

**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549**

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**FORM 10-Q**

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**[X] QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE  
SECURITIES EXCHANGE ACT OF 1934**

For the quarterly period ended June 30, 2002

OR

**[ ] TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE  
SECURITIES EXCHANGE ACT OF 1934**

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Commission File Number 0-18550

**NTS MORTGAGE INCOME FUND**

Incorporated pursuant to the Laws of the State of Delaware

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Internal Revenue Service - Employer Identification No. 61-1146077

10172 Linn Station Road, Louisville, Kentucky 40223

(502) 426-4800

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Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports) and (2) has been subject to such filing requirements for the past 90 days. Yes [X] No [ ]

As of August 6, 2002 there were approximately 3,187,000 shares of common stock outstanding.

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## PART I - FINANCIAL INFORMATION

### Item 1 - Financial Statements

#### NTS MORTGAGE INCOME FUND CONSOLIDATED BALANCE SHEETS

	As of June 30, 2002 (UNAUDITED)	As of December 31, 2001*
<u>ASSETS</u>		
Cash and equivalents	\$ 865,499	\$ 566,146
Membership initiation fees and other accounts receivable, net of allowance of approximately \$86,000 and \$58,000, respectively	1,503,248	1,453,796
Notes receivable	837,252	965,702
Inventory	41,377,095	47,327,572
Property and equipment, net of accumulated depreciation of approximately \$1,812,000 and \$1,028,000	3,701,063	3,644,161
Investment in unconsolidated affiliate	1,515,554	1,557,929
Advances to affiliates	--	28,052
Other assets	548,732	509,042
<b>TOTAL ASSETS</b>	<b>\$ 50,348,443</b>	<b>\$ 56,052,400</b>
<u>LIABILITIES AND STOCKHOLDERS' EQUITY</u>		
Accounts payable and accrued expenses	\$ 2,993,015	\$ 2,800,449
Accounts payable - affiliates	7,106,035	5,885,112
Mortgages and notes payable	18,563,302	25,371,135
Notes payable - affiliate	--	212,886
Lot deposits	285,370	212,614
Deferred revenues	152,344	118,200
<b>TOTAL LIABILITIES</b>	<b>29,100,066</b>	<b>34,600,396</b>
COMMITMENTS AND CONTINGENCIES (Note 14)		
<u>STOCKHOLDERS' EQUITY</u>		
Common stock, \$0.001 par value, 6,000,000 shares authorized; 3,187,333 shares issued and outstanding	\$ 3,187	\$ 3,187
Additional paid-in-capital	54,163,397	54,163,397
Accumulated deficit	(32,918,207)	(32,714,580)
<b>TOTAL STOCKHOLDERS' EQUITY</b>	<b>21,248,377</b>	<b>21,452,004</b>
<b>TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY</b>	<b>\$ 50,348,443</b>	<b>\$ 56,052,400</b>

\* Reference is made to the Fund's audited financial statements in the Form 10-K as filed with the Securities and Exchange Commission on April 1, 2002.

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

**NTS MORTGAGE INCOME FUND**  
**CONSOLIDATED STATEMENTS OF OPERATIONS**  
**(UNAUDITED)**

	Three Months Ended June 30,		Six Months Ended June 30,	
	2002	2001	2002	2001
<b>REVENUES</b>				
Lot sales, net of discounts	\$ 2,557,383	\$ 3,263,310	\$ 6,135,479	\$ 7,468,164
Land sale (Note 7)	6,100,000	--	6,100,000	--
Total sales	8,657,383	3,263,310	12,235,479	7,468,164
Cost of sales	6,622,417	2,501,646	9,359,500	6,110,524
Gross profit	2,034,966	761,664	2,875,979	1,357,640
Country Club income	423,639	340,576	626,453	340,576
Interest and miscellaneous income	20,551	23,814	37,971	33,387
<b>TOTAL REVENUES</b>	<b>2,479,156</b>	<b>1,126,054</b>	<b>3,540,403</b>	<b>1,731,603</b>
<b>EXPENSES</b>				
Selling, general and administrative - affiliated	833,747	731,864	1,537,723	1,494,813
Selling, general and administrative	436,154	431,216	844,965	870,191
Country Club expenses	637,800	527,511	1,080,276	527,511
Interest expense	14,447	15,833	44,982	30,979
Other taxes and licenses	27,500	(3,211)	73,641	37,804
Depreciation and amortization	37,999	13,796	76,569	27,023
(Income) loss from investment in unconsolidated affiliate	20,580	(67,033)	85,874	(38,158)
<b>TOTAL EXPENSES</b>	<b>2,008,227</b>	<b>1,649,976</b>	<b>3,744,030</b>	<b>2,950,163</b>
Net income (loss) before federal income tax	470,929	(523,922)	(203,627)	(1,218,560)
Net income (loss)	<u>\$ 470,929</u>	<u>\$ (523,922)</u>	<u>\$ (203,627)</u>	<u>\$ (1,218,560)</u>
Net income (loss) per share of common stock	<u>\$ 0.15</u>	<u>\$ (0.16)</u>	<u>\$ (0.06)</u>	<u>\$ (0.38)</u>
Weighted average number of shares	<u>3,187,333</u>	<u>3,187,333</u>	<u>3,187,333</u>	<u>3,187,333</u>

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

**NTS MORTGAGE INCOME FUND**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**  
**(UNAUDITED)**

	Six Months Ended June 30,	
	2002	2001
<b><u>CASH FLOWS FROM OPERATING ACTIVITIES</u></b>		
Net loss	\$ (203,627)	\$ (1,218,560)
Adjustments to reconcile net loss to net cash provided by (used in) operating activities:		
Depreciation and amortization expense	76,569	27,023
(Income) loss from investment in unconsolidated affiliate	85,874	(38,158)
Changes in assets and liabilities:		
Membership initiation fees and other accounts receivable	(44,103)	(471,393)
Notes receivable	128,450	(143,587)
Inventory	6,074,293	1,989,699
Accounts payable and accrued expenses	192,565	(366,899)
Lot deposits	72,756	49,212
Deferred revenues	34,144	15,301
Other assets	(51,524)	(159,190)
Net cash provided by (used in) operating activities	<u>6,365,397</u>	<u>(316,552)</u>
<b><u>CASH FLOW FROM INVESTING ACTIVITIES</u></b>		
Purchase of property and equipment	(225,451)	(195,929)
Capital contribution to unconsolidated affiliate	(43,500)	(24,100)
Net cash used in investing activities	<u>(268,951)</u>	<u>(220,029)</u>
<b><u>CASH FLOWS FROM FINANCING ACTIVITIES</u></b>		
Advances to/from affiliates	22,703	14,252
Accounts payable - affiliates	1,220,923	803,242
Proceeds from mortgage and notes payable	4,699,771	6,835,000
Proceeds from notes payable - affiliated	18,971	50,581
Payments on mortgages and notes payable	(11,507,604)	(6,912,663)
Payments on notes payable - affiliated	(231,857)	(345,952)
Other assets	(20,000)	(20,000)
Net cash (used in) provided by financing activities	<u>(5,797,093)</u>	<u>424,460</u>
Net increase (decrease) in cash and equivalents	<u>299,353</u>	<u>(112,121)</u>
CASH AND EQUIVALENTS, beginning of period	<u>566,146</u>	<u>570,465</u>
CASH AND EQUIVALENTS, end of period	<u>\$ 865,499</u>	<u>\$ 458,344</u>
Cash paid for interest, net of amounts capitalized	<u>\$ 31,574</u>	<u>\$ 33,533</u>

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

**NTS MORTGAGE INCOME FUND**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

The unaudited financial statements included herein should be read in conjunction with the Fund's 2001 Annual Report on Form 10-K, as filed with the Securities and Exchange Commission on April 1, 2002. In the opinion of the Fund's management, all adjustments (only consisting of normal recurring accruals) necessary for a fair presentation have been made to the accompanying financial statements for the three months and six months ended June 30, 2002 and 2001.

