-family houses as strategic investments, and two commercial real estate properties, one of which serves as the Company's

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corporate headquarters. Twenty one of the twenty two apartment complexes, the commercial property and the two single-family houses are completed and operating properties. One non-operating apartment complex is undergoing a major renovation.

The Company owns approximately 9.5 acres of unimproved real estate in Texas. The Company also owns an interest in a San Francisco hotel property through its subsidiaries' interest, in Justice Investors. In the opinion of management, each of the properties is adequately covered by insurance. None of the properties are subject to foreclosure proceedings or litigation other than that incurred in the normal course of business. The Company's rental property leases are short-term leases, with no lease extending beyond one year.

Las Colinas, Texas. The Las Colinas property is a water front apartment community along Beaver Creek that was developed in 1993 with 358 units on approximately 15.6 acres of land. The Company acquired the complex on April 30, 2004 for approximately \$27,145,000. As part of the purchase, an intangible asset of \$666,000 was recorded. This intangible asset was fully amortized straight-line over twelve months. Depreciation is recorded on the straight-line method, based upon an estimated useful life of 27.5 years. Real estate property taxes for the year ended June 30, 2005 were approximately \$932,000. The outstanding mortgage balance was approximately \$19,979,000 at June 30, 2005 and the maturity date of the mortgage is May 1, 2013.

Morris County, New Jersey. The Morris County property is a two-story garden apartment complex that was completed in June 1964 with 151 units on approximately 8 acres of land. The Company acquired the complex on September 15, 1967 at an initial cost of approximately \$1,600,000. Real estate property taxes for the year ended June 30, 2005 were approximately \$152,000. Depreciation is recorded on the straight-line method, based upon an estimated useful life of 40 years. The outstanding mortgage balance was approximately \$10,271,000 at June 30, 2005 and the maturity date of the mortgage is May 1, 2013.

St. Louis, Missouri. The St. Louis property is a two-story project with 264 units on approximately 17.5 acres. The Company acquired the complex on November 1, 1968 at an initial cost of \$2,328,000. For the year ended June 30, 2005, real estate property taxes were approximately \$138,000. Depreciation is recorded on the straight-line method, based upon an estimated useful life of 35 years. The outstanding mortgage balance was approximately \$5,454,000 at June 30, 2005 and the maturity date of the mortgage is July 1, 2008.

Florence, Kentucky. The Florence property is a three-story apartment complex with 157 units on approximately 6.0 acres. The Company acquired the property on December 20, 1972 at an initial cost of approximately \$1,995,000. For the year ended June 30, 2005, real estate property taxes were approximately

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\$46,000. Depreciation is recorded on the straight-line method, based upon an estimated useful life of 40 years. The outstanding mortgage balance was approximately \$4,200,000 at June 30, 2005 and the maturity date of the mortgage is June 30, 2015.

Irving, Texas. The Company's Irving properties consist of two apartment complexes. The first apartment complex is a two-story apartment with 224 units on approximately 9.9 acres. The Company acquired the property on September 16, 1994 at an initial cost of approximately \$4,150,000. For the year ended June 30, 2005, real estate property taxes were approximately \$188,000. Depreciation is recorded on the straight-line method, based upon an estimated useful life of 30 years. The outstanding mortgage balance was

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approximately \$4,185,000 at June 30, 2005 and the maturity date of the mortgage is January 1, 2008.

The second apartment complex consists of two-story town homes with 54 units on approximately 3.0 acres. The Company acquired the property on November 3, 2000 at an initial cost of approximately \$1,980,000. For the year ended June 30, 2005, real estate property taxes were approximately \$51,000. Depreciation is recorded on the straight-line method, based upon an estimated useful life of 39 years. The outstanding mortgage balance of \$1,182,000 was paid off in August 2004.

San Antonio, Texas. The San Antonio property is a two-story project with 132 units on approximately 4.3 acres. The Company acquired the complex on June 29, 1993 for \$2,752,000. For the year ended June 30, 2005, real estate taxes were approximately \$125,000. Depreciation is recorded on the straight-line method, based upon an estimated useful life of 30 years. The outstanding mortgage balance was approximately \$2,993,000 at June 30, 2005 and the maturity date of the mortgage is December 1, 2008.

Austin, Texas. The Company's Austin properties consist of two apartment complexes. The first Austin property is a two-story project with 249 units on approximately 7.8 acres. The Company acquired the complex on November 18, 1999 for \$4,150,000. The Company also acquired an adjacent complex with 59 units on January 8, 2002 for \$1,681,000. For the year ended June 30, 2005, real estate taxes were approximately \$138,000. Depreciation is recorded on the straight-line method, based upon an estimated useful life of 30 years. The outstanding mortgage balance was approximately \$7,884,000 at June 30, 2005 and the maturity date of the mortgage is July 1, 2023. The Company also owns approximately 6 acres of land adjacent to this property.

The second apartment complex consists of a two-story project with 112 units on 3.7 acres. The Company acquired the complex on September 5, 2001 for \$3,824,000. For the period ended June 30, 2005, real estate taxes were approximately \$80,000. Depreciation is recorded on the straight-line method, based upon an estimated useful life of 40 years. The outstanding mortgage balance was approximately \$2,190,000 at June 30, 2005 and the maturity date of the mortgage is September 1, 2009. This property was sold in August 2005.

Los Angeles, California. The Company owns two commercial properties, thirteen apartment complexes, and two single-family houses in the general area of West Los Angeles.

The first Los Angeles commercial property is a 5,500 square foot, two story building that serves as the Company's corporate offices. The Company acquired the building on March 4, 1999 for \$1,876,000. The property taxes for the year ended June 30, 2005 were approximately \$24,000. Depreciation is recorded on

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the straight-line method, based upon an estimated useful life of 30 years. The outstanding mortgage balance was approximately \$1,173,000 at June 30, 2005 and the maturity date of the mortgage is April 15, 2009.

The second Los Angeles commercial property is a 5,900 square foot commercial building. The Company acquired the building on September 15, 2000 for \$1,758,000. The property taxes for the year ended June 30, 2005 were approximately \$11,000. Depreciation is recorded on the straight-line method, based upon an estimated useful life of 39 years. The outstanding mortgage balance was approximately \$791,000 at June 30, 2005 and the maturity date of the mortgage is December 15, 2013.

The first Los Angeles apartment complex is a 10,600 square foot two-story apartment with 12 units. The Company acquired the property on July 30, 1999 at an initial cost of approximately \$1,305,000. For the year ended June 30,

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2005, real estate property taxes were approximately \$16,000. Depreciation is recorded on the straight-line method, based upon an estimated useful life of 30 years. The outstanding mortgage balance was approximately \$1,027,000 at June 30, 2005 and the maturity date of the mortgage is December 1, 2018.

The second Los Angeles apartment complex is a 29,000 square foot three-story apartment with 27 units. This complex is held by Intergroup Woodland Village, Inc. ("Woodland Village"), which is 55.4% and 44.6% owned by Santa Fe and the Company, respectively. The property was acquired on September 29, 1999 at an initial cost of approximately \$4,075,000. For the year ended June 30, 2005, real estate property taxes were approximately \$50,000. Depreciation is recorded on the straight-line method, based upon an estimated useful life of 30 years. The outstanding mortgage balance was approximately \$1,837,000 at June 30, 2005 and the maturity date of the mortgage is October 1, 2029.

The third Los Angeles apartment complex is a 12,700 square foot apartment with 14 units. The Company acquired the property on October 20, 1999 at an initial cost of approximately \$2,150,000. For the year ended June 30, 2005, real estate property taxes were approximately \$29,000. Depreciation is recorded on the straight-line method, based upon an estimated useful life of 30 years. The outstanding mortgage balance was approximately \$1,084,000 at June 30, 2005 and the maturity date of the mortgage is December 1, 2029.

The fourth Los Angeles apartment complex is a 10,500 square foot apartment with 9 units. The Company acquired the property on November 10, 1999 at an initial cost of approximately \$1,675,000. For the year ended June 30, 2005, real estate property taxes were approximately \$22,000. Depreciation is recorded on the straight-line method, based upon an estimated useful life of 30 years. The outstanding mortgage balance was approximately \$810,000 at June 30, 2005 and the maturity date of the mortgage is December 31, 2029.

The fifth Los Angeles apartment complex is a 26,100 square foot two-story apartment with 31 units. The Company acquired the property on May 26, 2000 at an initial cost of approximately \$7,500,000. For the year ended June 30, 2005, real estate property taxes were approximately \$86,000. Depreciation is recorded on the straight-line method, based upon an estimated useful life of 30 years. The outstanding mortgage balance was approximately \$4,085,000 at June 30, 2005 and the maturity date of the mortgage is August 1, 2033.

The sixth Los Angeles apartment complex is a 27,600 square foot two-story apartment with 30 units. The Company acquired the property on July 7, 2000 at an initial cost of approximately \$4,411,000. For the year ended June 30, 2005, real estate property taxes were approximately \$58,000. Depreciation is

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recorded on the straight-line method, based upon an estimated useful life of 39 years. In June 2003, the operations of this property stopped and in December 2003, major renovations of the property began. In May 2004, the Company paid off the mortgage in the amount of \$2,576,000 and obtained a new construction loan in the amount of \$6,268,000 as part of the renovation of the property. As of June 30, 2005, the balance of the construction loan was approximately \$5,133,000 and the maturity of the loan is April 1, 2006.

The seventh Los Angeles apartment complex is a 3,000 square foot apartment with 4 units. The Company acquired the property on July 19, 2000 at an initial cost of approximately \$1,070,000. For the year ended June 30, 2005, real estate property taxes were approximately \$14,000. Depreciation is recorded on the straight-line method, based upon an estimated useful life of 39 years. The outstanding mortgage balance was approximately \$434,000 at June 30, 2005 and the maturity date of the mortgage is August 1, 2030.

The eighth Los Angeles apartment complex is a 4,500 square foot two-story apartment with 4 units. The Company acquired the property on July 28, 2000 at

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an initial cost of approximately \$1,005,000. For the year ended June 30, 2005, real estate property taxes were approximately \$13,000. Depreciation is recorded on the straight-line method, based upon an estimated useful life of 39 years. The outstanding mortgage balance was approximately \$722,000 at June 30, 2005 and the maturity date of the mortgage is December 1, 2018.

The ninth Los Angeles apartment complex is a 7,500 square foot apartment with 7 units. The Company acquired the property on August 9, 2000 at an initial cost of approximately \$1,308,000. For the year ended June 30, 2005, real estate property taxes were approximately \$17,000. Depreciation is recorded on the straight-line method, based upon an estimated useful life of 39 years. The outstanding mortgage balance was approximately \$1,061,000 at June 30, 2005 and the maturity date of the mortgage is December 1, 2018.

The tenth Los Angeles apartment complex is a 4,700 square foot two-story apartment with 5 units. The Company acquired the property on August 15, 2000 at an initial cost of approximately \$997,000. For the year ended June 30, 2005, real estate property taxes were approximately \$13,000. Depreciation is recorded on the straight-line method, based upon an estimated useful life of 39 years. The outstanding mortgage balance was approximately \$663,000 at June 30, 2005 and the maturity date of the mortgage is December 1, 2018.

The eleventh Los Angeles apartment complex is a 32,800 square foot two-story apartment with 24 units. The Company acquired the property on March 8, 2001 at an initial cost of approximately \$2,859,000. For the year ended June 30, 2005, real estate property taxes were approximately \$38,000. Depreciation is recorded on the straight-line method, based upon an estimated useful life of 39 years. The outstanding mortgage balance was approximately \$1,717,000 at June 30, 2005 and the maturity date of the mortgage is April 1, 2031.

The twelfth Los Angeles apartment complex is a 13,000 square foot two-story apartment with 8 units. The Company acquired the property on May 1, 2001 at an initial cost of approximately \$1,206,000. For the year ended June 30, 2005, real estate property taxes were approximately \$16,000. Depreciation is recorded on the straight-line method, based upon an estimated useful life of 39 years. The outstanding mortgage balance was approximately \$565,000 at June 30, 2005 and the maturity date of the mortgage is November 1, 2029.

The thirteenth Los Angeles apartment complex, which is owned 100% by the Company's subsidiary Santa Fe, is a 4,200 square foot two-story apartment with

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2 units. Santa Fe acquired the property on February 1, 2002 at an initial cost of approximately \$785,000. For the year ended June 30, 2005, real estate property taxes were approximately \$10,000. Depreciation is recorded on the straight-line method based upon an estimated useful life of 39 years. The outstanding mortgage balance was approximately \$443,000 at June 30, 2005 and the maturity date of the mortgage is February 1, 2032.

The first Los Angeles single-family house is a 2,771 square foot home. The Company acquired the property on November 9, 2000 at an initial cost of approximately \$660,000. For the year ended June 30, 2005, real estate property taxes were approximately \$8,000. Depreciation is recorded on the straight-line method, based upon an estimated useful life of 39 years. The outstanding mortgage balance was approximately \$467,000 at June 30, 2005 and the maturity date of the mortgage is December 1, 2030.

The second Los Angeles single-family house is a 2,201 square foot home. The Company acquired the property on August 22, 2003 at an initial cost of approximately \$700,000. For the year ended June 30, 2005, real estate property taxes were approximately \$10,000. Depreciation is recorded on the straight-line method, based upon an estimated useful life of 39 years. The

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outstanding mortgage balance was approximately \$514,000 at June 30, 2005 and the maturity date of the mortgage is November 1, 2033.

San Francisco, California Hotel.

The San Francisco, California Hotel property owned by the Partnership is located near the Financial District, one block from the Transamerica Pyramid. The Embarcadero Center is within walking distance. Chinatown is directly across the bridge that runs from the hotel to Portsmouth Square Park. The hotel is a 31-story (including parking garage), steel and concrete, A-frame building, which contains 565 guest rooms situated on 22 floors as well as a 5,400 square foot Tru Spa health and beauty spa on the lobby level. The third floor houses the Chinese Culture Center. Other features of the Hotel include a rooftop swimming pool, 5-storied underground garage and pedestrian bridge across Kearny Street connecting the hotel and the Chinese Culture Center with Portsmouth Square Park in Chinatown. The bridge, built and owned by the partnership, is included in the lease to the Chinese Culture Center. In the opinion of management the property is adequately covered by insurance.

As discussed above, the Hotel Lease with Felcor was terminated, effective June 30, 2004, pursuant to the terms of a Settlement Agreement. At that time, possession and operations of the Hotel reverted to the Partnership. On May 31, 2005, the Hotel portion of the property was temporarily closed for extensive renovations to meet the requirements of the Hilton Franchise Agreement. The below ground parking garage and Tru Spa located on the lobby level of the Hotel, both of which are lessees of the Partnership, will remain open during the renovation work.

