

*Financial Statements*

**HOUSE EAR INSTITUTE**

June 30, 2006



# HENSIEK & CARON

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## INDEPENDENT AUDITOR'S REPORT

To The Board of Directors  
House Ear Institute

We have audited the accompanying statements of financial position of House Ear Institute (a nonprofit corporation) as of June 30, 2006 and 2005, and the related statements of activities, changes in net assets, cash flows, and functional expenses for the years then ended. These financial statements are the responsibility of the organization's management. Our responsibility is to express an opinion on these financial statements based on our audit.

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

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of House Ear Institute as of June 30, 2006 and 2005, and the changes in its net assets and its cash flows for the years then ended, in conformity with U.S. generally accepted accounting principles.

In accordance with *Government Auditing Standards*, we have also issued a report dated September 22, 2006, on our consideration of House Ear Institute's internal control structure over financial reporting and our tests of its compliance with certain provisions of laws, regulations, contracts and grants.

September 22, 2006

**HOUSE EAR INSTITUTE**  
**STATEMENTS OF FINANCIAL POSITION**  
**JUNE 30, 2006**

**ASSETS**

	<b>2006</b>	<b>2005</b>
Cash, including restricted amounts of \$234,826 in 2006 and \$898,169 in 2005	\$ 1,441,978	\$ 2,692,748
Bequests and other donations receivable	605,160	686,749
Accounts receivable, net of allowance for uncollectible accounts of \$303,685 in 2006 and \$231,481 in 2005	1,325,960	1,103,623
Educational and research supplies	78,432	91,877
Prepaid expenses and other assets	123,921	42,811
Pledges receivable	7,055,338	9,298,664
Notes receivable	416,711	97,177
Investments	29,334,930	35,220,770
Assets of split-interest agreements	2,279,491	2,376,922
Patent development costs	157,057	167,766
Patent costs, net of accumulated amortization of \$71,666 in 2006 and \$54,217 in 2005	101,559	81,494
Deferred bond costs, net of accumulated amortization of \$475,117 in 2006 and \$458,914 in 2005	202,538	218,741
Facilities and equipment, at cost, net	27,780,299	24,956,437
<b>Total Assets</b>	<b>\$ 70,903,374</b>	<b>\$ 77,035,779</b>

**LIABILITIES AND NET ASSETS**

Accounts payable and accrued expenses	\$ 1,830,012	\$ 1,311,798
Accrued interest payable	34,528	30,064
Note payable	1,176,190	1,252,454
Deferred revenue	314,402	1,251,631
Liability to beneficiaries under split-interest agreements	1,092,328	1,161,647
Deferred revenue - pooled income fund	42,559	58,592
Bonds payable	12,620,000	13,175,000
<b>Total Liabilities</b>	<b>17,110,019</b>	<b>18,241,186</b>
<b>Unrestricted Net Assets</b>		
Undesignated fund	13,730,847	13,871,229
Designated by Board of Trustees:		
Adrian Wood Memorial	1,500,000	1,500,000
Bond Retirement	9,773,957	9,749,297
<b>Total Unrestricted Net Assets</b>	<b>25,004,804</b>	<b>25,120,526</b>
<b>Temporarily Restricted Net Assets</b>	<b>14,709,089</b>	<b>19,201,223</b>
<b>Permanently Restricted Net Assets</b>	<b>14,079,462</b>	<b>14,472,844</b>
<b>Total Net Assets</b>	<b>53,793,355</b>	<b>58,794,593</b>
<b>Total Liabilities and Net Assets</b>	<b>\$ 70,903,374</b>	<b>\$ 77,035,779</b>

**HOUSE EAR INSTITUTE**  
**STATEMENTS OF ACTIVITIES**  
**FOR THE YEAR ENDED JUNE 30, 2006**  
WITH SUMMARIZED INFORMATION FOR THE YEAR ENDED JUNE 30, 2005