**Note 1 - Organization**

NTS Mortgage Income Fund (the "Fund"), a Delaware corporation, was formed on September 26, 1988. The Fund operated as a Real Estate Investment Trust ("REIT") under the Internal Revenue Code of 1986 (the "Code"), as amended, from its inception through December 31, 1996. The Fund began operating as a "C" corporation under the Code for tax purposes effective January 1, 1997. NTS Corporation is the sponsor of the Fund (the "Sponsor"). NTS Advisory Corporation is the advisor to the Fund (the "Advisor"), and NTS Residential Management Company is the manager of the Fund ("NTS Management"). The Advisor and NTS Management are affiliates of and are under common control with NTS Corporation. As used in this Form 10-Q the terms "we," "us" or "our," as the context requires, may refer to the Fund or its interests in properties and its joint venture.

Our wholly-owned subsidiaries are NTS/Lake Forest II Residential Corporation ("NTS/LFII") and NTS/Virginia Development Company ("NTS/VA").

NTS/LFII is the owner and developer of the Lake Forest North, single-family residential community located in Louisville, Kentucky, and will continue to own and develop the Lake Forest North project to completion and orderly sale as wholly-owned subsidiary of the Fund. NTS Residential Realty, Inc., a Kentucky corporation and an Affiliate of the Sponsor of the Fund, was formed on April 6, 1999, to act as a broker and agent for NTS/LFII for the sale of lots within the Lake Forest North project, and as a broker and agent for the sale of new homes within the Lake Forest North project.

NTS/VA is the owner and developer of the Fawn Lake, single-family residential community located near Fredericksburg, Virginia, and will continue to own and develop the Fawn Lake project to completion and orderly sale as wholly-owned subsidiary of the Fund. Fawn Lake Realty, Inc., a division of NTS/Residential Properties, Inc. Virginia, a Virginia corporation and an Affiliate of the Sponsor of the Fund, will continue to act as a broker and agent for NTS/VA for the sale of lots within the Fawn Lake project, and as a broker and agent for approved builders in the Fawn Lake project for the sale of new homes.

We own a 50% interest in the Orlando Lake Forest Joint Venture (the "Joint Venture"). See Note 8 - Investment in Unconsolidated Affiliate for further information pertaining to the investment.

**Note 2 - Basis of Accounting**

Our records are maintained on the accrual basis of accounting in accordance with accounting principles generally accepted in the United States ("GAAP").

**Note 3 - Principles of Consolidation and Basis of Presentation**

Our consolidated financial statements include the assets, liabilities, revenues and expenses of our wholly-owned subsidiaries (see Note 1). Investments of 50% or less in affiliated companies are accounted for under the equity method. All significant intercompany transactions and balances have been eliminated.

**Note 4 - Use of Estimates in Preparation of Financial Statements**

The preparation of financial statements in conformity with GAAP 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 consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

**Note 5 - Cash and Equivalents**

Cash and equivalents include cash on hand and short-term, highly liquid investments with initial maturities of three months or less.

**Note 6 - Revenue Recognition**

We recognize revenue and related costs from lot sales using the accrual method in accordance with GAAP. This occurs when payment has been received, and title possession and other attributes of ownership have been transferred to the buyer. We are not obligated to perform significant activities after the sale and we generally require a minimum down payment of at least 5% of the sales price of the lot. The Country Club recognizes revenue as services are performed.

**Note 7 - Inventory**

Inventory is stated at the lower of cost or net realizable value. Inventory includes all direct costs of land, land development, and amenities, including interest, real estate taxes, and certain other costs incurred during the development period, less amounts charged to cost of sales. Inventory costs are allocated to individual lots sold using their relative sales values. The use of the relative sales value method to record cost of sales requires the use of estimates of sales values, development costs and absorption periods over the life of the project. Given the long-term nature of the projects and inherent economic volatility of residential real estate and the use of estimates to determine sales values, development costs and absorption periods, it is reasonably possible that such estimates could change in the near term. Any changes in estimates are accounted for prospectively over the life of the project.

Inventory consists of approximately the following as of June 30, 2002:

	<u>NTS/LFII</u>	<u>NTS/VA</u>	<u>Consolidated</u>
Land held for future development, under development, and completed lots	\$ 2,170,000	\$ 18,342,000	\$ 20,512,000
Country club (net of membership initiation fees)	3,958,000	--	3,958,000
Amenities	<u>1,075,000</u>	<u>15,832,000</u>	<u>16,907,000</u>
	<u>\$ 7,203,000</u>	<u>\$ 34,174,000</u>	<u>\$ 41,377,000</u>

Inventory consists of the following as of December 31, 2001:

	<u>NTS/LFII</u>	<u>NTS/VA</u>	<u>Consolidated</u>
Land held for future development, under development, and completed lots	\$ 1,682,000	\$ 19,031,000	\$ 20,713,000
Country club (net of membership initiation fees)	5,199,000	--	5,199,000
Amenities	<u>1,456,000</u>	<u>19,960,000</u>	<u>21,416,000</u>
	<u>\$ 8,337,000</u>	<u>\$ 38,991,000</u>	<u>\$ 47,328,000</u>

We capitalized in inventory approximately \$700,000 of interest and real estate taxes for the six months ended June 30, 2002. Interest and real estate taxes incurred were approximately \$793,000.

We capitalized in inventory approximately \$1,063,000 of interest and real estate taxes for the six months ended June 30, 2001. Interest and real estate taxes incurred were approximately \$1,127,000.

Inventory as of June 30, 2002, as reflected above, includes approximately \$12,255,000, net of \$8,297,000 of country club membership initiation fees, of costs incurred to date for the development of the Lake Forest Country Club.

Inventory as of December 31, 2001, as reflected above, includes approximately \$13,324,000, net of \$8,125,000 of country club membership initiation fees, of costs incurred to date for the development of the Lake Forest Country Club.