REAL ESTATE INVESTMENT POLICIES

The most significant investment activity of the Company has been to acquire, renovate, operate, and when appropriate, sell income-producing real estate. Through its marketable securities portfolio, the Company has indirectly invested in additional real estate related investments such as hotels and office buildings.

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The Company is presently looking for new real estate investment opportunities and plans to continue to concentrate its real estate investments in developed properties. The acquisition of new real estate investments will depend on the Company's ability to find suitable investment opportunities and the availability of sufficient financing to acquire such investments. The Company plans to borrow funds to leverage its investment capital. The amount of the mortgage debt will depend on a number of factors including, but not limited to, the availability of financing and the ability of projected property cash flows to support its operations and debt service.

MORTGAGES

Information with respect to mortgage notes payable of the Company is set forth in Note 5 of the Notes to Consolidated Financial Statements.

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ECONOMIC AND PHYSICAL OCCUPANCY RATES

The Company leases units in its residential rental properties on a short-term basis, with no lease extending beyond one year. The economic occupancy gross potential rent less vacancy loss, bad debt, discounts and concessions divided by gross potential rent) and the physical occupancy (units occupied by tenant) for each of the Company's operating properties for fiscal year ended June 30, 2005 are provided below.

Property -----	Economic Occupancy -----	Physical Occupancy -----
Apartments:		
1. Las Colinas, TX	76%	96%
2. Morris County, NJ	92%	96%
3. St. Louis, MO	83%	89%
4. Florence, KY	86%	97%
5. Irving, TX (1)	78%	90%
6. Irving, TX (2)	46%	28%
7. San Antonio, TX	90%	92%
8. Austin, TX (1)	77%	92%
9. Austin, TX (2)	80%	100%
10. Los Angeles, CA (1)	73%	83%
11. Los Angeles, CA (2)	95%	100%
12. Los Angeles, CA (3)	92%	93%
13. Los Angeles, CA (4)	98%	100%
14. Los Angeles, CA (5)	83%	90%
15. Los Angeles, CA (6)	85%	75%
16. Los Angeles, CA (7)	*	*
17. Los Angeles, CA (8)	91%	100%
18. Los Angeles, CA (9)	84%	86%
19. Los Angeles, CA (10)	93%	100%
20. Los Angeles, CA (11)	83%	96%
21. Los Angeles, CA (12)	81%	100%
22. Los Angeles, CA (13)	100%	100%

*This property is not in operation and is currently undergoing major renovations.

MANAGEMENT OF THE PROPERTIES

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The Company may engage third party management companies as agents to manage certain of Company's residential rental properties. Effective May 1, 2005, the Company entered into third party management agreements (the "Agreements") with Morrison, Ekre & Bart Management Services, Inc. ("MEB") for property management services for five of its Texas apartment complexes, which are located in Austin, Irving and San Antonio. The Agreements provide for a management fee equal to two and one-half percent of the gross monthly receipts of each property and are for a term of two years, but can be terminated by either party upon thirty days written notice. Should the Company elect to terminate any of the Agreements, prior to the two year term, it would be obligated to pay to MEB a sum equal to a one month management fee. Subsequent to year end, the MEB Agreements were terminated on August 31, 2005, at which time the Company resumed direct management of those Texas properties.

Effective August 1, 2005, the Company entered into a Management Agreement with Century West Properties, Inc. ("Century West") to act as an agent of the Company to rent and manage all of the Company's residential rental properties in the Los Angeles, California area. The Management Agreement with Century

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West is for a term of twelve months ending on July 31, 2006 and will continue thereafter on a month-to-month basis, unless terminated upon 30 days prior written notice. The Management Agreements provide for a monthly fee equal to 4% of the monthly gross receipts from the properties with resident managers and a fee of 4 1/2% of monthly gross receipts for properties without resident managers. Century West is also entitled to reimbursement of any actual operating and maintenance costs advanced on behalf of the Company and is entitled to a fee of 5% for overhead and supervision of major improvements and a charge of 10% of the direct costs for overhead/supervision of a major remodeling project.

MARKETABLE SECURITIES INVESTMENT POLICIES

In addition to real estate, the Company also invests from time to time in income producing instruments, corporate debt and equity securities, mortgage backed securities, securities issued by REIT's and other companies which invest primarily in real estate.

The Company's securities investments are made under the supervision of a Securities Investment Committee of the Board of Directors. The Committee currently has three members and is chaired by the Company's Chairman of the Board and President, John V. Winfield. The Committee has delegated authority to manage the portfolio to the Company's Chairman and President together with such assistants and management committees he may engage. The Committee has established investment guidelines for the Company's investments. These guidelines presently include: (i) corporate equity securities should be listed on the New York or American Stock Exchanges or the Nasdaq NMS Market; (ii) securities should be priced above \$5.00 per share; and (iii) investment in a particular issuer should not exceed 5% of the market value of the total portfolio. The investment policies do not require the Company to divest itself of investments, which initially meet these guidelines but subsequently fail to meet one or more of the investment criteria. Non-conforming investments require the approval of the Securities Investment Committee. The Committee has in the past approved non-conforming investments and may in the future approve non-conforming investments. The Securities investment Committee may modify these guidelines from time to time.

The Company's investment portfolio is diversified with 63 different equity

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securities. The Company has four individual positions that comprise more than 5% of the equity value of the portfolio with the largest being 15.3% of the value of the portfolio. The amount of the Company's investment in any particular issue may increase or decrease, and additions or reductions to its securities portfolio may occur, at any time. While it is the internal policy of the Company to limit its initial investment in any single equity to less than 5% of its total portfolio value, that investment could eventually exceed 5% as a result of equity appreciation or reductions in other positions. Marketable securities are stated at market value as determined by the most recently traded price of each security at the balance sheet date. As of June 30, 2005, the market value of the Company's marketable securities was \$24,033,000.

The Company may also invest, with the approval of the Securities Investment Committee, in unlisted companies, through private placements. Those investments in non-marketable securities are carried at cost on the Company's balance sheet as part of other investments and are reviewed for impairment on a periodic basis.

As part of its investment strategies, the Company may assume short positions in marketable securities. Short sales are used by the Company to potentially offset normal market risks undertaken in the course of its investing

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activities or to provide additional return opportunities. As of June 30, 2005, the Company had obligations for securities sold (equities short) of \$5,257,000 and had no naked short positions.

In addition, the Company may utilize margin for its marketable securities purchases through the use of standard margin agreements with national brokerage firms. The use of available leverage is guided by the business judgment of management and is subject to any internal investment guidelines, which may be imposed by the Securities Investment Committee. The margin used by the Company may fluctuate depending on market conditions. The use of leverage could be viewed as risky and the market values of the portfolio may be subject to large fluctuations. As of June 30, 2005, the Company had a margin balance of \$6,726,000 and incurred \$904,000 and \$1,437,000 in margin interest expense during the year ended June 30, 2005 and June 30, 2004, respectively.

On July 18, 2003, the disinterested members of the respective Boards of Directors of the Company's subsidiary, Santa Fe and Santa Fe's subsidiary, Portsmouth, established a performance based compensation program for the Company's CEO, John V. Winfield, to keep and retain his services as a direct and active manager of the securities portfolios of those companies. On January 12, 2004, the disinterested members of the Securities Investment Committee of InterGroup also established a performance based compensation program for Mr. Winfield, which was ratified by the Board of Directors. The terms of that compensation arrangement is discussed in detail in Item 10 "Executive Compensation" of this Report. During fiscal years ended June 30, 2005 and June 30, 2004, the Company and its subsidiaries paid \$320,000 and \$2,077,000 respectively, to the Company's CEO as performance based compensation related to the management of the securities portfolios.

As Chairman of the Securities Investment Committee, the Company's President and Chief Executive officer, John V. Winfield, directs the investment activity of the Company in public and private markets pursuant to authority granted by the Board of Directors. Mr. Winfield also serves as Chief Executive Officer and Chairman of Santa Fe and Portsmouth and oversees the investment activity of those companies. Depending on certain market conditions and various risk

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factors, the Chief Executive Officer, his family, Santa Fe and Portsmouth may, at times, invest in the same companies in which the Company invests. The Company encourages such investments because it places personal resources of the Chief Executive Officer and his family members, and the resources of Santa Fe and Portsmouth, at risk in connection with investment decisions made on behalf of the Company.

Item 3. Legal Proceedings

The Company is not subject to any legal proceedings requiring disclosure under this Item.

Item 4. Submission of Matters to a Vote of Security Holders.

There were no matters submitted to a vote of security holders during the fourth quarter of the fiscal year covered by this Report.

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PART II

Item 5. Market for Common Equity and Related Stockholder Matters.

The Company's Common Stock is traded on The National Market System of the Nasdaq Stock Market, Inc. ("Nasdaq-NMS") under the symbol "INTG". It is also listed on the Pacific Exchange, Inc. The following table sets forth the high and low sales prices (adjusted for stock splits) for the Company's common shares for each quarter of the last two fiscal years.

Fiscal 2005 -----	High -----	Low -----
First Quarter 7/1 - 9/30	\$14.96	\$11.15
Second Quarter 10/1 - 12/31	\$14.31	\$12.50
Third Quarter 1/1 - 3/31	\$15.20	\$13.41
Fourth Quarter 4/1 - 6/30	\$19.10	\$14.75

Fiscal 2004 -----	High -----	Low -----
First Quarter 7/1 - 9/30	\$13.23	\$ 9.45
Second Quarter 10/1 - 12/31	\$12.87	\$11.40
Third Quarter 1/1 - 3/31	\$12.65	\$10.60
Fourth Quarter 4/1 - 6/30	\$13.33	\$10.50

As of September 12, 2005, there were approximately 560 shareholders of record and more than 1,400 beneficial holders of the Company's Common Stock.

DIVIDENDS

The Company has not declared any cash dividends on its common stock and does not foresee issuing cash dividends in the near future.

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SECURITIES AUTHORIZED FOR ISSUANCE UNDER EQUITY COMPENSATION PLANS.

The following table sets forth information as of June 30, 2005, with respect to compensation plans (including individual compensation arrangements) under which equity securities of the Company are authorized for issuance, aggregated as follows:

Plan category	Securities to be issued upon exercise of outstanding options, warrants and rights (a)	Weighted average exercise price of outstanding options warrants and rights (b)	Remaining available for future issuance under equity compensation plans (excluding securities reflected in column (a)) (c)
Equity compensation plans approved by security holders	378,000	\$9.66	72,000
Equity compensation plans not approved by security holders	None	N/A	None
Total	378,000	\$9.66	72,000

SMALL BUSINESS ISSUER PURCHASES OF EQUITY SECURITIES

2005 Period	(a) Total Number of Shares Purchased	(b) Average Price Paid Per Share	(c) Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	(d) Maximum Number of Shares that May Yet Be Purchased Under the Plans or Programs
Month #1 (April 1- April 30)	-	-	-	96,441
Month #2 (May 1- May 31)	-	-	-	96,441
Month #3 (June 1- June 30)	-	-	-	96,441
Total	-	-	-	96,441

The Company currently has only one stock repurchase program. The program was

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initially announced on January 13, 1998 and was first amended on February 10, 2003. The total number of shares authorized to be repurchased was 720,000, adjusted for stock splits. On October 12, 2004, the Board of Directors authorized the Company to purchase up to an additional 150,000 shares of Company's common stock, increasing the total remaining number of shares authorized for repurchase to 152,941. The program has no expiration date and can be amended from time to time in the discretion of the Board of Directors. No plan or program expired during the period covered by the table.

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Item 6. Management Discussion and Analysis of Financial Condition and Results of Operations.

INTRODUCTION

The discussion below and elsewhere in the Report includes forward-looking statements about the future business results and activities of the Company, which, by their very nature, involve a number of risks and uncertainties. When used in this discussion, the words "estimate", "project", "anticipate" and similar expressions, are subject to certain risks and uncertainties, such as the impact of terrorism and war on the national and international economies, including tourism and the securities markets, changes in general economic conditions, local real estate markets, and competition, as well as uncertainties relating to uninsured losses, securities markets, and litigation, including those discussed below that could cause actual results to differ materially from those projected. Readers are cautioned not to place undue reliance on these forward-looking statements. The Company undertakes no obligation to publicly release the results of any revisions to those forward-looking statements, which may be made to reflect events or circumstances after the date hereof or to reflect the occurrence of unanticipated events.

RECENT DEVELOPMENTS

In August 2005, the Company sold its 112-unit apartment complex located in Austin, Texas for \$4,400,000.

On July 27, 2005, Justice entered into a first mortgage loan (the "Prudential Loan") with The Prudential Insurance Company of America in a principal amount of \$30,000,000. The term of the Loan is for 120 months at a fixed interest rate of 5.22% per annum. The Loan calls for monthly installments of principal and interest in the amount of approximately \$165,100, calculated on a 360 month amortization schedule. The Loan is secured by a first deed of trust on the Partnership's Hotel property, including all improvements and personal property thereon and an assignment of all present and future leases and rents. The Loan is without recourse to the limited and general partners of Justice.

On July 27, 2005, Justice also obtained a \$10,000,000 Revolving Line of Credit ("LOC") from United Commercial Bank. The term of the LOC is for 60 months at an annual interest rate equal to either The Wall Street Journal Prime Rate or LIBOR + 2%, as selected by Justice, and is secured by a second deed of trust on the Hotel property. Interest only is payable monthly with principal and accrued interest due at maturity.

From the proceeds of the Prudential Loan, the Partnership retired its existing line of credit in the approximate amount of \$7,436,000, including accrued interest, and paid off a short term unsecured line of credit from United Commercial Bank in the amount of \$2,007,000, including accrued interest.

Justice believes that the Prudential Loan and the LOC will provide sufficient

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financial resources for the Partnership to complete the substantial renovations to the Hotel required by its Franchise License Agreement with Hilton. Justice also believes that it will be able to meet its debt service and operating capital needs through the reopening of the Hotel in the early part of 2006.

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RESULTS OF OPERATIONS

For the Year Ended June 30, 2005 as compared to June 30, 2004.

The Company had a net loss of \$3,128,000 for the year ended June 30, 2005 compared to net income of \$3,071,000 for the year ended June 30, 2004. The significant change is primarily attributable to the change in net investment gains(losses) from marketable securities, the change in the equity in net income(loss) of Justice Investors and the increase in the loss from real estate operations. These changes were partially offset by the gain on sale of real estate in the current fiscal year, the decrease in margin interest and trading expenses, the reduction in the impairment loss on other investments, the decrease in general and administrative expenses, the change in the tax provision from a tax expense to a tax benefit and the change in the minority interest.