	2006			2005	
	Unrestricted	Temporarily Restricted	Permanently Restricted	Total	Total
<b>Public Support and Revenue</b>					
Contributions	\$ 1,991,904	\$ 6,574,474	\$ 106,618	\$ 8,672,996	\$ 19,350,623
Grants and contracts - direct	3,940,937	-	-	3,940,937	4,727,345
Grants and contracts - indirect	1,936,383	-	-	1,936,383	2,174,800
Special events	497,041	155,282	-	652,323	527,760
Educational courses	125,884	-	-	125,884	94,525
Investment returns, net	918,437	306,438	-	1,224,875	1,416,149
Building operations	576,290	-	-	576,290	574,348
Clinical services	773,500	-	-	773,500	907,538
Royalties	179,644	-	-	179,644	282,524
Other	147,946	-	-	147,946	139,255
Change in value of split-interest agreements	-	(12,079)	-	(12,079)	(177,679)
Net assets released from restrictions	12,016,249	(11,516,249)	(500,000)	-	-
<b>Total Public Support and Revenue</b>	<u>23,104,215</u>	<u>(4,492,134)</u>	<u>(393,382)</u>	<u>18,218,699</u>	<u>30,017,188</u>
<b>Expenses</b>					
<b>Program Services</b>					
Research	13,523,552	-	-	13,523,552	13,319,322
Education	1,416,921	-	-	1,416,921	872,258
<b>Total Program Services</b>	<u>14,940,473</u>	<u>-</u>	<u>-</u>	<u>14,940,473</u>	<u>14,191,580</u>
<b>Supporting Services</b>					
Management and general	5,915,824	-	-	5,915,824	7,549,710
Fund raising	1,761,757	-	-	1,761,757	1,405,085
<b>Total Supporting Services</b>	<u>7,677,581</u>	<u>-</u>	<u>-</u>	<u>7,677,581</u>	<u>8,954,795</u>
<b>Total Expenses Before Debt Service Costs</b>	<u>22,618,054</u>	<u>-</u>	<u>-</u>	<u>22,618,054</u>	<u>23,146,375</u>
<b>Change in Net Assets Before Debt Service Costs</b>	486,161	(4,492,134)	(393,382)	(4,399,355)	6,870,813
<b>Debt Service Costs</b>	<u>601,883</u>	<u>-</u>	<u>-</u>	<u>601,883</u>	<u>473,427</u>
<b>Change in Net Assets</b>	<u>\$ (115,722)</u>	<u>\$ (4,492,134)</u>	<u>\$ (393,382)</u>	<u>\$ (5,001,238)</u>	<u>\$ 6,397,386</u>

**HOUSE EAR INSTITUTE  
STATEMENTS OF CHANGES IN NET ASSETS  
FOR THE YEAR ENDED JUNE 30, 2006**

	<u>Unrestricted</u>	<u>Temporarily Restricted</u>	<u>Permanently Restricted</u>	<u>Total</u>
<b>Net Assets, June 30, 2004</b>	\$ 28,558,520	\$ 10,569,835	\$13,268,672	\$ 52,397,027
<b>Change in Net Assets</b>	<u>(3,437,994)</u>	<u>8,631,388</u>	<u>1,204,172</u>	<u>6,397,566</u>
<b>Net Assets, June 30, 2005</b>	25,120,526	19,201,223	14,472,844	58,794,593
<b>Change in Net Assets</b>	<u>(115,722)</u>	<u>(4,492,134)</u>	<u>(393,382)</u>	<u>(5,001,238)</u>
<b>Net Assets, June 30, 2006</b>	<u>\$ 25,004,804</u>	<u>\$ 14,709,089</u>	<u>\$14,079,462</u>	<u>\$ 53,793,355</u>

**HOUSE EAR INSTITUTE  
STATEMENTS OF CASH FLOWS  
FOR THE YEAR ENDED JUNE 30, 2006**

	<u>2006</u>	<u>2005</u>
<b>Cash Flows from Operating Activities</b>		
Cash received from service recipients	\$ 6,029,595	\$ 7,890,152
Cash received from donors	10,281,940	15,698,489
Cash received from building operations, net	578,452	620,286
Cash paid to suppliers and employees	(19,784,774)	(21,124,935)
Interest and dividends received	750,496	766,034
Interest and other debt service costs paid	(597,419)	(457,242)
	<u>(2,741,710)</u>	<u>3,392,784</u>
<b>Net Cash Provided by (Used in) Operating Activities</b>		
<b>Cash Flows from Investing Activities</b>		
Additions to facilities and equipment	(5,285,029)	(2,502,772)
Patent costs	(17,355)	(29,555)
Purchases of investments	(20,989,744)	(28,988,674)
Proceeds from sale of investments	27,528,989	26,970,052
Collections on loans	53,698	42,906
	<u>1,290,559</u>	<u>(4,508,043)</u>
<b>Net Cash Used in (Provided by) Investing Activities</b>		
<b>Cash Flows from Financing Activities</b>		
Proceeds from donations and investment earnings restricted for:		
Endowment	831,643	1,204,172
Redemption of bonds	(555,000)	(520,000)
Proceeds from note payable	1,300,000	-
Payments on note payable	(1,376,262)	(181,602)
	<u>200,381</u>	<u>502,570</u>
<b>Net Cash Provided by Financing Activities</b>		
<b>Net Decrease in Cash</b>	(1,250,770)	(612,689)
<b>Cash, Beginning</b>	<u>2,692,748</u>	<u>3,305,437</u>
<b>Cash, Ending</b>	<u>\$ 1,441,978</u>	<u>\$ 2,692,748</u>