Pursuant to an agreement between NTS/LFII and the Lake Forest Country Club regarding the cost to develop the Country Club, NTS/LFII is to receive all initiation fees from membership sales for a period not to exceed 12 years from the date of the agreement (ending 2003). The remaining cost to be incurred for the current projected Country Club operating deficit for the period covered by the agreement is approximately \$720,000, which is expected to be offset by member initiation fees. During the six months ended June 30, 2002, approximately \$466,000 of the Lake Forest Country Club deficit was capitalized as a cost of inventory. During the six months ended June 30, 2001, approximately \$274,000 of the Fawn Lake Country Club deficit and \$406,000 of the Lake Forest Country Club deficit was capitalized as a cost of inventory.



During April 2001, the Fawn Lake Country Club was substantially completed. As a result of the Fund's intention to sell the Club as a single asset, SFAS No. 67, "Accounting for Costs and Initial Rental Operations of Real Estate Projects" requires that the Club be reported separately from inventory on the Fund's balance sheet as an asset available for sale. The assets estimated fair market value was determined to be approximately \$3,000,000 and is included in property and equipment on the accompanying balance sheets.

On April 15, 2002 NTS/Virginia Development Company, a subsidiary of the NTS Mortgage Income Fund, sold approximately 456 acres of land to the U.S. Department of the Interior's National Park Service. This land is located in Spotsylvania County, Virginia, adjacent to the Fredericksburg and Spotsylvania County Battlefields Memorial National Military Park. The sales price of the land was approximately \$6,100,000. The price was determined by arms-length negotiation between the buyer and seller, aided by an appraisal commissioned by the National Park Service. Approximately \$5,500,000 of the sales proceeds was utilized to reduce outstanding debt. The net proceeds after reducing debt and paying closing costs and fees related to the sale was used as working capital.

#### **Note 8 - Investment in Unconsolidated Affiliate**

Effective August 16, 1997, we became a partner in the Joint Venture. The other partners in the Joint Venture are Orlando Lake Forest, Inc., Orlando Capital Corporation and OLF II Corporation, all of whom are Affiliates of and are under common control with the Fund's Sponsor. The Joint Venture will continue to operate under its current legal name as the Orlando Lake Forest Joint Venture.

The Joint Venture owns the Orlando Lake Forest project, a single-family residential community located in Seminole County, Florida (near Orlando). The Joint Venture will continue to own and develop the Orlando Lake Forest project.

We contributed to the Joint Venture as a capital contribution its interest in the principal and interest of the first mortgage loan on the Orlando Lake Forest project, and obtained a 50% interest in the Joint Venture. The NTS entities named above hold cumulatively the remaining 50% interest in the Joint Venture.

The net income or net loss of the Joint Venture is allocated based on the respective partner's percentage interest, as defined in the joint venture agreement. As of June 30, 2002 and December 31, 2001, the Fund's percentage interest was 50%, and our investment balance in the Joint Venture was approximately \$1,515,600 and \$1,558,000, respectively. The Fund's share of the Joint Venture's net loss for the three months and six months ended June 30, 2002, was approximately \$21,000 and \$86,000, respectively. The Fund's share of the Joint Venture's net income for the three months and six months ended June 30, 2001, was approximately \$67,000 and \$38,000, respectively.

Presented below are condensed balance sheets for the Joint Venture as of June 30, 2002 and December 31, 2001, and statements of operations for the three months and six months ended June 30, 2002 and 2001:

	June 30, 2002	December 31, 2001
<u>Balance Sheets</u>		
Inventory	\$ 6,699,000	\$ 6,462,000
Other, net	246,000	332,000
Total assets	<u>\$ 6,945,000</u>	<u>\$ 6,794,000</u>
Mortgages and notes payable	179,000	1,006,000
Other liabilities	3,735,000	2,672,000
Equity	3,031,000	3,116,000
Total liabilities and equity	<u>\$ 6,945,000</u>	<u>\$ 6,794,000</u>

	Three Months Ended June 30,		Six Months Ended June 30,	
	2002	2001	2002	2001
<u>Statements of Operations</u>				
Lot sales, net of discounts	\$ 1,257,000	\$ 1,730,000	\$ 2,207,000	\$ 2,996,000
Cost of sales	(905,000)	(1,177,000)	(1,573,000)	(2,002,000)
Other expenses, net	(393,000)	(419,000)	(806,000)	(918,000)
Net (loss) income	<u>\$ (41,000)</u>	<u>\$ 134,000</u>	<u>\$ (172,000)</u>	<u>\$ 76,000</u>

## Note 9 - Mortgages and Notes Payable

Mortgages and notes payable consist of the following:

	June 30, 2002	December 31, 2001
Mortgage loan payable to a bank in the amount of \$18,000,000, bearing interest at the Prime Rate + 1.0%, payable monthly, due October 31, 2005, secured by inventory of NTS/VA and NTS/LFII, generally principal payments consist of approximately 91% of the Gross Receipts from lot sales, personally guaranteed by Mr. J.D. Nichols, Chairman of the Board of the Fund's Sponsor, for 50% of the outstanding loan balance and a \$2 million letter of credit from a third party lender with the beneficiary being the bank.	\$ 9,119,640	\$ 15,611,926
Note payable to a bank in the amount of \$9,000,000, bearing interest at 3.0%, payable monthly, due November 1, 2004, secured by a Certificate of Deposit owned by NTS Financial Partnership, an affiliate of the Fund.	6,696,959	6,696,959
Mortgage loan payable to a bank in the amount of \$4,000,000, bearing interest at the Prime Rate + 0.5%, payable monthly, due July 31, 2002, secured by the Lake Forest Country Club and golf course, principal reductions of \$300,000 every six months, guaranteed by NTS Corporation, the Fund's Sponsor.	1,830,000	1,960,000
Warehouse Line of Credit Agreements with two banks bearing interest at the Prime Rate + 1.0% and the Prime Rate + 0.75%, due December 15, 2002, \$(99,932) and September 18, 2002 \$(582,894), secured by notes receivable, principal payments consist of payments received from notes receivable securing the obligation. The \$99,932 Warehouse Line of Credit agreement is guaranteed by NTS Corporation.	615,793	603,714
Note payable in the amount of \$1,174,800, bearing interest at a Prime Rate + 0.5%, secured by a note receivable, due in monthly installments of \$5,000, with any outstanding principal and accrued interest due and payable in full on December 29, 2002.	34,388	290,979
Other	266,522	207,557
	<u>\$ 18,563,302</u>	<u>\$ 25,371,135</u>

We anticipate seeking renewals or refinancing the debts coming due within the next twelve months with existing creditors. We are currently negotiating the renewal of the loan which was due July 31, 2002. We believe we will be successful in obtaining an extension of the due date for this loan, although we offer no assurance of our success. The Prime Rate was 4.75% at June 30, 2002 and December 31, 2001.