The loss from real estate operations increased to \$1,723,000 for the year ended June 30, 2005 from \$1,183,000 for the year ended June 30, 2004 primarily due to the increase in the amortization of the intangible asset to \$555,000 from \$111,000, the loss on early extinguishment of debt of \$160,000 recognized in the current year partially offset by the overall decrease in operating expenses as a percentage of rental income to 42% from 46%. Rental income increased to \$12,966,000 from \$9,926,000 due to the inclusion of a full year's of rental income from the 358-unit Las Colinas, Texas property purchased in April 2004. The increase in the amortization of the intangible asset to \$555,000 from \$111,000 is due to the 10 months of amortization expense recorded in the current year as compared to 2 months recorded in the comparable prior year. This intangible asset was acquired along with the purchase of the Las Colinas, Texas property. The \$160,000 loss on early termination of debt in the current year is related to the early pay-off of a \$1,182,000 mortgage on the Company's 54-unit property located in Irving, Texas in August 2004. The increase in the mortgage interest and depreciation expenses is the result of the full year operation of the Las Colinas, Texas property in the current year. These expenses as a percentage of rental income are consistent with the prior year. Real estate taxes increased as a percentage of income to 15% from 10% as the result of the recent purchase of the Las Colinas, Texas property. Properties purchased recently have higher taxable basis for the purposes of calculating real estate taxes as compared to older properties.

In September 2004, the Company sold its 442-unit multi-family apartment complex located in Houston, Texas for \$11,850,000. The Company realized a gain on sale of real estate of \$6,006,000. This gain is reported under discontinued operations on the statement of operations.

Equity in net income(loss) of Justice Investors changed to a loss of \$2,303,000 for the year ended June 30, 2005 compared to income of \$3,136,000 for the year ended June 30, 2004. Effective July 1, 2004, Justice became the owner operator of the Hotel rather than a lessor. Thus, Partnership net income for fiscal 2005 includes the direct operating results of the Hotel, whereas in the prior year Justice received rental income from Felcor pursuant to a lease. The net operating loss from the hotel for fiscal 2005 was approximately \$1,734,000, while the Partnership received approximately \$2,617,000 in rent from the Hotel lease in fiscal 2004. Also, during fiscal 2004, a \$5,000,000

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settlement payment was made to Justice from the Hotel lessee to resolve disputes regarding certain obligations of Felcor and others under the terms of the Hotel Lease. In addition, Justice received a payment in December 2003 from the hotel lessee in the amount \$296,000 for part of the replacement costs of the sloped window system of the Hotel. Those two nonrecurring payments were included as other income by Justice in fiscal 2004.

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During fiscal 2005, the Justice also recorded a \$1,991,000 loss on disposition of assets as the Hotel was closed for major renovations on May 31, 2005. It is anticipated that the Hotel will be closed until the first part of calendar year 2006 before it reopens as the "Hilton San Francisco Financial District". The below ground parking garage and Tru Spa located on the lobby level of the Hotel, both of which are lessees of the Partnership, will remain open during the renovation work. Partnership rental income from the parking garage decreased to approximately \$1,005,000 in fiscal 2005 from approximately \$1,274,000 in fiscal 2004, primarily due to the closure of the Hotel for the last month of the fiscal year and lower Hotel occupancy rates in fiscal 2005. A further drop off in garage rental income is expected while the Hotel is being renovated, with an anticipated increase in garage rental income after the Hotel reopens as a Hilton.

Net investment gains(losses) on marketable securities changed to net losses of \$4,874,000 for the year ended June 30, 2005 from net gains of \$13,722,000 for the year ended June 30, 2004 as result of the significant decline in the market value of the Company's investment portfolio during the current year. For the year ended June 30, 2005, the Company had net unrealized losses of \$7,734,000 and net realized gains of \$2,860,000. For the year ended June 30, 2004, the Company had net unrealized gains of \$4,181,000 and realized gains of \$9,541,000. Gains and losses on marketable securities and other investments may fluctuate significantly from period to period in the future and could have a significant impact on the Company's net income. However, the amount of gain or loss on marketable securities and other investments for any given period may have no predictive value and variations in amount from period to period may have no analytical value. For a more detailed description of the composition of the Company's marketable securities please see the Marketable Securities section below.

During the year ended June 30, 2005, the Company recorded impairment losses of \$740,000 on other investments that were considered permanently impaired. In the comparable year, the Company recorded a impairment losses of \$1,155,000 related to other investments. These investments were determined to be impaired after review of their most recent financial statements and news releases.

Margin interest and trading expenses decreased to \$2,657,000 from \$4,629,000 primarily due to the decrease in the performance bonus granted to the Company's CEO based on the results of the Company's investment portfolio and the decrease in margin interest expense. During the year ended June 30, 2005, the CEO earned a performance bonus of \$320,000 compared with \$2,077,000 in the prior year. Margin interest expense also decreased to \$904,000 from \$1,437,000 in the prior year.

General and administrative expenses decreased to \$1,460,000 from \$1,892,000 as the result of management's effort to cut expenses across the board by reducing administrative staff. accounting related expenses and other general and administrative expenses.

The provision for income tax expense changed to a net tax benefit of \$2,668,000 from a net tax expense of \$3,515,000 as the result of the

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significant before tax loss of \$7,239,000 incurred in the current year as compared to the significant pretax income of \$8,407,000 generated in the prior year.

Minority interest expense(benefit) changed to a benefit of \$1,443,000 from an expense of \$1,821,000 as a result of significant loss incurred by the Company's subsidiary, Santa Fe during the current year as compared to income earned in the prior comparable year.

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MARKETABLE SECURITIES

The Company's securities investments are made under the supervision of a Securities Investment Committee of the Board of Directors. The Committee currently has three members and is chaired by the Company's Chairman of the Board and President, John V. Winfield. The Committee has delegated authority to manage the portfolio to the Company's Chairman and President together with such assistants and management committees he may engage. The Committee has established investment guidelines for the Company's investments. These guidelines presently include: (i) corporate equity securities should be listed on the New York or American Stock Exchanges or the Nasdaq NMS Market; (ii) securities should be priced above \$5.00 per share; and (iii) investment in a particular issuer should not exceed 5% of the market value of the total portfolio. The investment policies do not require the Company to divest itself of investments, which initially meet these guidelines but subsequently fail to meet one or more of the investment criteria. Non-conforming investments require the approval of the Securities Investment Committee. The Committee has in the past approved non-conforming investments and may in the future approve non-conforming investments. The Securities investment Committee may modify these guidelines from time to time.

The Company's investment portfolio is diversified with 63 different equity securities. The Company has four individual positions that comprise more than 5% of the equity value of the portfolio with the largest being 15.3% of the value of the portfolio. The amount of the Company's investment in any particular issue may increase or decrease, and additions or reductions to its securities portfolio may occur, at any time. While it is the internal policy of the Company to limit its initial investment in any single equity to less than 5% of its total portfolio value, that investment could eventually exceed 5% as a result of equity appreciation or reductions in other positions. Marketable securities are stated at market value as determined by the most recently traded price of each security at the balance sheet date. As of June 30, 2005, the market value of the Company's marketable securities was \$24,033,000.

The Company may also invest, with the approval of the Securities Investment Committee, in unlisted companies, through private placements. Those investments in non-marketable securities are carried at cost on the Company's balance sheet as part of other investments and are reviewed for impairment on a periodic basis.

As part of its investment strategies, the Company may assume short positions in marketable securities. Short sales are used by the Company to potentially offset normal market risks undertaken in the course of its investing activities or to provide additional return opportunities. As of June 30, 2005, the Company had obligations for securities sold (equities short) of \$5,257,000 and had no naked short positions.

In addition, the Company may utilize margin for its marketable securities purchases through the use of standard margin agreements with national

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brokerage firms. The use of available leverage is guided by the business judgment of management and is subject to any internal investment guidelines, which may be imposed by the Securities Investment Committee. The margin used by the Company may fluctuate depending on market conditions. The use of leverage could be viewed as risky and the market values of the portfolio may be subject to large fluctuations. As of June 30, 2005, the Company had a margin balance of \$6,726,000 and incurred \$904,000 and \$1,437,000 in margin interest expense during the year ended June 30, 2005 and June 30, 2004, respectively.

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The following table shows the composition of the Company's marketable securities by selected industry groups as of June 30, 2005.

Industry Group -----	Market Value -----	% of Total Investment Securities -----
Telecommunications and media	\$ 7,303,000	30.4%
Insurance and banks	5,262,000	21.9%
REITs, lodging, home builders and hotels	3,494,000	14.5%
Chemicals, building materials, Machinery metals, mining and paper	2,603,000	10.8%
Electric, pipelines, oil and gas	1,739,000	7.2%
Retail, restuarants and consumer goods	1,016,000	4.3%
Other	2,616,000	10.9%
	-----	-----
	\$ 24,033,000	100.0%
	=====	=====

The following table shows the net gain or loss on the Company's marketable securities and the associated margin interest and trading expenses for the year ended June 30, 2005 and 2004.

	2005 -----	2004 -----
Net investment gains(losses)	\$ (4,874,000)	\$ 13,722,000
Impairment loss on other investments	(258,000)	(1,155,000)
Dividend & interest income	942,000	777,000
Margin interest	(904,000)	(1,437,000)
Trading expenses	(1,753,000)	(3,192,000)
	-----	-----
Investment income(loss)	\$ (6,847,000)	\$ 8,715,000
	=====	=====

FINANCIAL CONDITION AND LIQUIDITY

The Company's cash flows are generated primarily from its real estate activities, sales of investment securities and borrowings related to both. The Company generated cash flow of \$3,929,000 from operating activities, generated net cash flow of \$5,188,000 from investing activities, and used net cash flow of \$9,026,000 for financing activities during the year ended June 30, 2005.

In September 2004, the Company sold its 442-unit multi-family apartment complex located in Houston, Texas for \$11,850,000. The Company realized a

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gain of \$6,006,000 and received net proceeds of \$11,273,000 after selling costs and attorneys' fees. As a part of the sale of property, the Company paid off the related mortgage loan in the amount of \$9,864,000.

In August 2004, the Company purchased an approximately two acre parcel of unimproved land in Kihei, Maui, Hawaii for \$1,467,000. The land is included property held for development on the balance sheet. To facilitate the purchase of the land, the Company obtained a loan in the amount of \$750,000. The loan is for a term of three years at a floating interest rate equal to the bank's base rate (4.75% as of June 30, 2005) plus 1%. Interest only is payable monthly.

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During the year ended June 30, 2005, the Company improved properties in the aggregate amount of \$2,922,000. Management believes the improvements to the properties should enhance market values, maintain the competitiveness of the Company's properties and potentially enable the Company to obtain a higher yield through higher rents.

During the year ended June 30, 2005, the Company purchased 48,400 shares of Portsmouth stock for a total investment of \$1,499,000.

During the year ended June 30, 2005, the Company purchased 20,268 shares of Santa Fe stock for a total investment of \$197,000.

During the year ended June 30, 2005, the Company had new borrowings in the form of mortgages totaling \$6,703,000 and made principal payments on mortgages totaling \$16,002,000. The Company also borrowed from a line of credit in the amount of \$1,313,000.

In June 2005, the Company refinanced a loan in the amount of \$4,006,000 on its 157-unit Florence, Kentucky property and obtained a new mortgage in the amount of \$4,200,000. The loan is a 10 year fixed rate loan at 4.995%.

During the year ended June 30, 2005, the Company used additional construction loan proceeds of \$1,753,000 renovate its 30-unit apartment located in Los Angeles, California. As of June 30, 2005, the balance on the construction loan was \$5,133,000.

In August 2004, the Company repaid a mortgage in the amount of \$1,182,000 on its 54-unit multi-family apartment located in Irving, Texas. Related to the repayment of the mortgage, the Company incurred an early termination fee of \$160,000.

The Company's Board of Directors has given the Company the authority to repurchase, from time to time, shares of its Common Stock. Such repurchases may be made at the discretion of management and depending upon market conditions. During the year ended June 30, 2005, the Company acquired an additional 76,500 shares of its Common Stock for \$1,040,000. Approximately 96,000 shares remain eligible for the Company to repurchase under that authorization.

Subsequent to the fiscal year end, Justice entered into a first mortgage loan (the "Prudential Loan") with The Prudential Insurance Company of America in a principal amount of \$30,000,000 on July 27, 2005. The term of the Loan is for 120 months at a fixed interest rate of 5.22% per annum. The Loan calls for monthly installments of principal and interest in the amount of approximately \$165,100, calculated on a 360 month amortization schedule. The Loan is secured by a first deed of trust on the Partnership's Hotel property, including all improvements and personal property thereon and an assignment of all present

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and future leases and rents. The Loan is without recourse to the limited and general partners of Justice.

On July 27, 2005, Justice also obtained a \$10,000,000 Revolving Line of Credit ("LOC") from United Commercial Bank. The term of the LOC is for 60 months at an annual interest rate equal to either The Wall Street Journal Prime Rate or LIBOR + 2%, as selected by Justice, and is secured by a second deed of trust on the Hotel property. Interest only is payable monthly with principal and accrued interest due at maturity.

From the proceeds of the Prudential Loan, the Partnership retired its existing line of credit in the approximate amount of \$7,436,000, including accrued

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interest, and paid off a short term unsecured line of credit from United Commercial Bank in the amount of \$2,007,000, including accrued interest.

The Justice believes that the Prudential Loan and the LOC will provide sufficient financial resources for the Partnership to complete the substantial renovations to the Hotel required by its Franchise License Agreement with Hilton. Justice also believes it will be able to meet its debt service and operating capital needs through the reopening of the Hotel in the early part of 2006.

That additional amount of leverage related to the Prudential Loan and the utilization of the LOC and the associated debt service will create additional risk for the Partnership and its ability to generate cash flows in the future since the Hotel asset has been virtually debt free for many years. The Partnership does not anticipate paying any partnership distributions until some time after operations commence under the Hilton brand and net income and capital requirements warrant such distributions. As a result, the Company may have to depend more on the revenues generated from the investment of its cash and securities assets during that transition period.

Management anticipates that the net cash flow generated from future operating activities will be sufficient to meet its operating and long-term debt service requirements.

OFF-BALANCE SHEET ARRANGEMENTS

The Company has no off balance sheet arrangements.