**HOUSE EAR INSTITUTE**  
**STATEMENTS OF CASH FLOWS**  
**FOR THE YEAR ENDED JUNE 30, 2006**  
(Continued)

	<u>2006</u>	<u>2005</u>
<b>Reconciliation of the Change in Net Assets</b>		
<b>To Net Cash Provided by (Used in) Operating Activities</b>		
Change in Net Assets	\$ (5,001,238)	\$ 6,397,566
Adjustments to reconcile the change in net assets to net cash provided by (used in) operating activities		
Change in allowance for uncollectible accounts	72,204	(370,640)
Change in present value of pledges receivable	(86,873)	(302,118)
Depreciation and amortization	2,434,235	2,330,208
Loss on disposal of fixed assets	51,135	105,276
Realized and unrealized gains on investments	(577,018)	(804,296)
Change in value of split-interest agreements	12,079	121,159
Donations of noncash assets	(449,623)	-
(Increase) Decrease in:		
Donations receivable	(5,440)	2,497,916
Accounts receivable	(207,512)	483,763
Educational and research supplies	13,445	6,036
Pledges receivable	2,330,200	(5,115,000)
Prepaid expenses and other assets	(81,110)	3,615
Increase (Decrease) in:		
Accounts payable and accrued expenses	518,214	103,563
Accrued bond interest payable	4,464	16,005
Other deferred revenue	(937,229)	(503,020)
Deferred compensation plan	-	(373,077)
Donations restricted for long-term purposes:		
Cash donations	(831,643)	(1,204,172)
 <b>Net Cash Provided by (Used in) Operating Activities</b>	 <u>\$ (2,741,710)</u>	 <u>\$ 3,392,784</u>

**HOUSE EAR INSTITUTE**  
**STATEMENTS OF FUNCTIONAL EXPENSES**  
**FOR THE YEARS ENDED JUNE 30, 2006**  
**WITH SUMMARIZED INFORMATION FOR JUNE 30, 2005**

	<b>2006</b>						<b>2005</b>	
	<b>Program Services</b>			<b>Supporting Services</b>			<b>Total Expenses</b>	
	<b>Research</b>	<b>Education</b>	<b>Total</b>	<b>Management and General</b>	<b>Fund Raising</b>	<b>Total</b>		
Salaries and wages	\$ 6,943,049	\$ 340,525	\$ 7,283,574	\$ 2,904,762	\$ 741,776	\$ 3,646,538	\$ 10,930,112	\$ 11,130,666
Taxes and employee benefits	1,646,628	80,364	1,726,992	656,163	175,059	831,222	2,558,214	2,535,291
<b>Total Personnel Costs</b>	8,589,677	420,889	9,010,566	3,560,925	916,835	4,477,760	13,488,326	13,665,957
Professional fees and contract service payments	813,899	393,396	1,207,295	467,816	173,389	641,205	1,848,500	1,839,560
Occupancy and related expenses	891,527	25,727	917,254	578,694	26,520	605,214	1,522,468	1,477,483
Travel, conferences, conventions and meetings	150,987	199,886	350,873	278,527	211,683	490,210	841,083	751,829
Special supplies and services	489,717	93,793	583,510	77,182	13,608	90,790	674,300	975,563
Cost of goods sold	366,511	7,459	373,970	-	-	-	373,970	364,421
Minor equipment and equipment maintenance	161,850	1,506	163,356	58,126	5,723	63,849	227,205	252,603
Office supplies and services	253,556	225,547	479,103	423,593	329,473	753,066	1,232,169	1,513,251
<b>Total Expenses Before Depreciation</b>	11,717,724	1,368,203	13,085,927	5,444,863	1,677,231	7,122,094	20,208,021	20,840,370
Depreciation - building	1,010,701	37,866	1,048,567	335,809	39,147	374,956	1,423,523	1,356,295
Depreciation - equipment and furniture	795,127	10,852	805,979	135,152	45,379	180,531	986,510	949,710
<b>Total Expenses Before Debt Service Costs</b>	<u>\$ 13,523,552</u>	<u>\$ 1,416,921</u>	<u>\$ 14,940,473</u>	<u>\$ 5,915,824</u>	<u>\$ 1,761,757</u>	<u>\$ 7,677,581</u>	<u>\$ 22,618,054</u>	<u>\$ 23,146,375</u>