On October 31, 2000, NTS/VA and NTS/LFII entered into a loan agreement with a financial institution for a combined principal sum of up to \$18,000,000 and used approximately \$5,930,000 and \$10,494,000 to pay the entire principal balance of the NTS/LFII and NTS/VA loans, respectively. The loan is secured by the NTS/LFII and NTS/VA projects, a \$2 million letter of credit issued by a third party lender with the NTS/VA and NTS/LFII lender stated as the beneficiary, a guarantee by the Fund for the full \$18,000,000, and a personal guarantee by J.D. Nichols for 50% of the outstanding loan balance. Once the outstanding balance on the Joint Venture's project loan is paid in full, it will be required to apply 50% of the net sales proceeds from lot sales against the outstanding balance on this \$18,000,000 loan. The lender requires contracts on lots with gross proceeds exceeding 80% of a section's development costs before advancing funds for a newly developed section at NTS/VA. The loan is a reducing revolver and the maximum amount outstanding at the end of each year shall be as follows:

December 31, 2002	\$	11,000,000
December 31, 2003	\$	7,000,000
December 31, 2004	\$	4,000,000

#### **Note 10 - Related Party Transactions**

As of June 30, 2002, the Sponsor and an affiliate owned 210,043 shares of the Fund. The Fund has entered into the following agreements with various Affiliates of the Sponsor regarding the ongoing operation of the Fund.

##### ***Property Management Agreements***

The ongoing operation and management of the Lake Forest North and Fawn Lake projects will be conducted by NTS Management under the terms of (i) a property management agreement executed on December 30, 1997, and dated as of October 1, 1997, by and among the Fund, NTS/LFII and NTS Management for the Lake Forest North project, and (ii) a property management agreement executed on December 30, 1997, and dated as of October 1, 1997, by and among the Fund, NTS/VA and NTS Management for the Fawn Lake project (collectively, the "Management Agreements"). NTS Management is a wholly-owned subsidiary of NTS Development Company. NTS Development Company is a wholly-owned subsidiary of the Fund's Sponsor. The Management Agreements have an initial term through December 31, 2003, subject to extension under certain conditions, and are renewable for successive six (6) year terms thereafter. Under the Management Agreements, NTS Management will be reimbursed for costs incurred in the operation and management of NTS/LFII and NTS/VA, will be entitled to an overhead recovery, and will accrue an incentive payment payable, all as provided therein.

These expense reimbursements include direct and pro-rated costs incurred in the management and operation of NTS/LFII and NTS/VA. Such costs include compensation costs of management, accounting, professional, engineering and development, marketing and office personnel employed by NTS Management and/or certain of its affiliates, as well as various non-payroll related operating expenses. Compensation costs are for those individuals who rendered services full time on and off site of the residential projects and with respect to the residential projects, but who have multiple residential projects responsibilities, some of which may be affiliated entities of NTS Management. For services provided by individuals not on site, or those with multiple residential projects responsibilities, costs are pro-rated by NTS Management and allocated to the appropriate residential project. As permitted by the Property Management Agreements, the Fund was charged the following approximate amounts for the three months and six months ended June 30, 2002 and 2001. These amounts are reflected in selling, general and administrative - affiliated on the accompanying consolidated statements of operations:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2002	2001	2002	2001
<u>Personnel related costs:</u>				
Financing and accounting	\$ 63,000	\$ 63,000	\$ 125,000	\$ 125,000
Data Processing	22,000	17,000	41,000	35,000
Human Resources	11,000	11,000	21,000	22,000
Executive and administrative services	36,000	38,000	71,000	77,000
Construction Management	35,000	30,000	71,000	59,000
Sales and Marketing	267,000	350,000	592,000	739,000
Legal	21,000	15,000	41,000	28,000
Total personnel related costs	455,000	524,000	962,000	1,085,000
Marketing	16,000	46,000	52,000	98,000
Rent	18,000	16,000	32,000	29,000
Other general and administrative	10,000	6,000	17,000	12,000
Total expense reimbursements	<u>\$ 499,000</u>	<u>\$ 592,000</u>	<u>\$ 1,063,000</u>	<u>\$ 1,224,000</u>

Additionally, NTS Management is entitled to an overhead recovery, which is a reimbursement for overhead expenses attributable to the employees and the efforts of NTS Management under the Management Agreements, in an amount equal to 3.75% of the projects' gross cash receipts, as defined in the Management Agreements. Overhead recovery for the three months and six months ended June 30, 2002, was approximately \$334,000 and \$474,000, respectively. Overhead recovery for the three months and six months ended June 30, 2001, was approximately \$140,000 and \$271,000, respectively. These amounts are classified with selling, general and administrative - affiliated in the accompanying consolidated statements of operations.

There were also expense reimbursements of approximately \$1,541,000 and \$1,470,000 accrued to NTS Management or an affiliate during the six months ended June 30, 2002 and 2001, respectively, for Fawn Lake Country Club and Lake Forest Country Club. Such costs include compensation costs

of management, golf course maintenance, golf professional, kitchen personnel, and accounting as well as various non-payroll related operating expenses. In addition, there were overhead recovery fees of approximately \$83,300 and \$78,200 accrued to NTS Management for overhead recovery fees at Fawn Lake Country Club and Lake Forest Country Club for the six months ended June 30, 2002 and 2001. The Lake Forest Country Club expense reimbursements and overhead recovery fees were capitalized in inventory for six months ended June 30, 2002 and 2001. The Fawn Lake Country Club expense reimbursements and overhead recovery fees were capitalized in inventory for the period January 1, 2001 to March 31, 2001. Beginning with April 1, 2001, the expense reimbursements and recovery fees of the Fawn Lake Country Club were included with country club operations in our statement of operations.

The Management Agreements also provide the opportunity for NTS Management to receive an incentive payment, as defined in the Management Agreements, equal to 10% of the net cash flows of the projects if certain financial obligations are met. The incentive payment will not begin accruing until after the cumulative cash flows of NTS/LFII, NTS/VA and the Fund's share of the cash flow of the Joint Venture have been sufficient to enable the Fund to return to the shareholders of the Fund an amount which, after adding thereto all other payments previously distributed to such shareholders of the Fund, is at least equal to the shareholders' original capital contribution. As of June 30, 2002, the Fund had raised approximately \$63,690,000 and had paid distributions of approximately \$23,141,000. As of June 30, 2002, no amount was accrued as an incentive payment in the Fund's consolidated financial statements.

### ***Advances and Notes Payable Affiliates***

We have received advances from an affiliate of our Sponsor, net of repayments, totaling approximately \$213,000 as of December 31, 2001. The advances bear interest at the Prime Rate.

As presented in the accompanying consolidated balance sheet as of June 30, 2002 accounts payable - affiliates of approximately \$7,106,000 is owed to NTS Development Company and NTS Residential Management Company for salary and overhead reimbursements. NTS Development Company and NTS Residential Management Company have agreed to defer amounts owed to them by the Fund as of December 31, 2001 and those amounts that will accrue during fiscal 2002 through the period ending March 31, 2003, other than as permitted by our cash flows. Management believes that NTS Development Company and NTS Residential Management have the financial ability to defer amounts owed them by us. There can be no assurances that this level of support will continue past March 31, 2003.