CONTRACTUAL OBLIGATIONS

The Company's contractual obligations and commercial commitments are its mortgages. The annual principal payments on the mortgages for the five-year period and thereafter commencing July 1, 2005 are approximately as follows:

Year ending June 30,	
2006	\$ 6,256,000
2007	1,192,000
2008	2,015,000
2009	1,301,000
2010	1,296,000
Thereafter	68,372,000

Total	\$80,432,000
	=====

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IMPACT OF INFLATION

The Company's residential and commercial rental properties provide income from short-term operating leases and no lease extends beyond one year. Rental increases are expected to offset anticipated increased property operating expenses.

The Company's revenue from its interest in Justice Investors is primarily dependent on hotel revenues. Hotel room rates are typically impacted by supply and demand factors, not inflation, because rental of a hotel room is usually for a limited number of nights. Room rates are usually adjusted to account for inflationary cost increases; therefore, the impact of inflation should be minimal.

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CRITICAL ACCOUNTING POLICIES

The Company reviews its long-lived assets including its investment in real estate and other investments for impairment when circumstances indicate that a potential loss in carrying value may have occurred. To the extent that projected future undiscounted cash flows from the operation of the hotel property, owned through the Company's investment in Justice Investors, and rental properties are less than the carrying value of the assets, the carrying value of the assets are reduced to their fair value. For other investments, the Company reviews the investment's operating results, financial position and other relevant factors to determine whether the estimated fair value of the asset is less than the carrying value of the asset.

In March 2004, the EITF ratified its consensus on Issue No. 03-1, The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments (EITF 03-1). On September 30, 2004, the Financial Accounting Standard Board (FASB) issued a final FASB Staff Position, FSP EITF Issue 03-1-1 that delays the effective date for the measurement and recognition guidance included in EITF 03-1. Disclosures required by EITF 03-1 have not been deferred and the Company has adopted those disclosures.

Marketable securities are stated at market value as determined by the most recently traded price of each security at the balance sheet date. Marketable securities are classified as trading with net change in unrealized gains or losses included in earnings. The Company's other accounting policies are straightforward in their application.

Item 7. Financial Statements.

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and
Shareholders of The InterGroup Corporation:

In our opinion, the accompanying consolidated balance sheets and the related consolidated statements of operations, shareholders' equity and cash flows present fairly, in all material respects, the financial position of The InterGroup Corporation at June 30, 2005, and the results of its operations and its cash flows for each of the two years in the period ended June 30, 2005 in conformity with accounting principles generally accepted in the United States of America. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits of these statements in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As discussed in Note 7 to the financial statements, the Company has restated its June 30, 2003 shareholders' equity.

/s/ PricewaterhouseCoopers LLP

Irvine, California
October 17, 2005

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THE INTERGROUP CORPORATION CONSOLIDATED BALANCE SHEET

As of June 30,	2005

ASSETS	
Investment in real estate, at cost:	
Land	\$ 22,899,000
Buildings, improvements and equipment	67,278,000
Less: accumulated depreciation	(19,235,000)

	70,942,000

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Property held for sale or development	14,924,000

	85,866,000
Investment in Justice Investors	9,522,000
Cash and cash equivalents	868,000
Restricted cash	2,981,000
Investment in marketable securities	24,033,000
Prepaid expenses and other assets	4,035,000

Total Assets	\$ 127,305,000
	=====

LIABILITIES AND SHAREHOLDERS' EQUITY

Liabilities:

Mortgage notes payable	\$ 80,432,000
Due to securities brokers	6,726,000
Obligation for securities sold	5,257,000
Line of credit	6,313,000
Accounts payable and other liabilities	3,512,000
Deferred income taxes	6,300,000

Total Liabilities 108,540,000

Minority Interest 6,624,000

Commitments and Contingencies

Shareholders' Equity:

Preferred stock, \$.01 par value, 2,500,000 shares authorized; none issued	-
Common stock - Class A, \$.01 par value, 2,500,000 shares authorized: none issued	-
Common stock, \$.01 par value, 4,000,000 shares authorized; 3,193,745 shares issued and 2,420,186 outstanding	21,000
Additional paid-in capital	8,686,000
Retained earnings	11,273,000
Treasury stock, at cost, 773,559 shares	(7,839,000)

Total Shareholders' Equity 12,141,000

Total Liabilities and Shareholders' Equity \$ 127,305,000

The accompanying notes are an integral part of the consolidated financial statements.

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THE INTERGROUP CORPORATION
CONSOLIDATED STATEMENTS OF OPERATIONS

For the Year Ended June 30,	2005	2004
	-----	-----
Real estate operations:		
Rental income	\$ 12,966,000	\$ 9,926,000

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Rental expenses:		
Property operating expenses	(5,701,000)	(4,933,000)
Mortgage interest expense	(3,818,000)	(3,120,000)
Real estate taxes	(1,994,000)	(1,123,000)
Depreciation	(2,461,000)	(1,822,000)
Amortization	(555,000)	(111,000)
Loss on early extinguishment of debt	(160,000)	-
	-----	-----
Loss from real estate operations	(1,723,000)	(1,183,000)
	-----	-----
Equity in net income(loss) of Justice Investors	(2,303,000)	3,136,000
	-----	-----
Investment transactions:		
Net investment gains(losses)	(4,874,000)	13,722,000
Impairment loss on other investments	(740,000)	(1,155,000)
Dividend and interest income	942,000	777,000
Margin interest and trading expenses	(2,657,000)	(4,629,000)
	-----	-----
Income(loss) from investment transactions	(7,329,000)	8,715,000
	-----	-----
Other income(expense):		
General and administrative expenses	(1,460,000)	(1,892,000)
Other income	121,000	143,000
	-----	-----
Other expense	(1,339,000)	(1,749,000)
	-----	-----
Income(loss) before provision for income taxes and minority interest	(12,694,000)	8,919,000
	-----	-----
Provision for income tax benefit(expense)	4,678,000	(3,729,000)
	-----	-----
Income(loss) before minority interest	(8,016,000)	5,190,000
Minority interest benefit(expense), net of tax	1,443,000	(1,821,000)
	-----	-----
Net income(loss) from continuing operations	\$ (6,573,000)	\$ 3,369,000
	-----	-----
Discontinued operations:		
Net loss on discontinued operations	\$ (614,000)	\$ (512,000)
Gain on sale of real estate	6,069,000	-
Provision for income tax benefit(expense)	(2,010,000)	214,000
	-----	-----
Income(loss) from discontinued operations	\$ 3,445,000	\$ (298,000)
	-----	-----
Net income(loss)	\$ (3,128,000)	\$ 3,071,000
	=====	=====
Income(loss) per share from continuing operations		
Basic	\$ (2.68)	\$ 1.34
Diluted	\$ (2.68)	\$ 1.19
	=====	=====
Income(loss) per share from discontinued operations		
Basic	\$ 1.40	\$ (0.12)
Diluted	\$ 1.22	\$ (0.12)
	=====	=====
Net(loss) income per share		
Basic	\$ (1.27)	\$ 1.22
Diluted	\$ (1.27)	\$ 1.08
	=====	=====
Weighted average number of shares outstanding	2,453,544	2,518,124
	=====	=====
Diluted weighted average number of shares		

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outstanding	2,821,044	2,836,124
	=====	=====

The accompanying notes are an integral part of the consolidated financial statements.

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THE INTERGROUP CORPORATION
CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY

	Common stock	Additional paid-in capital	Retained Earnings (restated)	Treasury Stock	Total
	-----	-----	-----	-----	-----
Balance at June 30, 2003	\$21,000	\$8,686,000	\$11,330,000	\$(6,390,000)	\$13,647,000
Net income			3,071,000		3,071,000
Purchase of treasury stock				(409,000)	(409,000)
	-----	-----	-----	-----	-----
Balance at June 30, 2004	21,000	8,686,000	14,401,000	(6,799,000)	16,309,000
Net loss			(3,128,000)		(3,128,000)
Purchase of treasury stock				(1,040,000)	(1,040,000)
	-----	-----	-----	-----	-----
Balance at June 30, 2005	\$21,000	\$8,686,000	\$11,273,000	\$(7,839,000)	\$12,141,000
	=====	=====	=====	=====	=====

The accompanying notes are an integral part of the consolidated financial statements.

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THE INTERGROUP COPORATION
CONSOLIDATED STATEMENTS OF CASH FLOWS

For the Year Ended June 30,	2005	2004
	-----	-----
Cash flows from operating activities:		
Net income (loss)	\$(3,128,000)	\$ 3,071,000
Adjustments to reconcile net income (loss) to cash (used in) provided by operating activities:		
Depreciation of real estate	2,461,000	1,822,000

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Depreciation (discontinued operations)	443,000	893,000
Amortization of intangible asset	555,000	111,000
Gain on sale of real estate	(6,069,000)	-
Loss on early extinguishment of debt	160,000	-
Equity in net income of Justice Investors	2,303,000	(3,136,000)
Net unrealized gain on investments	7,734,000	(4,181,000)
Impairment loss on other investments	740,000	1,155,000
Minority interest	(1,443,000)	1,821,000
Changes in assets and liabilities:		
Restricted cash	572,000	(42,000)
Prepaid expenses and other assets	1,204,000	789,000
Investment in marketable securities	34,632,000	(7,289,000)
Other investments	(1,716,000)	(2,815,000)
Accounts payable and other liabilities	(958,000)	47,000
Due to securities broker	(15,719,000)	2,124,000
Obligations for securities sold	(16,328,000)	5,096,000
Deferred taxes	(1,516,000)	1,863,000
	-----	-----
Net cash provided by operating activities	3,927,000	1,329,000
	-----	-----
Cash flows from investing activities:		
Net proceeds from sale of real estate	11,273,000	-
Investment in real estate	(1,467,000)	(27,180,000)
Purchase of intangible asset	-	(666,000)
Additions to buildings, improvements and equipment	(2,920,000)	(2,152,000)
Investment in Santa Fe	(197,000)	(1,031,000)
Investment in Portsmouth	(1,499,000)	(210,000)
Distributions from Justice Investors	-	953,000
	-----	-----
Net cash provided by(used in) investing activities	5,190,000	(30,286,000)
	-----	-----
Cash flows from financing activities:		
Borrowings from mortgage notes payable	6,703,000	31,656,000
Principal payments on mortgage notes payable	(16,002,000)	(8,201,000)
Borrowings from(repayment of) line of credit	1,313,000	5,000,000
Dividends paid to minority shareholders	-	(171,000)
Purchase of treasury stock	(1,040,000)	(409,000)
	-----	-----
Net cash provided by(used in) financing activities	(9,026,000)	27,875,000
	-----	-----
Net increase(decrease) in cash and cash equivalents	91,000	(1,082,000)
Cash and cash equivalents at beginning of period	777,000	1,859,000
	-----	-----
Cash and cash equivalents at end of period	\$ 868,000	\$ 777,000
	=====	=====

The accompanying notes are an integral part of the consolidated financial statements.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. Business and Significant Accounting Policies and Practices:

Description of the Business

The InterGroup Corporation ("InterGroup" or the "Company") was formed to buy, develop, operate and dispose of real property and to engage in various investment activities to benefit the Company and its shareholders.

As of June 30, 2005 and 2004, the Company had the power to vote 76.9% and 75.2%, respectively, of the voting shares of Santa Fe Financial Corporation ("Santa Fe"), a public company (OTCBB: SFEF). Those percentages include the power to vote an approximately 4% interest in the common stock in Santa Fe owned by the Company's Chairman and President pursuant to a voting trust agreement entered into on June 30, 1998.

Santa Fe's revenue is primarily generated through the management of its 68.8% owned subsidiary, Portsmouth Square, Inc. ("Portsmouth"), a public company (OTCBB: PRSI), which derives its revenue primarily as a general partner and a 49.8% limited partner in Justice Investors, a California limited partnership ("Justice" or the "Partnership"). Justice owns the land, improvements and leaseholds commonly known as the Holiday Inn Select Downtown & Spa, a 565-room hotel in San Francisco, California (the "Hotel").

Principles of Consolidation

The consolidated financial statements include the accounts of the Company and all controlled subsidiaries. All significant inter-company transactions and balances have been eliminated.

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 as of the date of the financial statements and the reported amounts of revenue and expenses during the reporting period. Actual results could differ from those estimates.

Investment in Real Estate

Investments in real estate are stated at cost. Depreciation of buildings, improvements and equipment is provided on the straight-line method based upon estimated useful lives of five to forty years for buildings and improvements and five to ten years for equipment. Expenditures for repairs and maintenance are charged to expense as incurred and improvements are capitalized.

In accordance with Statement of Financial Accounting Standards No. 144 (SFAS 144), "Accounting for Impairment or Disposal of Long-Lived Assets", the Company reviews its rental property assets for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. If expected future cash flows (undiscounted and excluding interest costs) are less than the carrying value of the rental asset, the asset is written down to its fair value. The estimation of expected future net cash flows is inherently uncertain and relies to a considerable extent on assumptions regarding current and future economic and market conditions, and

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the availability of capital. If, in future periods, there are changes in the estimates or assumptions incorporated into the impairment review analysis, the changes could result in an adjustment to the carrying amount of the long-lived asset. No impairment losses have been recorded for the year ended June 30, 2005 and 2004.

Properties are classified as held for sale when management commits to a plan to sell the asset, the asset is available for immediate sale, an active program to locate a buyer has been initiated, the sale of the asset is probable, the sale of the asset is actively marketed and it is unlikely that significant changes to the sale plan will be made or withdrawn. As of June 30, 2005, the Company had six properties classified as held for sale.

Cash and Cash Equivalents

Cash equivalents consist of highly liquid investments with an original maturity of three months or less when purchased and are carried at cost, which approximates fair value.

Restricted Cash

Restricted cash is comprised of amounts held by lenders for payment of real estate taxes, insurance, replacement reserves for the operating properties and tenant security deposits that are invested in certificates of deposit.

Marketable Securities

Marketable securities are stated at market value as determined by the most recently traded price of each security at the balance sheet date. Marketable securities are classified as trading securities with all unrealized gains and losses on the Company's investment portfolio recorded through the statement of operations.

Other Investments

The Company may also invest, with the approval of the Securities Investment Committee, in unlisted companies, through private placements. Those investments in non-marketable securities are carried at the lower of cost or estimated fair value on the Company's balance sheet as part of other investments and reviewed for impairment on a periodic basis.

Due to Securities Broker

The Company may utilize margin for its marketable securities purchases through the use of standard margin agreements with national brokerage firms. Various securities brokers have advanced funds to the Company for the purchase of marketable securities under standard margin agreements. These advanced funds are recorded as a liability.