**HOUSE EAR INSTITUTE**  
**NOTES TO FINANCIAL STATEMENTS**  
**JUNE 30, 2006**

**Note 1 - Summary of Significant Accounting Policies**

**Organization**

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

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

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

**Public Support and Revenue**

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

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

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

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

**HOUSE EAR INSTITUTE**  
**NOTES TO FINANCIAL STATEMENTS**  
**JUNE 30, 2006**

**Note 1 - Summary of Significant Accounting Policies** (continued)

**Public Support and Revenue** (continued)

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

**Medical and Research Supplies**

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

**Investments**

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

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

**Facilities and Equipment**

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

Medical and research facility	30 years
Equipment and furniture	3 to 10 years

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

**Deferred Revenue**

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

**Comparative Financial Information**

The financial statements include certain prior-year summarized comparative information in total but not by net asset class. Such information should be read in conjunction with the Institute's financial statements for the year ended June 30, 2005.

**HOUSE EAR INSTITUTE**  
**NOTES TO FINANCIAL STATEMENTS**  
**JUNE 30, 2006**

**Note 1 - Summary of Significant Accounting Policies** (continued)

**Statement of Cash Flows**

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

**Income Taxes**

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

**Expense Allocation**

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

**Use of Estimates**

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

**Note 2 - Concentration of Credit Risk**

The Institute maintains its cash balances at various financial institutions. Cash accounts are insured by the Federal Deposit Insurance Corporation up to \$100,000 per institution. At June 30, 2006, the Institute's uninsured cash balance totaled \$1,040,225.

**Note 3 - Pledges Receivable**

Unconditional promises to give consist of the following:

	<u>2006</u>	<u>2005</u>
Receivable in less than one year	\$ 4,776,786	\$ 4,595,333
Receivable in one to five years	2,453,167	4,964,819
Total unconditional promises to give	7,229,953	9,560,152
Less discounts to net present value	(174,615)	(261,488)
Net unconditional promises to give	<u>\$ 7,055,338</u>	<u>\$ 9,298,664</u>

**HOUSE EAR INSTITUTE**  
**NOTES TO FINANCIAL STATEMENTS**  
**JUNE 30, 2006**

**Note 3 - Pledges Receivable** (continued)

	<u>2006</u>	<u>2005</u>
Restricted for:		
Building construction, maintenance and debt reduction	\$ 4,613,747	\$ 7,112,574
Specific research projects	2,005,775	1,188,119
Endowment	384,324	929,355
Unrestricted	<u>51,492</u>	<u>68,616</u>
Total	<u>\$ 7,055,338</u>	<u>\$ 9,298,664</u>

**Note 4 - Investments**

As of June 30, 2006 and 2005, investments consist of the following:

<u>2006</u>	<u>Aggregate Fair Value</u>	<u>Cost</u>
Cash & cash equivalents	\$ 4,225,400	\$ 4,225,400
Corporate stocks	3,755,192	2,633,979
Corporate bonds	1,547,781	1,539,073
Mutual funds	10,032,600	9,585,030
United States Treasury bonds and notes	<u>9,773,957</u>	<u>5,357,960</u>
	<u>\$29,334,930</u>	<u>\$23,341,442</u>
<u>2005</u>	<u>Aggregate Fair Value</u>	<u>Cost</u>
Cash & cash equivalents	\$ 3,282,118	\$ 3,282,118
Corporate stocks	5,819,017	3,958,809
Corporate bonds	998,330	994,591
Mutual funds	13,380,108	12,750,399
United States Treasury bonds and notes	<u>11,741,197</u>	<u>7,346,992</u>
	<u>\$35,220,770</u>	<u>\$28,332,908</u>

Investment returns are summarized as follows:

<u>2006</u>	<u>Unrestricted</u>	<u>Temporarily Restricted</u>	<u>Total</u>
Interest and dividends	\$ 538,027	\$ 179,514	\$ 717,541
Net realized and unrealized gains	457,371	152,602	609,973
Investment fees	<u>(76,961)</u>	<u>(25,678)</u>	<u>(102,639)</u>
Total	<u>\$ 918,437</u>	<u>\$ 306,438</u>	<u>\$ 1,224,875</u>

**HOUSE EAR INSTITUTE**  
**NOTES TO FINANCIAL STATEMENTS**  
**JUNE 30, 2006**

**Note 4 - Investments** (continued)

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

**Note 5 - Split-interest Agreements**

The Institute administers two types of split-interest agreements:

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

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

**Note 6 - Facilities and Equipment**

Facilities and Equipment consists of the following:

	<u>2006</u>	<u>2005</u>
Building	\$39,357,460	\$39,156,055
Furniture and equipment	10,855,488	9,691,427
Construction in progress	5,044,756	1,276,540
	<u>55,257,704</u>	<u>50,124,022</u>
Less accumulated depreciation	27,477,405	25,167,585
	<u>\$27,780,299</u>	<u>\$24,956,437</u>

**HOUSE EAR INSTITUTE**  
**NOTES TO FINANCIAL STATEMENTS**  
**JUNE 30, 2006**

**Note 7 - Bonds Payable**

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

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

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

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

2006	\$ 590,000
2007	625,000
2008	665,000
2009	710,000
2010	755,000
Thereafter, through 2018	9,275,000
	\$12,620,000

Interest expense incurred in connection with these bonds for the years ended June 30, 2006 and 2005, was \$365,265 and \$236,967, respectively. The effective variable interest rate at June 30, 2006 and 2005 was 3.93% and 2.23%, respectively.