### ***Sale of Undeveloped Land***

On March 6, 2001, the NTS/LFII sold 26.5 acres of land to Lake Forest Fairways, LLC ("Fairways"), a limited liability company which was formed between NTS Development Company and Fairway Development, LLC (an unaffiliated third party). The initial payment was made on March 6, 2001 for \$30,000 per acre for a total of \$795,000. Fairways will also pay NTS/LFII at each closing of the sale of the first 100 home units, as an additional component of the purchase price for

the property, the sum of \$14,500 per home unit sold. The sale has been recorded using the cost recovery method and the transaction has been recorded for a total sales value of \$1,715,000, consisting of the initial payment at closing for \$795,000 and the gross future proceeds of \$1,450,000 which are discounted to a net present value \$920,000. Under the cost recovery method, no profit is recognized until cash payments by the buyer (Fairways) exceed the seller's (NTS/LFII) cost of the property sold. This unrecognized profit is offset against the receivable on the balance sheet. At June 30, 2002 and December 31, 2001, the receivable balance related to this sale was approximately \$384,000 and \$413,000, respectively. The transactional values were derived from an independent appraisal dated January 4, 2000. Two transactions occurred during the six months ended June 30, 2002.

## Note 11 - Country Club Accounting

During April 2001, the Fawn Lake Country Club was substantially completed. As a result of our intention to sell the Club as a single asset, SFAS No. 67, "Accounting for Costs and Initial Rental Operations of Real Estate Projects" requires that the Club's operations no longer be capitalized to inventory costs upon substantial completion. Instead, the Club's results of operations have been included in our statement of operations beginning with April 1, 2001.

Presented below is the condensed statement of operations for the Fawn Lake Country Club for the three months and six months ended June 30, 2002:

	Three Months Ended June 30, 2002	Six Months Ended June 30, 2002
<u>Revenues</u>		
Operating revenue	\$ 423,000	\$ 622,000
Other revenue	1,000	4,000
Total revenues	424,000	626,000
<u>Expenses</u>		
Cost of goods sold	83,000	111,000
Selling, general and administrative - affiliates	360,000	645,000
Selling, general and administrative	185,000	305,000
Depreciation	10,000	19,000
Total expenses	638,000	1,080,000
Net loss	\$ <u>(214,000)</u>	\$ <u>(454,000)</u>

## Note 12 - Income Taxes

We recognize deferred tax assets and liabilities for the expected future tax consequence of events that have been included in the financial statements or tax returns. Under this method, deferred tax assets and liabilities are determined based on the difference between our book and tax bases of assets and liabilities and tax carry forwards using enacted tax rates in effect for the year in which the differences are expected to reverse. The principal tax carry forwards and temporary differences

giving rise to our deferred taxes, consist of tax net operating loss carry forwards, valuation allowances and differences in inventory basis for book and tax.

A valuation allowance is provided when the probability that the deferred tax asset to be realized does not meet the criteria established by the Financial Accounting Standards Board. We have determined, based on a history of operating losses by its subsidiaries and its expectations for the future, that it is more likely than not that the net deferred tax assets at June 30, 2002 and December 31, 2001, will not be realized. Accordingly, we have recorded a valuation allowance for the entire amount of the net deferred tax asset. As of December 31, 2001, we had a federal net operating loss carry forward of approximately \$11,585,000 expiring during 2012, 2013, 2014, 2015 and 2016.

### **Note 13 - Financial Instruments**

The book values of cash and cash equivalents, trade receivables and trade payables are considered to be representative of their respective fair values because of the immediate or short-term maturity of these financial instruments. The fair value of our notes receivable and debt instruments approximated the book value because a substantial portion of the underlying instruments are variable rate notes.

### **Note 14 - Commitments and Contingencies**

We, as an owner of real estate, are subject to various environmental laws of federal and local governments. Compliance by us with existing laws has not had a material adverse effect on the our financial condition and results of operations. However, we cannot predict the impact of new or changed laws or regulations on our current properties or on properties that we may acquire in the future.

We do not believe there is any litigation threatened against us other than routine litigation arising out of the ordinary course of business, some of which is expected to be covered by insurance, none of which is expected to have a material adverse effect on our consolidated financial statements. However, due to the event on September 11, 2001 affecting the insurance industry, we are unable to determine what price we will be able to renew our insurance coverage when the policies expire in September 2002, or if the coverage available will be adequate.

NTS/LFII and NTS/VA have various letters of credit outstanding to governmental agencies and utility companies totaling approximately \$2,352,000 as of June 30, 2002 and December 31, 2001. The primary purpose of these documents is to ensure the work at the developments is completed in accordance with the construction plans as approved by the appropriate governmental agency or utility company.

It is estimated that development of the remaining homeowner's association amenities at NTS/LFII will be substantially complete by April 2003. Based on engineering studies and projections, NTS/LFII will incur additional costs, excluding interest, of approximately \$925,000 during 2002 and 2003 to complete the homeowner's association amenities.



It is estimated that the amenities at NTS/VA will be substantially complete by December 2008. Based on engineering studies and projections, NTS/VA will incur additional costs, excluding interest, of approximately \$1,070,000 to complete the amenities for the project. These costs are estimated to be incurred as follows: \$200,000 for 2002, \$350,000 for 2003, \$0 for 2004, \$50,000 for 2005, \$420,000 for 2006, \$0 for 2007, and \$50,000 for 2008.

#### **Note 15 - Guaranties to the Fund**

NTS Guaranty Corporation (the “Guarantor”), an Affiliate of the Sponsor, has guaranteed that investors of the Fund will receive, over the life of the Fund, aggregate distributions from the Fund (from all sources) in an amount at least equal to their original capital contributions, as defined in the Fund’s Prospectus. As of June 30, 2002, the Fund has raised approximately \$63,690,000 and has paid distributions of \$23,141,000.

The liability of the Guarantor under the above guaranty is expressly limited to its assets and its ability to draw upon a \$10 million demand note receivable from Mr. J.D. Nichols, Chairman of the Board of Directors of the Sponsor. There can be no assurance that Mr. Nichols will, if called upon, be able to honor his obligation to the Guarantor. The total amounts guaranteed by the Guarantor are in excess of its net worth, and there is no assurance that the Guarantor will be able to satisfy its obligation under these guaranties. The Guarantor may in the future provide guaranties for other Affiliates of the Fund.

#### **Note 16 - Provisions for Write-down to Net Realizable Value**

Statement of Financial Accounting Standards (“SFAS”) No. 144, “Accounting for the Impairment or Disposal of Long-Lived Assets,” became effective January 1, 2002, and specifies circumstances in which certain long-lived assets must be reviewed for impairment. If the carrying amount of an asset exceeds the sum of its expected future cash flows, the asset’s carrying value must be written down to fair value. Application of this standard during the period ended June 30, 2002 did not result in an impairment loss.

## **Item 2 - Management's Discussion and Analysis of Financial Condition and Results of Operations**

Management's Discussion and Analysis of Financial condition and Results of Operations ("MD&A") should be read in conjunction with the Consolidated Financial Statements in Item 1 and the Cautionary Statements below.