Obligation for Securities Sold

Obligation for securities sold represents the fair market value of shares sold with the promise to deliver that security at some future date and the fair market value of shares underlying the written call options with the obligation to deliver that security when and if the option is exercised. The obligation may be satisfied with current holdings of the same security or by subsequent purchases of that security. Unrealized gains and losses from changes in the obligation are included in earnings.

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Treasury Stock

The Company records the acquisition of treasury stock under the cost method.

Rental Income

Rental income is recognized as earned. Revenue recognition from apartment rentals commences when an apartment unit is placed in service and occupied by a rent-paying tenant. Apartment units are leased on a short-term basis, with no lease extending beyond one year.

Income Taxes

Deferred income taxes are determined using the liability method. A deferred tax asset or liability is determined based on the difference between the financial statement and tax basis of assets and liabilities as measured by statutory tax rates. Deferred tax expense is the result of changes in the asset and/or liability for deferred taxes.

Fair Value of Financial Instruments

The carrying amount of cash and cash equivalents, restricted cash, marketable securities, other investments, mortgage notes payable, amounts due securities brokers and obligations for securities sold approximates fair value. The fair value of mortgage notes payable is estimated using discounted cash flows of future payments based on the borrowing rates available to the Company for debt with similar terms and maturities.

Stock-Based Compensation Plans

Effective December 15, 2002, the Company adopted Statement of Financial Accounting Standards No. 148, "Accounting for Stock-Based Compensation-Transition and Disclosure", which amends Statement of Financial Accounting Standards No. 123, "Accounting for Stock-Based Compensation" (SFAS 148). In accounting for its plans, the Company, as allowable under the provisions of SFAS 148, applies Accounting Principles Board Opinions No. 25, "Accounting for Stock issued to Employees." As a result of this election, the Company does not recognize compensation expense for its stock option plans. For options issued in fiscal years 2005 and 2004, options are vested as of the grant date. Had the Company determined compensation cost based on the fair value for its stock options at grant date (based on 16,500 and 15,000 in fiscal years 2005 and 2004, respectively), net income(loss) and earnings(loss) per share would have been reduced to the pro forma amounts as follows:

	2005	2004
	-----	-----
Net income(loss)	\$(3,128,000)	\$ 3,071,000
Stock based employee Compensation expense*	(77,000)	(64,000)
	-----	-----
Pro forma net income(loss)	\$(3,205,000)	\$ 3,007,000
Earnings(loss) per share		
Basic as reported	\$ (1.27)	\$ 1.22
Basic pro forma	\$ (1.31)	\$ 1.19
Diluted as reported	\$ (1.27)	\$ 1.08
Diluted pro forma	\$ (1.31)	\$ 1.06

*Determined under fair value based on method for awards net of related tax

effects (40%).

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The difference between the net income as reported and the pro forma net income is due to subtraction of the fair market value (net of tax effect) of the vested stock options of \$129,000 and \$107,000, respectively, for the fiscal years ended June 30, 2005 and 2004.

The Black-Scholes option pricing model was used with the following weighted-average assumptions for 2005; risk-free interest rate of 3.87%; dividend yield of 0%; expected Common Stock market price volatility factor of 24.60; and a weighted-average expected life of the options of 10 years. The weighted-average fair value of options granted in fiscal years 2005 and 2004 were \$7.83 and \$7.12 per share, respectively. The aggregate fair value of the options granted in fiscal years 2005 and 2004 were \$129,000 and \$107,000 respectively.

Earnings Per Share

Basic earnings per share is computed by dividing net income available to common stockholders by the weighted average number of common shares outstanding. The computation of diluted earnings per share is similar to the computation of basic earnings per share except that the weighted-average number of common shares is increased to include the number of additional common shares that would have been outstanding if potential dilutive common shares had been issued. The Company's only potentially dilutive common shares are stock options. Stock options are included in diluted earnings per share by application of the treasury stock method. As of June 30, 2005, the Company had 367,500 stock options that were considered potentially dilutive common shares and 25,500 stock options that were considered anti-dilutive. These amounts were included in the calculation for diluted earnings per share.

2. Investment in Real Estate:

At June 30, 2005, the Company's investment in real estate consisted of twenty six properties located throughout the United States. These properties include twenty two apartment complexes, two single-family houses as strategic investments, and two commercial real estate properties, one of which serves as the Company's corporate headquarters. Twenty one of the twenty two apartment complexes are completed, operating properties. The one non-operating apartment complex is undergoing a major renovation.

In September 2004, the Company sold its 442-unit multi-family apartment complex located in Houston, Texas for \$11,850,000. The Company realized a gain of \$6,006,000 and received net proceeds of \$11,273,000 after selling costs and attorneys' fees.

Under the provisions of the Statement of Financial Accounting Standards No.144, Accounting for Impairment or Disposal of Long-Lived Assets, for properties disposed of during the year or for properties for which the Company actively markets for sale at a price that is reasonable in relation to its market value, the properties are required to be classified as held for sale on the balance sheet and accounted for under discontinued operations in the statement of operations. The revenues and expenses from the operation of these properties have been reclassified from continuing operations for the year ended June 30, 2005 and 2004 and reported as income from discontinued operations in the consolidated statements of operations.

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As of June 30, 2005, the Company had six properties held for sale, two of the properties are located in Texas and the remaining four are located in California. The two Texas properties were sold in September 2004 and August 2005, respectively. The revenues and expenses from the operation for these six properties have been reclassified from continuing operations for the year ended June 30, 2005 and 2004 and reported as income from discontinued operations in the consolidated statements of operations.

Revenues and expenses from the operation of these properties for the year ended June 30, 2005 and 2004 are summarized as follows:

For the year ended June 30,	2005	2004
Revenues	\$1,728,000	\$ 3,831,000
Expenses	(2,342,000)	(4,343,000)
Net loss	(614,000)	(512,000)

Depreciation expense for the year ended June 30, 2005 and 2004, was \$443,000 and \$893,000, respectively.

In August 2004, the Company purchased an approximately two acre parcel of unimproved land in Kihei, Maui, Hawaii for \$1,467,000. The land is included property held for development on the balance sheet.

In April 2004, the Company purchased a 358-unit apartment complex in Los Colinas, Texas for \$27,145,000 in a tax-deferred exchange with the St. Louis, Missouri property sold in August 2001. To finance the purchase, the Company obtained a nine year \$20,000,000 mortgage note. In accordance with SFAS 141, "Business Combinations," the acquisition value was allocated to the land and building utilizing an "as if vacant" methodology, with the balance of the purchase price allocated to identifiable intangible assets. Identifiable intangible assets relate to the value of the in-place operating leases and comprise: (i) origination value, which represents the "cost avoidance" value associated with acquired in-place leases; and (ii) value of the renewal of in-place leases, which represents the estimated loss of revenue and costs incurred to renew the operating leases following its expiration. The origination value and the value of the renewal of in-place tenant leases are recorded as a deferred charge and are amortized over the remaining lease term of twelve months.

Based on this valuation, the purchase price and closing costs were allocated as follows:

Land	\$ 4,050,000
Building	22,429,000
Intangible asset - origination costs	206,000
Intangible asset - renewal lease-up costs	460,000

	\$27,145,000
	=====

During the year ended June 30, 2005 and 2004, the Company recorded an amortization expense associated with these intangible assets in the amount of \$555,000 and \$111,000, respectively.

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3. Marketable Securities and Other Investments:

At June 30, 2005, all of the Company's marketable securities are classified as trading securities. In accordance with SFAS No. 115, "Accounting for Certain Investments in Debt and Equity Securities," the change in the unrealized gains and losses on these investments are included earnings. Trading securities are summarized as follows:

As of June 30, 2005

Investment	Cost	Gross Unrealized Gain	Gross Unrealized Loss	Net Unrealized Gain	Market Value
-----	-----	-----	-----	-----	-----
Corporate					
Equities	\$21,701,000	\$3,991,000	(\$1,659,000)	\$2,332,000	\$24,033,000

Of the gross unrealized loss of \$1,659,000, \$1,291,000 of the loss is related to securities held for over one year.

As of June 30, 2005, the Company had net other investments of \$2,168,000. This balance includes \$4,063,000 in other investment, net an impairment loss of \$1,895,000. Included in the prepaid expenses and other assets of \$4,035,000 are other investments of \$2,168,000.

As part of the investment strategies, the Company may assume short positions in marketable securities. Short sales are used by the Company to potentially offset normal market risks undertaken in the course of its investing activities or to provide additional return opportunities. As of June 30, 2005, the Company had obligations for securities sold (equities short) of \$5,257,000 and had no naked short positions.

For the year ended June 30, 2005, net losses on marketable securities of \$4,874,000 included net unrealized losses of \$7,734,000 and net realized gains of \$2,860,000. For the year ended June 30, 2004, net investment gains of \$13,722,000 included net unrealized gains of \$4,181,000 and net realized gains of \$9,541,000.

4. Investment in Justice Investors:

The consolidated accounts include a 49.8% interest in Justice Investors through the Company's interest in Santa Fe. Justice owns the land improvements and leasehold commonly known as the Holiday Inn Select Downtown & Spa, a 565-room hotel in the financial district of San Francisco, California. Portsmouth is both a general and limited partner in Justice and oversees operations and shares management responsibilities with the other general partner. Portsmouth records its investment in Justice on the equity basis.

The Company amortizes the step up in the asset values which represents the access purchase price over the underlying book value and is allocable to the depreciable assets of its investment in Justice Investors over 40 years, which approximates the remaining life of the primary asset, the hotel building.

For the Company's investment in Justice, to the extent that projected future undiscounted cash flows from the operation of the Hotel property are less than

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the carrying value of the asset, the investment would be considered permanently impaired and the carrying value of the asset would be reduced to its fair value.

Historically, Justice's most significant income source was a lease between the Partnership and Felcor Lodging Trust, Inc. ("Felcor") for the Hotel portion of the property. Pursuant to a Settlement Agreement entered into on May 3, 2004,

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Felcor agreed to terminate its lease and surrender possession of the Hotel to Justice, on June 30, 2004. Effective July 1, 2004, Justice became the owner-operator of the Hotel, with the assistance of a Management Agreement with Dow Hotel Company, LLC. ("Dow") to perform the day-to-day management functions of the Hotel. The Partnership also derives income from the lease of the garage portion of the property to Evon and from a lease on the lobby level of the Hotel to Tru Spa. The Company also derives revenue from management fees from Justice for actively managing the hotel as a general partner.

On December 10, 2004, Justice entered into a Franchise License Agreement for the right to operate the Hotel property as a Hilton brand hotel. Prior to operating the hotel as a Hilton, the Partnership is required to make substantial renovations to the hotel to meet Hilton standards in accordance with a product improvement plan agreed upon by Hilton and the Partnership, as well as complying with other brand standards. The Partnership currently estimates that the cost of the renovation project will be approximately \$33 million. That amount includes approximately \$28 million for the actual cost of the renovations and approximately \$5 million for construction interest and estimated carrying costs of operations during the renovation period. The Agreement requires that those renovations be complete and the Hotel commence operations as a Hilton hotel no later than June 1, 2006. The term of the Agreement is for a period of 15 years commencing on the opening date, with an option to extend the license term for another five years, subject to certain conditions.

On March 15, 2005, the Partnership announced its decision to close down its Hotel operations on or about June 1, 2005 to complete renovations of the Hotel as required by the Hilton Agreement. It is anticipated that the Hotel will be closed for a period of approximately seven to nine months before a contemplated reopening in the early part of 2006 as the "Hilton San Francisco Financial District". The below ground parking garage and Tru Spa located on the lobby level of the Hotel, both of which are lessees of the Partnership, will remain open during the renovation work.

Condensed financial statements for Justice Investors are as follows:

JUSTICE INVESTORS CONDENSED BALANCE SHEET

As of June 30,	2005

Assets	
Total current assets	\$ 1,277,000
Property, plant and equipment, net of accumulated depreciation of \$13,405,000	5,003,000
Land	1,124,000
Construction in progress	7,952,000
Other assets	133,000

Total assets	\$15,489,000
	=====

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Liabilities and partners' capital	
Total current liabilities	\$ 4,444,000
Long term debt	7,131,000
Partners' capital	3,914,000

Total liabilities and partners' capital	\$15,489,000
	=====

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JUSTICE INVESTORS
CONDENSED STATEMENTS OF OPERATIONS

For the year ended June 30,	2005	2004
	-----	-----
Hotel revenue	\$ 12,930,000	\$ -
Hotel rent	-	2,617,000
Garage rent	1,005,000	1,274,000
Other income	53,000	5,477,000
Operating expenses	(16,218,000)	(2,506,000)
Loss on disposition of assets	(1,991,000)	-
	-----	-----
Net income(loss)	\$ (4,221,000)	\$ 6,862,000
	=====	=====

5. Mortgage Notes Payable:

As of June 30, 2005, the Company had mortgage debt outstanding of \$80,432,000. The mortgages carry variable rates from 3.50% to 8.44% and fixed rates ranging from 4.35% to 8.23%.

In June 2005, the Company refinanced a loan in the amount of \$4,006,000 on its 157-unit Florence, Kentucky property and obtained a new mortgage in the amount of \$4,200,000. The loan is a 10 year fixed rate loan at 4.995%.

In September 2004, as a part of the sale of its 442-unit property in Houston, Texas, the Company paid off the related mortgage loan in the amount of \$9,864,000.

In August 2004, the Company repaid a mortgage in the amount of \$1,182,000 on its 54-unit multi-family apartment located in Irving, Texas. Related to the repayment of the mortgage, the Company incurred an early termination fee of \$160,000.

In August 2004, to facilitate the purchase of the land in Kihei, Maui, the Company obtained a loan in the amount of \$750,000. The loan is for a term of three years at a floating interest rate equal to the bank's base rate (4.75% as of June 30, 2005) plus 1%. Interest only is payable monthly.

In May 2004, the Company paid off a mortgage in the amount of \$2,668,000 and obtained a new construction loan in the amount of \$6,268,000 as part of a major renovation of its 30-unit apartment complex located in Los Angeles. During the year ended June 30, 2005, the Company used additional construction loan proceeds of \$1,753,000 to renovate this apartment complex. As of June 30, 2005, the balance on the construction loan was \$5,133,000.

In April 2004, the Company purchased a 358-unit apartment complex in Las Colinas, Texas for \$27,145,000 in a tax-deferred exchange with the St. Louis, Missouri property sold in August 2001. To finance the purchase, the Company

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obtained a nine year \$20,000,000 mortgage note with a fixed rate of 4.99%. After nine years, the loan is extendable at a variable interest rate for one additional year. For the first year of the loan, interest only payments of \$86,000 per month are required.