**Note 8 - Note Payable**

The Institute has a promissory note, which is payable in monthly installments of \$15,476 including interest at the banks prime rate less .50%, due on demand or, if no demand is made, on November 1, 2012.

**HOUSE EAR INSTITUTE**  
**NOTES TO FINANCIAL STATEMENTS**  
**JUNE 30, 2006**

**Note 9 - Employee Annuity Plan**

The Institute has an employee annuity plan which covers employees with one year of service and who work at least 30 hours per week. The Institute contributes 4% of each employee's eligible salary, and makes matching contributions up to fifty cents for every one dollar an eligible employee contributes. The Institute's total contribution will not exceed 8% for each employee. Employer contributions for the years ended June 30, 2006 and 2005 were \$663,822 and \$546,425, respectively.

**Note 10 - Building Operations**

The Institute's medical and research facility is comprised of a total of 108,109 square feet. The Institute occupies approximately 73% of the building. The portion of the facility not occupied by the Institute is leased to various medical practitioners, including the House Ear Clinic. All leased space is rented at prevailing market rates. The lease arrangements expire from 2006 to 2011, and generally contain options to renew at the discretion of the Institute, thereby allowing flexibility for growth. Future minimum lease payments for the next five years are as follows:

<u>Years ending June 30,</u>	
2007	\$ 604,272
2008	604,676
2009	632,036
2010	632,036
2011	7,934

**Note 11 - Related-Party Transactions**

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

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

During the years ended June 30, 2006 and 2005, the Institute received rental income from the Clinic of \$514,335 and \$514,335, respectively. In addition, at June 30, 2006, the Clinic owed the Institute \$6,270 for current tenant costs. The clinic owed the Institute \$15,452 for such costs at June 30, 2005.

One member of the Institute's Board of Trustees has acted as a broker in placing various insurance policies; commissions earned from the insurance carriers are not determinable.

## **ADDITIONAL INFORMATION**



**HENSIEK & CARON**

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

**INDEPENDENT AUDITOR'S REPORT  
ON ADDITIONAL INFORMATION**

To the Board of Directors  
House Ear Institute

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

*Hensiek & Caron*

September 22, 2006

**HOUSE EAR INSTITUTE**  
**SCHEDULE OF CHANGES IN NET ASSETS**  
**FOR THE YEAR ENDED JUNE 30, 2006**

	<u>2005</u>	<u>Donations Income and Transfers</u>	<u>Expenditures and Transfers</u>	<u>2006</u>
<b>Unrestricted Net Assets - Board Designated</b>				
Adrienne Wood Memorial	\$ 1,500,000	\$ -	\$ -	\$ 1,500,000
Bond retirement	9,749,297	23,373	-	9,772,670
<b>Total Unrestricted Net Assets - Board Designated</b>	<u>\$ 11,249,297</u>	<u>\$ 23,373</u>	<u>\$ -</u>	<u>\$ 11,272,670</u>
<b>Permanently Restricted Net Assets</b>				
Clair Kos	\$ 54,026	\$ -	\$ -	\$ 54,026
HPH Chair	1,590,886	-	-	1,590,886
General	1,650,666	101,650	-	1,752,316
Rupley Fellowship	250,000	-	-	250,000
Library	376,561	-	-	376,561
Electron microscope	500,000	-	-	500,000
Kenneth & Charity Ritter	82,500	-	-	82,500
McLoraine permanent capital	2,312,872	-	-	2,312,872
J House	27,598	-	-	27,598
CC Levine Research	1,502,127	-	-	1,502,127
CARE Center	50,000	-	-	50,000
Lied	1,000,000	-	-	1,000,000
Hearst Lab Internship	500,000	-	-	500,000
Lied Children's Center	1,000,000	-	-	1,000,000
Kenneth & Charity Ritter	174,932	-	-	174,932
McLoraine	1,000,000	-	-	1,000,000
Capital Campaign 2004 - Endowment	500,000	-	-	500,000
Jack H Skirball Center for Emerging Research	500,000	-	(500,000)	-
Elliott & Eleanor Taylor Fund	250,000	-	-	250,000
Lesley Woods Endowed Care Fund for Professional Actors	1,050,000	-	-	1,050,000
Caruso Endowment	121,320	-	-	121,320
Pledges - Present Value Adjustment	(20,644)	4,968	-	(15,676)
<b>Total Permanently Restricted Net Assets</b>	<u>\$ 14,472,844</u>	<u>\$ 106,618</u>	<u>\$ (500,000)</u>	<u>\$ 14,079,462</u>