### **Cautionary Statements**

Some of the statements included in this Item 2 may be considered "forward-looking statements" since such statements relate to matters which have not yet occurred. For example, phrases such as "the Fund anticipates," "believes" or "expects" indicate that it is possible that the event anticipated, believed or expected may not occur. Should such event not occur, then the result which we expected also may not occur or occur in a different manner, which may be more or less favorable to us. We do not undertake any obligations to publicly release the result of any revisions to these forward-looking statements that may be made to reflect any future events or circumstances.

Any forward-looking statements included in the MD&A section, or elsewhere in this report, which reflect management's best judgment based on factors known, involve risks and uncertainties. Readers are cautioned not to place undue reliance on any forward-looking statements, which reflect management's analysis only as of the date hereof. We undertake no obligation to publicly revise these forward-looking statements as a result of a number of factors, including but not limited to those discussed below. Any forward-looking information provided by us pursuant to the safe harbor established by recent securities legislation should be evaluated in the context of these factors.

Our subsidiaries, NTS/LFII and NTS/VA, and the Joint Venture, in which we have a 50% interest, are engaged in the development and sale of residential subdivision lots, the pricing and sale of which are subject to risks generally associated with real estate development and applicable market forces beyond our control, including general and local economic conditions, competition, interest rates, real estate tax rates, other operating expenses, the supply of and demand for properties, zoning laws, other governmental rules and fiscal policies, and acts of God. All of the properties owned by NTS/LFII, NTS/VA and the Joint Venture are encumbered by development loans from third party lenders which, given the nature of the risks incumbent in real estate investment and development activities as stated above, are inherently subject to default should the ability of NTS/LFII, NTS/VA, Joint Venture and/or the Fund to make principal and interest payments under such development loans become impaired.

There is the potential for occurrences which could affect our ability to control our professional and administrative expenses. Furthermore, the debt service regarding our borrowings is variable based on current interest rates, any fluctuations in which are beyond our control. These variances could, for example, impact the Fund's projected cash and cash requirements as well as projected returns.

## Liquidity and Capital Resources

Our current source of liquidity is primarily the ability of our subsidiaries to draw upon their respective development loans. Additional liquidity is provided by net proceeds retained from residential lot closings by the properties owned by our subsidiaries and Joint Venture in which we have a 50% interest. The various development loans call for principal payments ranging from 72% to 91% of gross receipts from lot sales.

We intend to meet the minimum principal payment requirement on our \$18,000,000 mortgage loan payable at December 31, 2002. The intention is based on our belief that the current and expected interest rate environment, regional economies affecting NTS/LFII and NTS/VA, and lot sales trends from years past will be conducive to producing the planned revenues from each development. There can be no assurances or guarantees that any of these or other pertinent factors will be more or less favorable to our achievement of planned revenue and expense goals.

On April 15, 2002, Fawn Lake sold approximately 456 acres of land to the U.S. Department of the Interior's National Park Service. This land is located in Spotsylvania County, Virginia, adjacent to the Fredericksburg and Spotsylvania County Battlefields Memorial National Military Park. The sales price of the land was approximately \$6,100,000. The price was determined by arms-length negotiation between the buyer and seller, aided by an appraisal commissioned by the National Park Service. Approximately \$5,500,000 of the sales proceeds was utilized to reduce outstanding debt. The remaining net proceeds, after reducing debt and paying closing costs and fees related to the sale, were used as working capital.

## Consolidated Cash Flows and Financial Condition

Key elements of the consolidated statements of cash flows:

	Six Months Ended June 30,	
	2002	2001
Net cash from operating activities	\$ 6,365,397	\$ (316,552)
Net cash from investing activities	(268,951)	(220,029)
Net cash from operating and investing activities	6,096,446	(536,581)
Net cash from financing activities	(5,797,093)	424,460
Net increase (decrease) in cash and equivalents	\$ <u>299,353</u>	\$ <u>(112,121)</u>

### *Operating Activity*

Cash provided by operating activities was approximately \$6,365,000 for the six months ended June 30, 2002. The decrease in inventory of approximately \$6,074,000, is a direct result of the land sale at NTS/VA and is the primary component of the activity.

Cash used in operating activities was approximately \$317,000 for the six months ended June 30, 2001. The primary components of the cash used in operating activities were a net loss of approximately \$1,218,560, a decrease in accounts payable of approximately \$367,000, which was primarily for the development of NTS/LFII and NTS/VA projects and an increase in membership initiation fees and other accounts receivable of approximately \$471,000, offset by a decrease in inventory of approximately \$1,989,700.

### ***Investing Activity***

Cash used for investing activities was approximately \$269,000 for the six months ended June 30, 2002. The components of the use of cash for investing activities were capital additions, primarily at the NTS/LFII and NTS/VA golf operations.

Cash used for investing activities was approximately \$220,000 for the six months ended June 30, 2001. The components of the use of cash for investing activities were capital additions, primarily at the NTS/LFII and NTS/VA golf operations, of approximately \$196,000.

### ***Financing Activity***

Cash used in financing activities was approximately \$5,797,000 for the six months ended June 30, 2002. This is primarily the result of loan payments made using the proceeds of the land sale at NTS/VA. The components of the cash used in financing activities included the continued deferral of accounts payable to affiliates of approximately \$1,221,000 which is owed to NTS Development Company and NTS Residential Management Company for salary and overhead reimbursements.

Cash provided by financing activities was approximately \$424,000 for the six months ended June 30, 2001. This is primarily the result of the continued deferral of accounts payable to affiliates of approximately \$803,000, which is owed to NTS Development Company and NTS Residential Management Company for salary and overhead reimbursements, which were partially offset by other activity.

## **Results of Operations**

### ***Revenues***

The following is an analysis of material changes in results of operations for the three months and six months ended June 30, 2002 and 2001. Items that did not have a material impact on operations for the periods listed have been excluded from this discussion.

On April 15, 2002, Fawn Lake sold approximately 456 acres of land to the U.S. Department of the Interior's National Park Service. This land is located in Spotsylvania County, Virginia, adjacent to the Fredericksburg and Spotsylvania County Battlefields Memorial National Military Park. The sales price of the land was approximately \$6,100,000. The price was determined by arms-length negotiation between the buyer and seller, aided by an appraisal commissioned by the National Park

Service. Approximately \$5,500,000 of the sales proceeds was utilized to reduce outstanding debt. The net proceeds after reducing debt and paying closing costs and fees related to the sale was used as working capital.

Revenue for the three months ended June 30, 2002, includes approximately \$2,496,000 in lot sales consisting of approximately \$924,000 and \$1,572,000 from NTS/LFII and NTS/VA, respectively. During this period 23 lots were sold for an average price of approximately \$109,000.

Revenue for the three months ended June 20, 2001, included approximately \$3,263,000 in lot sales consisting of approximately \$1,422,000 and \$1,841,000 from NTS/LFII and NTS/VA, respectively. During this period 31 lots were sold for an average price of approximately \$105,000.