In November 2003, the Company refinanced four mortgage loans totaling \$2,457,000 and obtained four new mortgage loans totaling \$3,535,000. All four loans have a fixed interest rate of 6.38% for the first ten years of the loan. After ten years, the interest rate is adjustable through maturity on December 1, 2018.

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In August 2003, the Company acquired a single-family house in Los Angeles, California for \$700,000. In October 2003, the Company obtained a mortgage loan of \$525,000 on this unencumbered property.

Each mortgage is secured by its respective land and building. Mortgage notes payable secured by real estate are comprised of the following information as of June 30, 2005:

Property	Number of Units	Note Origination Date	Note Maturity Date	Mortgage Balance	Interest Rate
Los Angeles	30	May 2004	April 2006	\$5,133,000	3.50%
Los Angeles	Office	September 2000	December 2013	791,000	6.00%
Los Angeles	24	March 2001	April 2031	1,717,000	7.15%
Los Angeles	5	July 2000	August 2030	434,000	7.59%
Los Angeles	1	November 2000	December 2030	467,000	8.44%
Kihei, Maui	Land	August 2004	August 2007	750,000	5.75%
Total variable interest debt				\$9,292,000	
Austin	112	September 2001	September 2009	\$ 2,190,000	8.23%
Austin	249	June 2003	July 2023	7,884,000	5.46%
Florence	157	June 2005	June 2015	4,200,000	4.99%
Irving	224	July 2001	January 2008	4,185,000	7.01%
Las Colinas	358	April 2004	May 2013	19,979,000	4.99%
Morris County	151	April 2003	May 2013	10,271,000	5.43%
San Antonio	132	November 1998	December 2008	2,993,000	6.62%
St. Louis	264	June 1998	July 2008	5,454,000	6.73%
Los Angeles	31	July 2003	August 2033	4,085,000	4.35%
Los Angeles	27	October 1999	October 2029	1,837,000	7.73%
Los Angeles	14	October 1999	November 2029	1,084,000	7.89%
Los Angeles	12	November 2003	December 2018	1,027,000	6.38%
Los Angeles	9	November 1999	December 2029	810,000	7.95%
Los Angeles	8	May 2001	November 2029	565,000	7.00%
Los Angeles	7	November 2003	December 2018	1,061,000	6.38%
Los Angeles	5	November 2003	December 2018	663,000	6.38%
Los Angeles	4	November 2003	December 2018	722,000	6.38%
Los Angeles	2	February 2002	February 2032	443,000	6.45%
Los Angeles	1	October 2003	November 2033	514,000	5.75%
Los Angeles	Office	February 1999	April 2009	1,173,000	7.76%
Total fixed interest debt				\$71,140,000	

a maturity of greater than one year from the date of purchase. We do not invest in securities with a maturity in excess of 24 months.

7. FAIR VALUE MEASUREMENTS

We adopted SFAS 157 as of October 1, 2008, with the exception of the application of SFAS 157 to nonrecurring nonfinancial assets and nonfinancial liabilities. SFAS 157 clarifies the definition of fair value, establishes a framework for measuring fair value, and expands the disclosures on fair value measurements.

Under SFAS 157, fair value is defined as the exit price, or the amount that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants as of the measurement date. SFAS 157 also establishes a hierarchy for inputs used in measuring fair value that maximizes the use of observable inputs and minimizes the use of unobservable inputs by requiring that the most observable inputs be used when available.

Observable inputs are inputs market participants would use in valuing the asset or liability based on market data obtained from independent sources. Unobservable inputs are inputs that reflect our assumptions about the factors market participants would use in valuing the asset or liability based upon the best information available in the circumstances. The categorization of financial assets and financial liabilities within the valuation hierarchy is based upon the lowest level of input that is significant to the fair value measurement.

Table of Contents**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)****7. FAIR VALUE MEASUREMENTS (CONTINUED)**

The hierarchy is broken down into three levels defined as follows:

Level 1 Inputs are quoted prices in active markets for identical assets or liabilities.

Level 2 Inputs include quoted prices for similar assets or liabilities in active markets, quoted prices for identical or similar assets or liabilities in markets that are not active, and inputs (other than quoted prices) that are observable for the asset or liability, either directly or indirectly.

Level 3 Inputs are unobservable for the asset or liability. See the section below titled *Level 3 Valuation Techniques* for further discussion of how we determine fair value for investments classified as Level 3.

Assets and Liabilities that are Measured at Fair Value on a Recurring Basis

As of our effective date of October 1, 2008, fair value under SFAS 157 is applied to financial assets such as commercial paper, corporate bonds and government municipal bonds which are classified and accounted for as available-for-sale. These items are stated at fair value at each reporting period; however, the definition of fair value is now applied using SFAS 157.

The following table provides information by level for assets and liabilities that are measured at fair value, as defined by SFAS No. 157, on a recurring basis (in thousands):

	Total carrying value at December 31, 2008	Fair Value Measurements at December 31, 2008		
		Quoted price in active markets (Level 1)	Using: Significant other observable inputs (Level 2)	Significant unobservable inputs (Level 3)
Cash equivalents:				
Money market	\$ 9,914	\$ 9,914	\$	\$
Available-for-sale marketable securities:				
Corporate bonds	4,357	4,178		179
Total cash equivalents and marketable securities measured at fair value	\$ 14,271	\$ 14,092	\$	\$ 179

Cash equivalents and marketable securities measured at fair value using quoted market prices are classified within Level 1 of the valuation hierarchy. Given the current conditions of the credit markets, there is some risk the unrealized losses as of December 31, 2008 could increase if the credit markets deteriorate.

Level 3 Valuation Techniques

Financial assets are considered Level 3 when their fair values are determined using pricing models, discounted cash flow methodologies or similar techniques and at least one significant model assumption or input is unobservable. Level 3 financial assets also include certain investment securities for which there is limited market activity or a decrease in the observability of market pricing for these investments, such that the determination of fair value requires significant judgment or estimation. Our Lehman Brothers security was valued at \$179,100 primarily using broker pricing that incorporates transaction details within an inactive market as a baseline, as well as assumptions about liquidity and credit valuation adjustments of marketplace participants at December 31, 2008. No change was made in the Level 3 valuation during the first quarter of fiscal 2009.

Table of Contents**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)****7. FAIR VALUE MEASUREMENTS (CONTINUED)**

The use of different assumptions, applying different judgment to inherently subjective matters and changes in future market conditions could result in significantly different estimates of fair value of these securities, currently and in the future. The fair value of our securities could change significantly based on changes in market conditions and continued uncertainties in the credit markets. If these uncertainties continue or if these securities experience credit rating downgrades, we may incur additional impairment charges for other securities in our investment portfolio.

8. GOODWILL AND OTHER IDENTIFIABLE INTANGIBLE ASSETS

Amortizable identifiable intangible assets were comprised of the following (in thousands):

	December 31, 2008			September 30, 2008		
	Gross carrying amount	Accum. amort.	Net	Gross carrying amount	Accum. amort.	Net
Purchased and core technology	\$ 45,188	\$ (31,581)	\$ 13,607	\$ 46,660	\$ (30,745)	\$ 15,915
License agreements	2,440	(2,440)		2,440	(2,440)	
Patents and trademarks	8,966	(4,919)	4,047	8,906	(4,682)	4,224
Customer maintenance contracts	700	(481)	219	700	(464)	236
Customer relationships	17,209	(5,862)	11,347	18,137	(5,472)	12,665
Non-compete agreements	1,019	(160)	859	1,075	(83)	992
Total	\$ 75,522	\$ (45,443)	\$ 30,079	\$ 77,918	\$ (43,886)	\$ 34,032

Amortization expense was \$1.9 million for both the three month periods ended December 31, 2008 and 2007.

Estimated amortization expense related to identifiable intangible assets for the remainder of fiscal 2009 and the five succeeding fiscal years is as follows (in thousands):

2009 (nine months)	\$ 5,776
2010	7,253
2011	5,362
2012	3,952
2013	2,962
2014	2,648

The changes in the carrying amount of goodwill were as follows (in thousands):

Beginning balance, October 1, 2008	\$ 86,578
Foreign currency translation adjustment	(2,980)
Ending balance, December 31, 2008	\$ 83,598

Table of Contents**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)****9. INCOME TAXES**

Income taxes have been provided for at an effective rate of 0.9% and 34.9% for the three month periods ended December 31, 2008 and 2007, respectively.

On October 3, 2008 the President signed the Tax Extenders and Alternative Minimum Tax Relief Act of 2008 that retroactively extended the research and development tax credit until December 31, 2009. We recorded a discrete tax benefit of \$0.4 million during the first quarter of fiscal 2009 for research and development credits earned during the last three quarters of fiscal 2008.

The discrete tax event affected our effective tax rates as shown in the table below:

	Three months ended December 31,	
	2008	2007
Effective tax rate before impact of discrete tax benefit	37.0%	34.9%
Impact of discrete tax benefit	-36.1%	0.0%
Effective tax rate	0.9%	34.9%

A reconciliation of the beginning and ending amount of uncertain tax positions is as follows (in thousands):

Uncertain tax positions as of October 1, 2008	\$ 3,652
Increases related to:	
Prior year income tax positions	199
Uncertain tax positions as of December 31, 2008	\$ 3,851

The total amount of uncertain tax positions that if recognized would affect the effective tax rate is \$3.7 million. We recognize interest and penalties related to income tax matters in income tax expense. During the three months ended December 31, 2008, we recognized \$0.1 million in interest. As of December 31, 2008, we had \$0.8 million in accrued interest and penalties on our consolidated balance sheet.

There are no tax positions for which it is reasonably possible that the total amounts of uncertain tax positions will significantly increase or decrease over the next 12 months.

We operate in multiple tax jurisdictions both in the U.S. and outside of the U.S. Accordingly, we must determine the appropriate allocation of income to each of these jurisdictions. This determination requires us to make several estimates and assumptions. Tax audits associated with the allocation of this income, and other complex issues, may require an extended period of time to resolve and may result in adjustments to our income tax balances in those years that are material to our consolidated financial position and results of operations. Certain open tax years are expected to close in future periods that may result in adjustments to our income tax balances in those periods that are material to our consolidated financial position and results of operations.

Table of Contents**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)****10. FINANCIAL GUARANTEES**

In general, we warrant our products to be free from defects in material and workmanship under normal use and service for a period of up to five years from the date of receipt. We have the option to repair or replace products we deem defective with regard to material or workmanship. Estimated warranty costs are accrued in the period that the related revenue is recognized based upon an estimated average per unit repair or replacement cost applied to the estimated number of units under warranty. These estimates are based upon historical warranty incidence and are evaluated on an ongoing basis to ensure the appropriateness of the warranty reserve. The following table summarizes the activity associated with the product warranty accrual (in thousands):

	Three months ended December 31,			
	Balance at October 1	Warranties expensed	Settlements made	Balance at December 31
2008	\$ 1,214	\$ 221	\$ (205)	\$ 1,230
2007	\$ 1,155	\$ 165	\$ (186)	\$ 1,134

We are not responsible and do not warrant that custom software versions created by original equipment manufacturer (OEM) customers based upon our software source code will function in a particular way, will conform to any specifications or are fit for any particular purpose and do not indemnify these customers from any third-party liability as it relates to or arises from any customization or modifications made by the OEM customer.

11. CONTINGENCIES*Legal Proceedings*

On April 19, 2002, a consolidated amended class action complaint was filed in the United States District Court for the Southern District of New York asserting claims relating to the initial public offering (IPO) of our subsidiary NetSilicon, Inc. and approximately 300 other public companies. We acquired Net Silicon, Inc. on February 13, 2002. The complaint names us as a defendant along with NetSilicon, certain of its officers and certain underwriters involved in NetSilicon's IPO, among numerous others, and asserts, among other things, that NetSilicon's IPO prospectus and registration statement violated federal securities laws because they contained material misrepresentations and/or omissions regarding the conduct of NetSilicon's IPO underwriters in allocating shares in NetSilicon's IPO to the underwriters' customers. We believe that the claims against the NetSilicon defendants are without merit and have defended the litigation vigorously. Pursuant to a stipulation between the parties, the two named officers were dismissed from the lawsuit, without prejudice, on October 9, 2002.

In June 2003, we elected to participate in a proposed settlement agreement with the plaintiffs in this litigation. Had it been approved by the Court, this proposed settlement would have resulted in a dismissal, with prejudice, of all claims in the litigation against us and against any of the other issuer defendants who elected to participate in the proposed settlement, together with the current or former officers and directors of participating issuers who were named as individual defendants. This proposed settlement was conditioned on, among other things, a ruling by the District Court that the claims against NetSilicon and against the other issuers who had agreed to the settlement would be certified for class action treatment for purposes of the proposed settlement, such that all investors included in the proposed classes in these cases would be bound by the terms of the settlement unless an investor opted to be excluded from the settlement in a timely and appropriate fashion.

On December 5, 2006, the U.S. Court of Appeals for the Second Circuit issued a decision in In re Initial Public Offering Securities Litigation that six purported class action lawsuits containing allegations substantially similar to those asserted against us could not be certified as class actions due, in part, to the Court of Appeals' determination that individual issues of reliance and knowledge would predominate over issues common to the proposed classes. On January 8, 2007, the plaintiffs filed a petition seeking rehearing en banc of this ruling. On April 6, 2007 the Court of Appeals denied the plaintiffs' petition for rehearing of the Court's December 5, 2006 ruling. The Court of Appeals, however, noted that the plaintiffs remained free to ask the District Court to certify classes different from the ones originally proposed which might meet the standards for class certification that the Court of Appeals articulated in its December 5, 2006 decision. The plaintiffs have since moved for certification of different classes in the District Court,

and that motion remains pending.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

11. CONTINGENCIES (CONTINUED)

In light of the Court of Appeals' December 5, 2006 decision regarding certification of the plaintiffs' claims, the District Court entered an order on June 25, 2007 terminating the proposed settlement between the plaintiffs and the issuers, including NetSilicon. Because any possible future settlement with the plaintiffs, if a settlement were ever to be negotiated and ultimately agreed to, would involve the certification of a class action for settlement purposes, the impact of the Court of Appeals' rulings on the possible future settlement of the claims against NetSilicon is uncertain. On August 14, 2007, the plaintiffs filed amended complaints in six focus cases. The issuer defendants and the underwriter defendants separately moved to dismiss the claims against them in the amended complaints in the six focus cases. On March 26, 2008, the District Court issued an order in which it denied in substantial part the motions to dismiss the amended complaints in the six focus cases.