**HOUSE EAR INSTITUTE**  
**SCHEDULE OF CHANGES IN NET ASSETS**  
**FOR THE YEAR ENDED JUNE 30, 2006**  
(Continued)

	<b>2005</b>	<b>Donations Income and Transfers</b>	<b>Expenditures and Transfers</b>	<b>2006</b>
<b>Temporarily Restricted Net Assets</b>				
Online Hearing Screening Tests	\$ 1,563	\$ -	\$ -	\$ 1,563
Support for clinical fellows-Care Center	65,000	(20,000)	-	45,000
AAO Meeting Fund	-	20,000	(15,749)	4,251
Energizer Pediatric Audiology Traineeship	-	210,000	(9,197)	200,803
Ahmanson Imaging Equipment	8,886	-	-	8,886
Guenther Foundation	142,831	-	407	143,238
Otitis Media Conference	4,605	-	-	4,605
Bundy Foundation	118,115	-	-	118,115
Taper Fdn-Children's Program	10,516	-	-	10,516
Western Lion's fund	16,072	10,770	(3,196)	23,646
Caruso (genetic hearing loss)	412,132	221,620	(90,786)	542,966
Advanced Imaging Facility Fund	99,884	-	(99,884)	-
Levine - NF2 Research	1,641,191	187,941	-	1,829,132
Otitis media research	110,000	-	-	110,000
Daniel's fund for CARE Center	85,035	-	(43,545)	41,490
Genetics of Presbycusis	-	1,000,000	(50,446)	949,554
Inner Ear Exhibit	-	205,000	(205,000)	-
Microscope upkeep	166,860	25,361	(43,927)	148,294
Dr. Linthicum Equipment	-	3,274	(2,737)	537
Research initiative	180,974	-	-	180,974
Rupley fellows	53,968	12,680	-	66,648
Hearst Lab interns	41,261	25,361	(14,740)	51,882
Quota Fellows	12,099	-	-	12,099
Unitrusts & Pooled income funds	1,102,387	-	(12,079)	1,090,308
Jameson Laboratory fund	3,400	-	-	3,400
Educational Grants	-	13,300	(13,300)	-
Herklotz-Education/Outreach	250,797	-	(108,585)	142,212
Building fund	1,911,262	220,932	(1,267,785)	864,409
Graziadio Education/Outreach Prog	278,766	-	(209,498)	69,268
CARE Operating	-	1,922,590	(709,989)	1,212,601
CMB research	-	112,550	(112,550)	-
Family Camp	26,797	38,220	(54,588)	10,429
Sound Partners	25,316	103,662	(80,782)	48,196
HEI-TR-Meniere's Disease (Linthicum)	1,050	245	-	1,295
Care Clinic Research	30,860	65,000	(95,860)	-
David Lim Fund	9,874	6,200	-	16,074
Howard House Clinical Studies Lab	205,336	-	(205,336)	-
Ritter Endowment Earnings	45,682	13,058	-	58,740
Hearing Aid Research Fund	5,802	100	(5,902)	-

**HOUSE EAR INSTITUTE**  
**SCHEDULE OF CHANGES IN NET ASSETS**  
**FOR THE YEAR ENDED JUNE 30, 2006**  
(Continued)

	<b>2005</b>	<b>Donations Income and Transfers</b>	<b>Expenditures and Transfers</b>	<b>2006</b>
<b>Temporarily Restricted Net Assets - Continued</b>				
Audiovisual Department Fund	\$ 4,420	\$ -	\$ -	\$ 4,420
CARE Patio Fund	-	1,500	-	1,500
Capital Campaign 2004 - Programs	984,283	1,737,466	(2,721,749)	-
Cochlear Implant Fund	203,850	5,000	-	208,850
Capital Campaign 2004 - Building	10,059,984	838,339	(4,942,097)	5,956,226
General Research Fund	-	16,145	(16,145)	-
Jack H Skirball Center for Emerging Resea	-	500,000	(500,000)	-
Underwriter Fund	111,000	-	(111,000)	-
Public Forum Fund, May 2003	7,000	-	(7,000)	-
Educational Liaison in the CARE Center	-	10,000	(10,000)	-
William H. Slattery Fund	53,290	28,090	-	81,380
Elliott & Eleanor Taylor Fund	220,825	-	(110,412)	110,413
William M Luxford Pediatric Hearing Fund	2,000	6,000	(1,088)	6,912
Lesley Woods Outreach Fund	350,000	-	(75,000)	275,000
Lesley Woods Care Fund	136,250	53,257	(136,250)	53,257
<b>Total Temporarily Restricted Net Assets</b>	<b>\$ 19,201,223</b>	<b>\$ 7,593,661</b>	<b>\$ (12,085,795)</b>	<b>\$ 14,709,089</b>