Costs of sales for the three months ended June 30, 2002 and 2001, were approximately \$6,622,000 and \$2,502,000, respectively.

Cost of sales for the three months and six months ended June 30, 2002, includes approximately \$4,569,000 for the land sale at NTS/VA.

Revenue for the six months ended June 30, 2002, includes approximately \$6,055,000 in lot sales consisting of approximately \$2,514,000 and \$3,541,000 from NTS/LFII and NTS/VA, respectively. During this period 49 lots were sold for an average selling price of approximately \$124,000.

Revenue for the six months ended June 31, 2001, includes approximately \$5,733,000 in lot sales consisting of approximately \$2,612,000 and \$3,121,000 from NTS/LFII and NTS/VA, respectively. During this period 57 lots were sold for an average selling price of approximately \$101,000.

On March 6, 2001, the NTS/LFII sold 26.5 acres of land to Lake Forest Fairways, LLC ("Fairways"), a limited liability company which was formed between NTS Development Company and Fairway Development, LLC (an unaffiliated third party). The initial payment was made on March 6, 2001 for \$30,000 per acre for a total of \$795,000. Fairways will also pay NTS/LFII at each closing of the sale of the first 100 home units, as an additional component of the purchase price for the property, the sum of \$14,500 per home unit sold. The sale has been recorded using the cost recovery method and the transaction has been recorded for a total sales value of \$1,715,000, consisting of the initial payment at closing for \$795,000 and the gross future proceeds of \$1,450,000 which are discounted to a net present value \$920,000. Under the cost recovery method, no profit is recognized until cash payments by the buyer (Fairways) exceed the seller's (NTS/LFII) cost of the property sold. Cost of sales was recognized for this transaction in the amount of \$1,715,000 in 2001. This unrecognized profit is offset against the receivable on the balance sheet. At June 30, 2002 and December 31, 2001, the receivable balance related to this sale was approximately \$384,000 and \$413,000, respectively. The transactional values were derived from an independent appraisal dated January 14, 2000.

Costs of sales for the six months ended June 30, 2002 and 2001, were approximately \$9,360,000 and \$6,111,000, respectively.

Presented below are the gross profit margins for the three months and six months ended June 30, 2002 and 2001:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2002	2001	2002	2001
NTS/LF II	22%	27%	22%	16%
NTS/VA	24%	21%	24%	21%
Combined gross profit margins	23%	23%	23%	18%

The difference in the cost of sales percentage of NTS/LFII compared to NTS/VA and the difference in the lot sales mix will create a proportionate change in the combined gross profit margin throughout a given year. The estimated cost of sales percentages are performed at the end of each fiscal year and the resulting cost of sales percentages are applied prospectively. Management assesses the basis for these annual projections at the end of each quarter and if changes in facts and circumstances warrant, interim adjustments are made to the cost of sales percentages prospectively.

In comparing the gross margin percentages for the six months ended June 30, 2002 and 2001, respectively, Management's estimates have changed relative to the ultimate sales values, development costs and absorption periods. The inherent economic volatility of residential real estate does not allow us to be certain that the gross profit margins that we now believe will be realized during the duration of the projects will remain unchanged.

The net increase in gross profit margin at NTS/LFII is a function of a change in the estimates of sales values, development costs and absorption periods over the life of the project and the unrecognized profit for the six months ended June 30, 2001 for the land sold to Fairways, which is being accounted for using the cost recovery method. The gross profit margin for the six months ended June 30, 2001 would have been approximately 32% without the land sale to Fairways.

We periodically review the value of land and inventories and determine whether any impairment charges are needed to reflect declines in value. We did not record any impairment charges during the six months ended June 30, 2002 and 2001. The estimated net realizable value of real estate inventories represents our best estimate based on present plans and intentions, selling prices in the ordinary course of business and anticipated economic and market conditions. Accordingly, the realization of the value of our real estate inventories is dependent on future events and conditions that may cause actual results to differ from amounts presently estimated.

Beginning with April 1, 2001, the income and expenses of the Fawn Lake Country Club have been included in the Fund's statement of operations. This is a result of the substantial completion of the Club and the intention to sell the Club as a single asset. The net impact on the results of operations was a net operating deficit of approximately \$454,000 for the six months ended June 30, 2002.

Presented below is the condensed statement of operations for the Fawn Lake Country Club for the three months and six months ended June 30, 2002:

	Three Months Ended June 30, 2002	Six Months Ended June 30, 2002
<u>Revenues</u>		
Operating revenue	\$ 423,000	\$ 622,000
Other revenue	1,000	4,000
Total revenues	424,000	626,000
<u>Expenses</u>		
Cost of goods sold	83,000	111,000
Selling, general and administrative - affiliates	360,000	645,000
Selling, general and administrative	185,000	305,000
Depreciation	10,000	19,000
Total expenses	638,000	1,080,000
Net loss	\$ <u>(214,000)</u>	\$ <u>(454,000)</u>

Interest income on cash equivalents and miscellaneous income includes interest income earned from short-term investments made by the Fund with cash reserves for the six months ended June 30, 2002 and 2001.

### ***Expenses***

The ongoing operation and management of NTS/LFII and NTS/VA will be conducted by NTS Management under the terms of (i) a property management agreement executed on December 30, 1997, and dated as of October 1, 1997, by and among the Fund, NTS/LFII and NTS Management for the Lake Forest North project, and (ii) a property management agreement executed on December 30, 1997 and dated as of October 1, 1997, by and among the Fund, NTS/VA and NTS Management for the Fawn Lake project (collectively, the "Management Agreements"). NTS Management is a wholly-owned subsidiary of NTS Development Company. NTS Development Company is a wholly-owned subsidiary of the Fund's Sponsor. The Management Agreements have an initial term through December 31, 2003, subject to extension under certain conditions, and are renewable for successive six (6) year terms thereafter. Under the Management Agreements, NTS Management will be reimbursed for costs incurred in the operation and management of NTS/LFII and NTS/VA, will be entitled to an overhead recovery, and will accrue an incentive payment payable, all as provided therein.

The expenses related to the Management Agreements are presented as selling, general and administrative - affiliated on the accompanying consolidated statements of operations. As defined in the Management Agreements, the expenses are classified in two ways, expense recovery and overhead recovery. The expense recovery includes direct and pro-rated costs incurred in the management and operation of NTS/LFII and NTS/VA. Such costs include compensation costs of management, accounting, professional, engineering and development, marketing and office

personnel employed by NTS management and/or certain of its affiliates as well as various non-payroll related operating expenses. Compensation costs are for those individuals who rendered services full time on and off site of the residential projects and with respect to the residential projects, but who have multiple residential projects responsibilities, some of which may be affiliated entities of NTS Management. For services provided by individuals not on site, or those with multiple residential projects responsibilities, costs are pro-rated by NTS Management and allocated to the appropriate residential project.