We intend to continue to defend the litigation vigorously. The litigation process is inherently uncertain and unpredictable, however, and there can be no guarantee as to the ultimate outcome of this pending lawsuit. We maintain liability insurance for such matters and expect that the liability insurance will be adequate to cover any potential unfavorable outcome, less the applicable deductible amount of \$250,000 per claim. As of December 31, 2008, we have accrued a liability for the deductible amount of \$250,000 which we believe reflects the amount of loss that is probable. In the event we have losses that exceed the limits of the liability insurance, such losses could have a material effect on our business and our consolidated results of operations or financial condition.

In addition to the matter discussed above, in the normal course of business, we are subject to various claims and litigation, including patent infringement and intellectual property claims. Our management expects that these various claims and litigation will not have a material adverse effect on our consolidated results of operations or financial condition.

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

SAFE HARBOR STATEMENT UNDER THE PRIVATE SECURITIES LITIGATION REFORM ACT OF 1995

This Form 10-Q contains certain statements that are forward-looking statements as that term is defined under the Private Securities Litigation Reform Act of 1995, and within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended.

The words believe, anticipate, intend, estimate, target, may, will, expect, plan, project, should, negative thereof or other expressions, which are predictions of or indicate future events and trends and which do not relate to historical matters, identify forward-looking statements. Such statements are based on information available to our management as of the time of such statements and relate to, among other things, expectations of the business environment in which we operate, projections of our future performance, perceived opportunities in the market and statements regarding our mission and vision. Forward-looking statements involve known and unknown risks, uncertainties and other factors, which may cause our actual results, performance or achievements to differ materially from anticipated future results, performance or achievements expressed or implied by such forward-looking statements. We undertake no obligation to publicly update or revise any forward-looking statement, whether as a result of new information, future events or otherwise.

Our operating results and performance trends may be affected by a number of factors, including, without limitation, those described under Item 1A, Risk Factors in our Annual Report on Form 10-K for the year ended September 30, 2008. Those risk factors, and other risks, uncertainties and assumptions identified from time to time in our filings with the Securities and Exchange Commission, including without limitation, our quarterly reports on Form 10-Q and our registration statements, could cause our actual future results to differ from those projected in the forward-looking statements as a result of the factors set forth in our various filings with the Securities and Exchange Commission and of changes in general economic conditions, changes in interest rates and/or exchange rates and changes in the assumptions used in making such forward-looking statements.

CRITICAL ACCOUNTING POLICIES

A description of our critical accounting policies was provided in the Management's Discussion and Analysis of Financial Condition and Results of Operations section of our Annual Report on Form 10-K for the year ended September 30, 2008. An update to our critical accounting policy related to goodwill and marketable securities is included below.

Goodwill

We performed our annual goodwill impairment assessment in the third quarter of fiscal 2008. Based on this analysis, we concluded that the fair value of our reporting unit, measured as our market capitalization as of June 30, 2008, plus a control premium, exceeded the carrying amount and therefore goodwill was not considered impaired.

Due to the current recessionary environment and the resulting impact on our business, we are monitoring our stock price, control premium and other conditions in relation to potential additional goodwill impairment testing. We have defined the criteria that will result in additional interim goodwill impairment testing. If these criteria are met, we will undertake the analysis to determine whether a goodwill impairment has occurred, which could have a material effect on our financial position and results of operations. As of December 31, 2008, our market capitalization, including a 30% control premium, exceeded our carrying value.

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

CRITICAL ACCOUNTING POLICIES (CONTINUED)

Marketable Securities

We changed our policy as of October 1, 2008 to account for our marketable securities as available-for-sale on a prospective basis. All marketable securities purchased after October 1, 2008 are carried at fair value, with unrealized gains and losses excluded from earnings and reported as a separate component of stockholders' equity. In addition, we have reclassified the Lehman Brothers bond as available-for-sale as we plan on selling a portion of this bond in fiscal 2009. We obtain quoted market prices and trading activity for each security, where available, review the financial solvency of each security issuer and obtain other relevant information from our investment advisors to estimate the fair value for each security in our investment portfolio.

OVERVIEW

We operate in the communications technology industry, which is characterized by rapid technological advances and evolving industry standards. The market can be significantly affected by new product introductions and marketing activities of industry participants. We compete for customers on the basis of existing and planned product features, service capabilities, company reputation, brand recognition, technical support, relationships with partners, quality and reliability, product development capabilities, price and availability.

We help customers connect, monitor, and control local or remote electronic devices over a network or via the Internet. We continue to leverage a common core technology base to develop and provide innovative connectivity solutions to our customers. Our Drop-In Networking Solutions initiative provides opportunities for us in the next wave of Internet growth. The initial wave was focused on connecting people, first with personal computers and now with cell phones, PDA's and other related consumer devices. This next wave is about connecting devices and machines. We are ideally positioned to take full advantage of the second wave of Internet growth with our Drop-In Networking Solutions that will provide significant market expansion in what is now being referred to in the market as wireless machine to machine (M2M) connectivity.

M2M communication works by connecting communication hardware to a physical asset so that information about its status and performance can be sent to a computer system and used to automate a business process or a human action so that a person does not have to do it manually. Incorporating products from both our embedded and non-embedded categories, our Drop-In Networking Solution is making it easy for customers to effectively drop-in a wireless M2M solution.

The decrease in revenue and earnings per diluted share for the first quarter of fiscal 2009 compared to the first quarter of fiscal 2008 is a result of lower than anticipated revenue across all regions and most product lines attributable to rapidly deteriorating demand conditions for our products that began in November 2008. The weakening of the Euro and the British pound also contributed to the decrease in revenue and net income. Although total revenue was lower than anticipated in the first fiscal quarter of 2009 compared to the prior year comparable quarter, wireless revenue increased as a percent of total revenue from 21.4% in the first quarter of fiscal 2008 to 32.5% in the first quarter of fiscal 2009. We anticipate that growth in the future will result from products and services that are developed internally as well as from products and services that are acquired. We are continuing to invest in our wireless and M2M projects while closely monitoring and controlling discretionary spending. We also are actively managing our supply chain to ensure that our key sources of supply are intact.

Table of Contents**ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (CONTINUED)****OVERVIEW (CONTINUED)**

Net income decreased \$2.7 million to \$1.0 million, or \$0.04 per diluted share, for the three months ended December 31, 2008, compared to \$3.7 million, or \$0.14 per diluted share, for the three months ended December 31, 2007. The Tax Extenders and Alternative Minimum Tax Relief Act of 2008 retroactively extended the research and development tax credit until December 31, 2009, resulting in a discrete tax benefit of \$0.4 million, or \$0.01 per diluted share, recorded during the first quarter of fiscal 2009 for research and development credits earned during the last three quarters of fiscal 2008.

Our net working capital position (total current assets less total current liabilities) decreased \$0.8 million to \$111.4 million at December 31, 2008 and our current ratio was 6.7 to 1 as of that date. Cash and cash equivalents and short-term marketable securities decreased \$4.4 million to \$69.1 million during the period. At December 31, 2008, we had no debt other than capital lease obligations and a deferred payment for the Spectrum acquisition.

CONSOLIDATED RESULTS OF OPERATIONS

The following table sets forth selected information derived from our interim condensed consolidated statements of operations (dollars in thousands):

	Three months ended December 31,				% increase (decrease)
	2008		2007		
Net sales	\$ 41,361	100.0%	\$ 44,574	100.0%	(7.2)%
Cost of sales (exclusive of amortization of purchased and core technology shown separately below)	19,069	46.1	19,543	43.8	(2.4)
Amortization of purchased and core technology	1,044	2.5	1,136	2.6	(8.1)
Gross profit	21,248	51.4	23,895	53.6	(11.1)
Operating expenses:					
Sales and marketing	9,625	23.3	8,686	19.5	10.8
Research and development	6,974	16.8	6,589	14.8	5.8
General and administrative	3,883	9.4	4,041	9.0	(3.9)
Total operating expenses	20,482	49.5	19,316	43.3	6.0
Operating income	766	1.9	4,579	10.3	(83.3)
Other income, net	259	0.6	1,059	2.3	(75.5)
Income before income taxes	1,025	2.5	5,638	12.6	(81.8)
Income tax provision	9	0.0	1,968	4.4	(99.5)
Net income	\$ 1,016	2.5%	\$ 3,670	8.2%	(72.3)%

NET SALES

The following summarizes our net sales for the periods indicated:

	Three months ended December 31,				% increase (decrease)
(\$ in thousands)	2008		2007		
Non-embedded	\$ 23,340	56.4%	\$ 23,857	53.5%	(2.2)%

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Embedded	18,021	43.6	20,717	46.5	(13.0)
Total net sales	\$ 41,361	100.0%	\$ 44,574	100.0%	(7.2)%

Table of Contents**ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (CONTINUED)****NET SALES (CONTINUED)***Non-embedded*

Our non-embedded revenue decreased by \$0.5 million or 2.2% for the three months ended December 31, 2008 compared to the three months ended December 31, 2007 resulting primarily from decreases in net sales of serial cards, serial server and USB products, which were substantially offset by an increase in cellular products and incremental net sales of Sarian-branded products. Most of the decrease in our non-embedded net sales took place in the North American, Asian Pacific and Latin American regions offset by a slight increase in the European, Middle Eastern and African (EMEA) region due to the acquisition of Sarian which provided net sales of \$3.1 million for the first quarter of fiscal 2009. Without the Sarian acquisition, our non-embedded revenue would have decreased 15.2%. Sarian was acquired during the third quarter of fiscal 2008.

Embedded

Our embedded revenue decreased by \$2.7 million or 13.0% for the three months ended December 31, 2008 compared to the three months ended December 31, 2007 resulting primarily from decreases in net sales of modules. Most of the decrease in our embedded net sales took place in the North American, EMEA and Asian Pacific regions, while embedded net sales increased slightly in the Latin American region. Spectrum net sales of \$1.0 million are included in the North American embedded product sales for the first quarter of fiscal 2009. Without the Spectrum acquisition our embedded revenue would have decreased 18.1%. Spectrum was acquired during the fourth quarter of fiscal 2008. The following summarizes our net sales by geographic region:

(\$ in thousands)	Three months ended December		\$ increase (decrease)	% increase (decrease)
	2008	31, 2007		
North America	\$ 23,145(1)	\$ 28,124	\$ (4,979)	(17.7)%
EMEA	13,328(2)	11,144	2,184	19.6
Asia Pacific	3,834	4,529	(695)	(15.3)
Latin America (including Mexico)	1,054	777	277	35.6
Total net sales	\$ 41,361	\$ 44,574	\$ (3,213)	(7.2)%

(1) Includes
Spectrum net
sales of \$1,048

(2) Includes Sarian
net sales of
\$3,111

Fluctuation in foreign currency rates, primarily the Euro and British Pound, for the three month period ended December 31, 2008 compared to the same period in the prior year had an unfavorable impact on net sales of \$1.4 million.

GROSS PROFIT

Gross profit margin for the three months ended December 31, 2008 was 51.4% compared to 53.6% for the three months ended December 31, 2007. The decrease in gross profit margin in the first quarter of fiscal 2009 was primarily due to product and customer mix changes within both the embedded and non-embedded product categories, as well as lower gross profit margins provided by Sarian non-embedded products and Spectrum sales within embedded products. The weakening of the Euro and British Pound had a \$0.9 million unfavorable impact on the gross profit for the three months ended December 31, 2008. We anticipate that our gross profit margins for the remainder of the fiscal year will

be in a range of 50 to 53 percent which includes amortization of purchased and core technology of approximately two percentage points.

Table of Contents**ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (CONTINUED)****OPERATING EXPENSES**

Total operating expenses increased by \$1.2 million due to incremental operating expenses for Sarian and Spectrum, acquired in April 2008 and July 2008, respectively, offset partially by a favorable foreign currency impact of \$0.5 million due to the weakening of the Euro and British Pound in the first quarter of fiscal 2009.

(\$ in thousands)	Three months ended December 31,				\$ increase (decrease)
	2008		2007		
Operating expenses:					
Sales and marketing	\$ 9,625	23.3%	\$ 8,686	19.5%	\$ 939
Research and development	6,974	16.8	6,589	14.8	385
General and administrative	3,883	9.4	4,041	9.0	(158)
Total operating expenses	\$ 20,482	49.5%	\$ 19,316	43.3%	\$ 1,166

The net increase in sales and marketing expenses of \$0.9 million is primarily due to incremental ongoing expenses of \$0.7 million for Sarian and Spectrum and \$0.2 million for compensation-related expenses.

The net increase in research and development expenses of \$0.4 million is due primarily to incremental ongoing expenses of \$0.2 million for Sarian and Spectrum and \$0.2 million of compensation-related expenses.

The net decrease in general and administrative expenses of \$0.2 million was due primarily to a \$0.4 million reduction in depreciation and amortization expense as certain intangibles have become fully amortized and a \$0.6 million reduction in compensation-related expenses, professional fees and various other general and administrative expenses. This was partially offset by the incremental ongoing expenses of \$0.8 million for Sarian and Spectrum.

OTHER INCOME, NET

Other income, net was \$0.3 million for the three months ended December 31, 2008 as compared to \$1.1 million for the three months ended December 31, 2007, a decrease of \$0.8 million. The decrease was due to foreign currency transaction losses of \$0.3 million and a reduction of interest income, net of \$0.5 million. The decrease in interest income was related primarily to lower average invested balances of marketable securities and cash equivalents for the first quarter of fiscal 2009 compared to the first quarter of fiscal 2008 and a lower average interest rate of 3.7% and 5.1% for the three months ended December 31, 2008 and 2007, respectively.

INCOME TAXES

For the three months ended December 31, 2008, income taxes have been provided at an effective rate of 0.9% compared to 34.9% for the three months ended December 31, 2007. On October 3, 2008 the President signed the Tax Extenders and Alternative Minimum Tax Relief Act of 2008 that retroactively extended the research and development tax credit until December 31, 2009. As a result, we recorded a discrete tax benefit of \$0.4 million during the first quarter of fiscal 2009 for research and development credits earned during the last three quarters of fiscal 2008, which reduced the effective tax rate by 36.1 percentage points. We expect our annualized 2009 income tax rate, before the impact of discrete items, to be approximately 34% to 36%.

Table of Contents**ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (CONTINUED)****LIQUIDITY AND CAPITAL RESOURCES**

We have financed our operations principally with funds generated from operations. At December 31, 2008, we had cash, cash equivalents and short-term marketable securities of \$69.1 million compared to \$73.5 million at September 30, 2008. Our working capital (current assets less total current liabilities) decreased \$0.8 million to \$111.4 million at December 31, 2008 compared to \$112.2 million at September 30, 2008.