**HOUSE EAR INSTITUTE  
SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS  
FOR THE YEAR ENDED JUNE 30, 2006**

HEI Project Number	Federal Grantor/Pass-through Grantor Program Title	Federal Catalog Number	Agency or Pass-through Number	Contract Period	Expenditures
569	Department of Defense	12.42	DAMD 17-01-1-0710	01/01/02 - 12/31/04	\$ 572,231
503	National Science Foundation	NA	OII-0630593	05/01/06 - 04/30/07	27,398
761	National Science Foundation	47.075	BCS-0214224	08/01/02 - 07/31/07	103,828
786	National Science Foundation	47.07	0312434	07/15/03 - 06/30/06	188,207
790	National Science Foundation	NA	BCS-0350764	08/18/03 - 08/17/05	55,003
Pass-through National Institute of Health					
501	National Institutes of Health	93.173	RO1 DC003552	08/01/98 - 06/30/06	176,791
512	National Institutes of Health	93.173	RO3 DC007349	12/01/05 - 11/30/06	29,244
513	National Institutes of Health	93.173	RO3 DC007515	12/12/05 - 11/30/06	37,874
524	National Institutes of Health	93.173	RO1 DC004189	08/01/99 - 07/31/04	22,006
529	National Institutes of Health	93.173	RO1 DC03592	04/01/00 - 03/31/04	15,153
532	National Institutes of Health	93.173	RO1 DC04562	07/01/00 - 06/30/05	121
538	National Institutes of Health	93.173	RO1 DC04675	03/01/01 - 02/28/06	247,630
555	National Institutes of Health	93.173	RO1 DC04993	07/01/01 - 05/31/06	233,865
556	National Institutes of Health	93.173	RO1 DC05025	09/01/01 - 08/31/04	269,868
559	National Institutes of Health	93.173	RO1 DC04796	09/28/01 - 08/31/06	282,108
577	National Institutes of Health	93.173	RO3 DC008192	04/01/06 - 03/31/07	18,012
597	National Institutes of Health	93.173	RO1 DC04792	05/01/01 - 04/30/06	279,768
704	National Institutes of Health	93.173	R13 DC007326	04/01/05 - 03/31/06	14,918
709	National Institutes of Health	93.173	F32 DC007247	09/01/04 - 08/31/07	47,832
711	National Institutes of Health	93.173	RO1 DC007173	07/01/05 - 06/30/07	240,483
720	National Institutes of Health	93.173	R13 DC007831	07/01/05 - 06/30/07	17,064
753	National Institutes of Health	93.173	RO1 DC01526	04/15/02 - 03/31/07	218,756
758	National Institutes of Health	93.173	RO1 DC05220	07/01/02 - 06/30/05	155,013
759	National Institutes of Health	93.173	RO3 DC05335	07/05/02 - 06/30/05	57,532
763	National Institutes of Health	93.173	RO1 DC05843	09/20/02 - 08/31/07	128,967
773	National Institutes of Health	93.838	RO1 HL070293	04/01/03 - 03/31/07	115,824
774	National Institutes of Health	93.173	R21 DC006139	04/01/03 - 03/31/05	66,387
778	National Institutes of Health	93.173	RO1 DC006185	05/15/03 - 04/30/07	278,267
785	National Institutes of Health	93.173	RO1 DC006238	07/15/03 - 06/30/08	359,069
787	National Institutes of Health	93.173	R21 DC006035	07/18/03 - 06/30/05	52,243
788	National Institutes of Health	93.173	P30 DC006276	08/01/03 - 05/31/08	188,956
789	National Institutes of Health	93.173	P30 DC006276	08/01/03 - 05/31/08	88,133
Pass-through from Huntington Medical Research Institute - A Cochlear Nucleus Auditory					
557	Prosthesis Based on Microstimulation	93.173	N01-DC-1-2105	06/30/01 - 06/29/04	166,030
Pass-through from University of California at Los Angeles - Auditory Development in Early					
599	Amplified Children	93.173	1712GCB979	01/01/02 - 08/31/05	109,986
Pass-through from Indiana University -					
634	Comparison of Sensory Aids in Deaf Children	93.173	RO1 DC000064	04/01/01 - 03/31/05	23,727
Pass-through from Johns Hopkins University - Childhood Development after Cochlear					
754	Implantation	93.173	8206 00394	05/01/02 - 04/30/07	221,403
Pass-through from Massachusetts General Hospital - Genotype Phenotype Relationship in					
769	Neurofibromatosis 2	93.835	RO1 NS40527	09/20/02 - 07/31/06	18,686
Pass-through from Jackson Laboratory -					
779	Genetics of Age Related Hearing Loss	93.173	RO1 DC005827	05/05/03 - 04/30/06	49,466
					<u>\$ 5,177,848</u>