Reimbursements for expense recovery of approximately \$499,000 and \$592,000 were accrued to NTS Management or an Affiliate during the three months June 30, 2002 and 2001, respectively, for actual personnel, marketing and administrative costs as they relate to NTS/LFII, NTS/VA and the Fund. For the six months ended June 30, 2002 and 2001, the expense recovery accrued to NTS Management or an affiliate was approximately \$1,063,000 and \$1,224,000.

Reimbursements for expense recovery decreased approximately \$93,000 for the three months ended June 30, 2002, as compared to the same period in 2001. Reimbursements for expense recovery decreased approximately \$161,000 for the six months ended June 30, 2002, as compared to the same period in 2001. The decrease is primarily a result of a decrease in commission paid to sales agents employed by NTS/VA for the three months and six months ended June 30, 2002, as compared to same period in 2001.

Additionally, NTS Management is entitled to an overhead recovery, which is a reimbursement for overhead expenses attributable to the employees and the efforts of NTS Management under the Management Agreements, in an amount equal to 3.75% of the projects' gross cash receipts, as defined in the Management Agreements. Historically, this amount has been deferred and is reflected as an increase in the accounts payable - affiliates. This amount included a fee of approximately \$229,000 for the land sale at NTS/VA for the three months and six months ended June 30, 2002.

Selling, general and administrative expenses include directors' fees, legal, outside accounting, other investor related cost, repairs and maintenance cost. Selling, general and administrative expenses also include those costs incurred directly by NTS/VA for marketing related activities.

For the three months ended June 30, 2002 and 2001, the amounts incurred for selling, general and administrative expenses were approximately \$436,000 and \$431,000, respectively. For the six months ended June 30, 2002 and 2001, the amounts incurred for selling, general and administrative expenses were approximately \$845,000 and \$870,000, respectively. The decrease in the selling, general and administrative expense is primarily a result of a decrease in advertising costs at NTS/VA for the six months ended June 20, 2002 compared to the same period in 2001.

We have budgeted an increase of approximately 25% in our insurance expense upon renewal of our policies in September 2002, as compared to 2001.



Increases and decreases in interest expense generally correspond directly to increases and decreases in the outstanding balances of the Fund's borrowings and its subsidiaries borrowings as well as in the capitalization percentage. For the six months ended June 30, 2002 and 2001, approximately \$572,000 and \$997,000, respectively, was capitalized in inventory and approximately \$45,000 and \$31,000, respectively, was expensed. The decrease in total interest is primarily due to decreases in our interest rate on variable rate mortgage loans.

Depreciation expense relates to equipment used for development activity which is being depreciated over five to seven years.

No benefit for income taxes was provided during the six months ended June 30, 2002 and 2001, as we have recorded a valuation allowance equal to the amount of the recorded benefit. We have determined that it is more likely than not that the net deferred tax asset will not be realized.

### ***Critical Accounting Policies***

We periodically review the value of land and inventories and determine whether any impairment charges need to be recorded to reflect declines in value. The estimated net realizable value of real estate inventories represents our estimate based on present plans and intentions, selling prices in the ordinary course of business and anticipated economic and market conditions. Accordingly, the realization of the value of our real estate inventories is dependent on future events and conditions that may cause actual results to differ from amounts presently estimated. We did not record any impairment charges during the period ended June 30, 2002.

During April 2001, the Fawn Lake Country Club was substantially completed. As a result of our intention to sell the Club as a single asset, SFAS No. 67, "Accounting for Costs and Initial Rental Operations of Real Estate Projects," requires that the Club be reported separately from inventory on our balance sheets as an asset available for sale. The asset's estimated fair market value was determined to be approximately \$3,000,000 and is included in property and equipment on the June 30, 2002 and December 31, 2001, balance sheets. At that time, Fawn Lake Country Club's operating revenues and expenses were required to be recognized on the Fund's income statement. Prior to completion of the club, the net operating losses were capitalized to inventory, the same accounting treatment which is applied to the Lake Forest Country Club.

No benefit for income taxes was provided during the six months ended June 30, 2002 and 2001, as we have recorded a valuation allowance equal to the amount of the recorded benefit. We have determined that it is more likely than not that the net deferred tax asset will not be realized.

### **Item 3 - Quantitative and Qualitative Disclosures About Market Risk**

Our primary market risk exposure with regard to financial instruments is changes in interest rates. The Fund's debt instruments bear interest at both variable and fixed rates as discussed in Note 9 of the Fund's financial statements. For the six months ended June 30, 2002, a hypothetical 100 basis point increase in interest rates would result in an approximate \$109,000 increase in interest expense and an approximate \$64,000 decrease in the fair value of debt for the six months then ended. During the six months ended June 30, 2002, the majority of interest expense incurred was capitalized in inventory.

## **PART II - OTHER INFORMATION**

### **Item 1 - Legal Proceedings**

None.

### **Item 2 - Changes in Securities**

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.

### **Item 6 - Exhibits and Reports on Form 8-K**

#### **a) Exhibits:**

- 99.1 Certification of Chief Executive Officer
- 99.2 Certification of Chief Financial Officer

#### **b) Reports on Form 8-K:**

Form 8-K was filed on May 29, 2002 to report in Item 4 that we have elected to change our independent public accountant. This Form 8-K was amended on June 12, 2002.

## **SIGNATURES**

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.

NTS Mortgage Income Fund

/s/ Brian F. Lavin

Brian F. Lavin  
President and Director of the  
Mortgage Income Fund

Date: August 14, 2002

**CERTIFICATION OF CHIEF EXECUTIVE OFFICER REGARDING  
PERIODIC REPORT FILED PURSUANT TO SECTION 13(A) OR 15(D)  
OF THE SECURITIES EXCHANGE ACT OF 1934**

I, Brian F. Lavin, certify, pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that:

To the best of my knowledge and belief, the Quarterly Report on Form 10-Q filed with the Securities and Exchange Commission on August 14, 2002 by the NTS Mortgage Income Fund and to which this certification is appended (the “Periodic Report”) fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934, and the information contained in the Periodic Report fairly presents, in all material respects, the financial condition and results of operations of the NTS Mortgage Income Fund.

/s/ Brian F. Lavin

Brian F. Lavin

President and Director of the Mortgage Income Fund

**CERTIFICATION OF CHIEF FINANCIAL OFFICER REGARDING  
PERIODIC REPORT FILED PURSUANT TO SECTION 13(A) OR 15(D)  
OF THE SECURITIES EXCHANGE ACT OF 1934**

I, Gregory A. Wells, certify, pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that:

To the best of my knowledge and belief, the Quarterly Report on Form 10-Q filed with the Securities and Exchange Commission on August 14, 2002 by the NTS Mortgage Income Fund and to which this certification is appended (the “Periodic Report”) fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934, and the information contained in the Periodic Report fairly presents, in all material respects, the financial condition and results of operations of the NTS Mortgage Income Fund.

/s/ Gregory A. Wells

Gregory A. Wells

Senior Vice President and Chief Financial Officer  
of NTS Capital Corporation