Highlights of Consolidated Statement of Cash Flow (in thousands):

	Three months ended December 31,		
	2008	2007	Change
Operating activities	\$ (1,986)	\$ 4,017	\$ (6,003)
Investing activities	11,048	(6,409)	17,457
Financing activities	297	1,599	(1,302)
Effect of exchange rate changes on cash and cash equivalents	(903)	196	(1,099)
Net increase (decrease) in cash and cash equivalents	\$ 8,456	\$ (597)	\$ 9,053

Reconciliation of Net Income to Cash Inflows (Outflows) from Operating Activities (in thousands):

	Three months ended December 31,		
	2008	2007	Change
Net income	\$ 1,016	\$ 3,670	\$ (2,654)
Deferred income taxes	(836)	(1,235)	399
Depreciation and amortization	2,444	2,497	(53)
Stock-based compensation	968	872	96
Other reconciling items	110	33	77
Net income adjusted for non-cash expenses	3,702	5,837	(2,135)
Net changes in operating assets and liabilities	(5,688)	(1,820)	(3,868)
Cash flows (used in) provided by operating activities	\$ (1,986)	\$ 4,017	\$ (6,003)

The decrease in net cash provided by operating activities of \$6.0 million for the comparable three month periods ended December 31, 2008 and 2007 is primarily due to a decrease in net income of \$2.6 million and a net increase in the use of operating assets and liabilities of \$3.9 million at December 31, 2008 as compared to December 31, 2007. Inventory increased primarily due to certain forecasted sales being deferred to future quarters, pre-builds of new products and strategic inventory purchases, partially offset by a decrease in accounts receivable.

Net cash provided by investing activities was \$11.0 million during the three months ended December 31, 2008 compared to net cash used by investing activities of \$6.4 million during the same period in the prior fiscal year. The net increase of \$17.4 million was primarily due to the change in marketable securities in which net settlements of marketable securities were \$11.9 million during the three months ended December 31, 2008 compared to net purchases of marketable securities of \$3.9 million during the same period one year ago. Purchases of property, equipment, improvements and certain other intangible assets decreased \$0.3 million in the first quarter of fiscal 2009 as compared to the same quarter a year ago. We spent \$1.3 million for a contingent purchase price payment related to the FS Forth acquisition in the first quarter of fiscal 2008. We anticipate total fiscal 2009 capital expenditures will be approximately \$3.3 million.

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

LIQUIDITY AND CAPITAL RESOURCES (CONTINUED)

We generated \$0.3 million from financing activities during the three months ended December 31, 2008 compared to \$1.6 million during the same period a year ago, a net decrease of \$1.3 million, primarily as a result of a decrease in proceeds from stock option and employee stock purchase plan transactions, and a decrease of cash provided by the excess tax benefits related to the exercise of stock options.

Our management believes that current financial resources, cash generated from operations and our potential capacity for additional debt and/or equity financing will be sufficient to fund operations in the foreseeable future.

There have been no material changes in our contractual obligations disclosed in our Annual Report on Form 10-K for the year ended September 30, 2008.

RECENTLY ISSUED ACCOUNTING PRONOUNCEMENTS

In April 2008, the Financial Accounting Standards Board (FASB) issued FASB Staff Position No. 142-3,

Determination of the Useful Life of Intangible Assets (FSP SFAS 142-3). FSP SFAS 142-3 amends the factors that should be considered in developing renewal or extension assumptions used to determine the useful life of a recognized intangible asset under SFAS No. 142, Goodwill and Other Intangible Assets (SFAS 142). FSP SFAS 142-3 intends to improve the consistency between the useful life of a recognized intangible asset under SFAS 142 and the period of expected cash flow used to measure the fair value of the asset under SFAS No. 141 (Revised 2007), Business Combinations and other accounting principles generally accepted in the United States. This statement is effective for financial statements issued for fiscal years and interim periods within those years beginning after December 15, 2008 and must be applied prospectively to intangible assets acquired after the effective date. We are currently evaluating the impact of FSP SFAS 142-3 on our consolidated financial statements.

In December 2007, the FASB issued SFAS No. 141(R), Business Combinations (SFAS 141(R)). This Statement retained the fundamental requirements in the former Statement that the acquisition method of accounting (previously referred to as the purchase method) be used for all business combinations and for an acquirer to be identified for each business combination. This Statement defined the acquirer as the entity that obtains control of one or more businesses in the business combination and established the acquisition date as the date that the acquirer achieves control. The new standard requires the acquiring entity in a business combination to recognize the assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree. This Statement also makes certain other modifications to the former Statement. SFAS 141(R) is effective for business combinations that are consummated by us beginning October 1, 2009. Early adoption is not permitted. SFAS 141(R) is expected to have a material impact on how we will identify, negotiate, and value future acquisitions and how such acquisitions will affect our consolidated financial statements.

In February 2007, the FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities Including an Amendment of FASB Statement No. 115 (SFAS 159). This Statement provides companies with an option to measure, at specified election dates, many financial instruments and certain other items at fair value that are not currently measured at fair value. A company that adopts SFAS 159 will report unrealized gains and losses on items for which the fair value option has been elected in earnings at each subsequent reporting date. This Statement also establishes presentation and disclosure requirements designed to facilitate comparisons between entities that choose different measurement attributes for similar types of assets and liabilities. This Statement is effective for fiscal years beginning after November 15, 2007, which is our fiscal years beginning October 1, 2008. We adopted SFAS 159 on October 1, 2008 and elected not to apply the fair value option; therefore, the adoption had no impact on our consolidated financial statements.

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

RECENTLY ISSUED ACCOUNTING PRONOUNCEMENTS (CONTINUED)

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements (SFAS 157). SFAS 157 defines fair value, establishes a framework for measuring fair value in accordance with generally accepted accounting principles, and expands disclosures about fair value measurements. In February 2008, the FASB issued FASB Staff Position No. 157-1, Application of FASB Statement No. 157 to FASB Statement No. 13 and Other Accounting Pronouncements That Address Fair Value Measurements for Purposes of Lease Classification or Measurement Under Statement 13 (FSP 157-1) and FASB Staff Position No. 157-2, Effective Date of FASB Statement No. 157 (FSP 157-2). FSP 157-1 amends SFAS 157 to exclude various accounting pronouncements that address fair value measurements for purposes of lease classification or measurement under Statement 13, with the exception of assets or liabilities assumed in a business combination that are required to be measured at fair value under SFAS 141 or SFAS 141(R). FSP 157-2 defers the effective date of SFAS 157 to our fiscal years beginning October 1, 2009 for all nonfinancial assets and nonfinancial liabilities, except for items that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually). In October 2008, the FASB issued FASB Staff Position No. 157-3 (FSP 157-3) which clarifies the application of SFAS 157 in a market that is not active and provides an example to illustrate key considerations in determining the fair value of a financial asset when the market for that financial asset is not active. We adopted the required provision of SFAS 157 for our financial assets and liabilities at the beginning of our fiscal year 2009 (see Note 7 to the Consolidated Financial Statements) and the remaining provisions will be adopted by us for our fiscal years beginning October 1, 2009. We are currently evaluating the impact of FSP 157-2 on our consolidated financial statements.

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ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

INTEREST RATE RISK

Our exposure to interest rate risk relates primarily to our investment portfolio. The majority of our marketable securities are classified as held-to-maturity and are carried at amortized cost. Beginning October 1, 2008, newly acquired marketable securities are classified as available-for-sale and any unrealized gain or loss is included in other comprehensive income within stockholders' equity. Marketable securities consist of commercial paper and corporate bonds. Our credit policy specifies the types of eligible investments and minimum credit quality of our investments, as well as diversification and concentration limits which mitigate our risk. Our portfolio contains no auction rate securities. We do not use derivative financial instruments to hedge against interest rate risk because the majority of our investments mature in less than a year. A change in interest rates would not have a material effect on our consolidated financial statements.

FOREIGN CURRENCY RISK

We have transactions that are executed in the U.S. Dollar, British Pound, Euro and Japanese Yen. As a result, we are exposed to foreign currency transaction risk associated with certain sales transactions being denominated in Euros, British Pounds or Japanese Yen, and foreign currency translation risk as the financial position and operating results of our foreign subsidiaries are translated into U.S. Dollars for consolidation. We have not implemented a hedging strategy to reduce foreign currency risk.

For the three months ended December 31, 2008 and 2007, we had approximately \$18.2 million and \$17.1 million, respectively, of net sales to foreign customers including export sales, of which \$7.9 million and \$8.7 million, respectively, were denominated in foreign currency, predominantly Euros and British Pounds for the three months ended December 31, 2008 and predominantly Euros for the three months ended December 31, 2007. In future periods, a significant portion of sales will continue to be made in both Euros and British Pounds.

The average monthly exchange rate for the Euro to the U.S. Dollar decreased approximately 8.8% from 1.4476 to 1.3201 and the average monthly exchange rate for the Japanese Yen to the U.S. Dollar increased approximately 17.8% from 0.0088 to 0.0104 for the first three months of fiscal year 2009 as compared to the same period one year ago. The average monthly exchange rate for the British Pound to the U.S. Dollar has decreased approximately 22.8% from 2.0455 to 1.5788 for the first three months of fiscal year 2009 as compared to the same period one year ago. The British Pound to the U.S. Dollar exchange rate has continued to decline since December 31, 2008. A 10% change from the first three months of fiscal 2009 average exchange rate for the Euro, British Pound and Yen to the U.S. Dollar would have resulted in a 1.9% increase or decrease in net sales and a 1.9% increase or decrease in stockholders' equity. The above analysis does not take into consideration any pricing adjustments we need to consider in response to changes in the exchange rate.

CREDIT RISK

We have some exposure to credit risk related to our accounts receivable portfolio. Exposure to credit risk is controlled through regular monitoring of customer financial status, credit limits and collaboration with sales management on customer contacts to facilitate payment.

Investments are made in accordance with our investment policy and consist of commercial paper and corporate bonds. We may have some exposure related to the fair value of our securities, which could change significantly based on changes in market conditions and continued uncertainties in the credit markets. If these uncertainties continue or if these securities experience credit rating downgrades, we may incur additional impairment charges for other securities in our investment portfolio.

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ITEM 4. CONTROLS AND PROCEDURES

EVALUATION OF DISCLOSURE CONTROLS AND PROCEDURES

As of the end of the period covered by this report, we conducted an evaluation, under the supervision and with the participation of the principal executive officer and principal financial officer, of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934 (the Exchange Act)). Based on this evaluation, the principal executive officer and principal financial officer concluded that our disclosure controls and procedures were effective to ensure that information required to be disclosed by us in reports that we file or submit under the Exchange Act was recorded, processed, summarized and reported within the time periods specified in Securities and Exchange Commission rules and forms and is accumulated and communicated to our management, including the principal executive and principal financial officer, or persons performing similar functions, as appropriate to allow timely decisions regarding required disclosure.

There was no change in our internal control over financial reporting during our most recently completed fiscal quarter that materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

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PART II. OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

The disclosures set forth in Note 11 to the Condensed Consolidated Financial Statements in Part I, Item 1 of this Form 10-Q are incorporated herein by reference.

ITEM 1A. RISK FACTORS

There have been no material changes to the risk factors provided in Part I, Item 1A of our 2008 Annual Report on Form 10-K as filed with the SEC on December 5, 2008.

ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

None

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

None

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

None

ITEM 5. OTHER INFORMATION

None

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PART II. OTHER INFORMATION
ITEM 6. EXHIBITS

Exhibit No.	Description
2(a)	Share Purchase Agreement dated April 28, 2008 among Digi International Limited, a subsidiary of Digi International Inc., and all of the shareholders of Sarian Systems Limited (excluding schedules and exhibits which the Registrant agrees to furnish supplementally to the Securities and Exchange Commission upon request) (1)
3(a)	Restated Certificate of Incorporation of the Company, as amended (2)
3(b)	Amended and Restated By-Laws of the Company (3)
4(a)	Share Rights Agreement, dated as of April 22, 2008, between the Company and Wells Fargo Bank, N.A., as Rights Agent (4)
4(b)	Form of Amended and Restated Certificate of Powers, Designations, Preferences and Rights of Series A Junior Participating Preferred Shares (5)
31(a)	Rule 13a-14(a)/15d-14(a) Certification of Chief Executive Officer
31(b)	Rule 13a-14(a)/15d-14(a) Certification of Chief Financial Officer
32	Section 1350 Certification

(1) Incorporated by reference to Exhibit 2(a) to the Company's Form 10-Q for the quarter ended March 31, 2008 (File No. 1-34033)

(2) Incorporated by reference to Exhibit 3(a) to the Company's Form 10-K for the year ended September 30, 1993 (File No. 0-17972)

(3)

Incorporated by reference to Exhibit 3(b) to the Company's Form 10-Q for the quarter ended June 30, 2008 (File No. 1-34033)

(4) Incorporated by reference to Exhibit 4(a) to the Company's Registration Statement on Form 8-A filed on April 25, 2008 (File No. 1-34033)

(5) Incorporated by reference to Exhibit 4(b) to the Company's Registration Statement on Form 8-A filed on April 25, 2008 (File No. 1-34033)

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SIGNATURE

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this Report to be signed on its behalf by the undersigned thereunto duly authorized.

DIGI INTERNATIONAL INC.

Date: February 9, 2009

By: /s/ Subramanian Krishnan
Subramanian Krishnan
Senior Vice President, Chief Financial Officer
and Treasurer (Principal Financial and
Accounting Officer)

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EXHIBIT INDEX

Exhibit Number	Document Description	Form of Filing
2(a)	Share Purchase Agreement dated April 28, 2008 among Digi International Limited, a subsidiary of Digi International Inc., and all of the shareholders of Sarian Systems Limited (excluding schedules and exhibits which the Registrant agrees to furnish supplementally to the Securities and Exchange Commission upon request)	Incorporated by Reference
3(a)	Restated Certificate of Incorporation of the Company, as Amended (incorporated by reference to the corresponding exhibit number to the Company's Form 10-K for the year ended September 30, 1993 (File No. 0-17972))	Incorporated by Reference
3(b)	Amended and Restated By-Laws of the Company	Incorporated by Reference
4(a)	Share Rights Agreement, dated as of April 22, 2008, between the Company and Wells Fargo Bank, N.A., as Rights Agent	Incorporated by Reference
4(b)	Form of Amended and Restated Certificate of Powers, Designations, Preferences and Rights of Series A Junior Participating Preferred Shares	Incorporated by Reference
31(a)	Rule 13a-14(a)/15d-14(a) Certification of Chief Executive Officer	Filed Electronically
31(b)	Rule 13a-14(a)/15d-14(a) Certification of Chief Financial Officer	Filed Electronically
32	Section 1350 Certification	Filed Electronically