**HOUSE EAR INSTITUTE  
NOTES TO THE SCHEDULE OF FEDERAL FINANCIAL ASSISTANCE  
FOR THE YEAR ENDED JUNE 30, 2006**

**Note 1 - Significant Accounting Policies**

**Basis of Presentation**

The accompanying Schedule of Federal Financial Assistance includes all federal grants to House Ear Institute (Institute) which had activity during fiscal 2006. The schedule has been prepared on the accrual basis of accounting. Grant revenues are recorded for financial reporting purposes when the Institute has met the qualifications for the respective grants.

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

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

**Note 3 - Reconciliation of Schedule of Federal Assistance**

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

Total Grant Expenditures per Schedule of Federal Financial Assistance	\$ 5,177,848
Other Grants	
National Organization for Hearing Research Foundation	217,141
American Otological Society	4,599
Cochlear Americans	81,212
Howard Leight Industries	13,974
Deafness Research Foundation	20,000
Caruso Family Foundation	40,959
Advance Bionics	3,357
Implanted Acoustics	150,082
Novartis Pharma AG	90,003
Sonic Innovation	20,000
March of Dimes	57,730
Miscellaneous consulting	415
	<hr/>
Total Grants and Contracts Revenue per Audited Financial Statements	<u>\$ 5,877,320</u>

**SINGLE AUDIT**



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

To the Board of Directors  
House Ear Institute

We have audited the financial statements of House Ear Institute as of and for the year ended June 30, 2006, and have issued our report thereon dated September 22, 2006. We conducted our audit in accordance with generally accepted auditing standards and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

**Compliance**

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

**Internal Control Over Financial Reporting**

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

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

September 22, 2006



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

To the Board of Directors  
House Ear Institute

**Compliance**

We have audited the compliance of House Ear Institute with the types of compliance requirements described in the *U.S. Office of Management and Budget (OMB) Circular A-133 Compliance Supplement* that are applicable to each of its major federal programs for the year ended June 30, 2006. House Ear Institute's major federal programs are identified in the summary of auditor's results section of the accompanying schedule of findings and questioned costs. Compliance with the requirements of laws, regulations, contracts and grants applicable to each of its major federal programs is the responsibility of House Ear Institute's management. Our responsibility is to express an opinion on House Ear Institute's compliance based on our audit.

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

In our opinion, House Ear Institute complied, in all material respects, with the requirements referred to above that are applicable to each of its major federal programs for the year ended June 30, 2006.

**Internal Control Over Compliance**

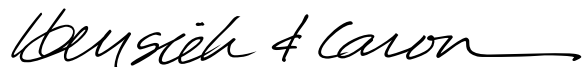
The management of House Ear Institute is responsible for establishing and maintaining effective internal control over compliance with requirements of laws, regulations, contracts and grants applicable to federal programs. In planning and performing our audit, we considered House Ear Institute's internal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

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

**Schedule of Expenditures of State and Federal Awards**

We have audited the basic financial statements of House Ear Institute as of and for the year ended June 30, 2006, and have issued our report thereon dated September 22, 2006. Our audit was performed for the purpose of forming an opinion on the basic financial statements taken as a whole. The accompanying Schedule of Expenditures of State and Federal Awards is presented for purposes of additional analysis as required by OMB Circular A-133 and is not a required part of the basic financial statements. Such information has been subjected to the auditing procedures applied in the audit of the basic financial statements and, in our opinion, is fairly stated, in all material respects, in relation to the basic financial statements taken as a whole.

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



September 22, 2006

**HOUSE EAR INSTITUTE  
STATUS OF FINDINGS AND QUESTIONED COSTS  
JUNE 30, 2006**

**A. SUMMARY OF AUDIT RESULTS**

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

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

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

**B. FINDINGS – FINANCIAL STATEMENTS AUDIT**

None

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

None

**HOUSE EAR INSTITUTE  
SCHEDULE OF PRIOR YEAR FINDINGS AND QUESTIONED COSTS  
FOR THE YEAR ENDED JUNE 30, 2006**

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

None