# Merit School of Music

Financial Report
June 30, 2014

**Contents**

McGladrey

**Independent Auditor's Report**

To the Board of Trustees
Merit School of Music

**Report on the Financial Statements**

We have audited the accompanying financial statements of Merit School of Music (Merit) which comprise the statements of financial position as of June 30, 2014 and 2013, and the related statements of activities, functional expenses and cash flows for the years then ended and the related notes to the financial statements.

**Management's Responsibility for the Financial Statements**

Management is responsible for the preparation and fair presentation of these financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

**Auditor's Responsibility**

Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

**Opinion**

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Merit School of Music as of June 30, 2014 and 2013, and the changes in its net assets and its cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

McGladrey LLP

Chicago, Illinois
November 14, 2014

**Merit School of Music**

**Statements of Financial Position**
**June 30, 2014 and 2013**

| | **2014** | 2013 |
|---|---|---|
| **Assets** | | |
| Cash and equivalents | **$ 518,028** | $ 352,661 |
| Pledges receivable, net | **763,650** | 544,180 |
| Tuitions receivable, net | **148,485** | 216,069 |
| Other assets | **179,060** | 188,496 |
| Investments | **12,449,000** | 11,090,973 |
| Property and equipment, net | **8,754,282** | 8,699,867 |
| | **$ 22,812,505** | $ 21,092,246 |
| **Liabilities and Net Assets** | | |
| Liabilities | | |
| Accounts payable | **$ 178,361** | $ 58,615 |
| Accrued expenses | **159,667** | 171,786 |
| Line of credit | **55,000** | - |
| Deferred tuition revenue | **286,289** | 305,645 |
| Annuity contract obligation | **50,000** | 34,600 |
| | **729,317** | 570,646 |
| Net Assets | | |
| Unrestricted | | |
| Undesignated | **7,828,276** | 7,869,245 |
| Board designated | **7,238,649** | 5,882,573 |
| | **15,066,925** | 13,751,818 |
| Temporarily restricted | **1,091,604** | 845,123 |
| Permanently restricted | **5,924,659** | 5,924,659 |
| | **22,083,188** | 20,521,600 |
| | **$ 22,812,505** | $ 21,092,246 |

See Notes to Financial Statements.

## Merit School of Music

## Statement of Activities
## Year Ended June 30, 2014

| | Unrestricted | | | | | |
|---|---|---|---|---|---|---|
| | Undesignated | Board Designated | Total | Temporarily Restricted | Permanently Restricted | **Total** |
| Revenue: | | | | | | |
| Contributions | $ 1,284,939 | $ 517 | $ 1,285,456 | $ 673,068 | $ - | **$ 1,958,524** |
| Government grants | 12,100 | - | 12,100 | - | - | **12,100** |
| Student fees | 1,137,747 | - | 1,137,747 | - | - | **1,137,747** |
| School contracts | 555,087 | - | 555,087 | - | - | **555,087** |
| Fundraising events, net of expenses of $270,225 | 1,335,085 | 32,000 | 1,367,085 | 102,315 | - | **1,469,400** |
| Rental income | 333,755 | - | 333,755 | - | - | **333,755** |
| Miscellaneous income | 33,580 | 41 | 33,621 | - | - | **33,621** |
| Interest and dividends | 132 | 276,890 | 277,022 | 4,583 | - | **281,605** |
| Net assets released from restrictions | 1,132,822 | (585,772) | 547,050 | (547,050) | - | **-** |
| | 5,825,247 | (276,324) | 5,548,923 | 232,916 | - | **5,781,839** |
| Expenses: | | | | | | |
| Program services: | | | | | | |
| Tuition-free Conservatory | 667,046 | - | 667,046 | - | - | **667,046** |
| Bridges: Partners in Music | 1,059,206 | - | 1,059,206 | - | - | **1,059,206** |
| Instrumental Music Program | 626,431 | - | 626,431 | - | - | **626,431** |
| Private lessons | 1,457,761 | - | 1,457,761 | - | - | **1,457,761** |
| Other programs | 581,214 | - | 581,214 | - | - | **581,214** |
| | 4,391,658 | - | 4,391,658 | - | - | **4,391,658** |
| Support services: | | | | | | |
| General and administration | 877,332 | 3,000 | 880,332 | - | - | **880,332** |
| Fundraising | 597,226 | - | 597,226 | - | - | **597,226** |
| | 1,474,558 | 3,000 | 1,477,558 | - | - | **1,477,558** |
| | 5,866,216 | 3,000 | 5,869,216 | - | - | **5,869,216** |
| **Increase (decrease) in net assets before investment income** | (40,969) | (279,324) | (320,293) | 232,916 | - | **(87,377)** |
| Realized and unrealized gain on investments | - | 1,635,400 | 1,635,400 | 13,565 | - | **1,648,965** |
| **Increase (decrease) in net assets** | (40,969) | 1,356,076 | 1,315,107 | 246,481 | - | **1,561,588** |
| Net assets: | | | | | | |
| Beginning of year | 7,869,245 | 5,882,573 | 13,751,818 | 845,123 | 5,924,659 | **20,521,600** |
| End of year | $ 7,828,276 | $ 7,238,649 | $ 15,066,925 | $ 1,091,604 | $ 5,924,659 | **$ 22,083,188** |

See Notes to Financial Statements.

## Merit School of Music

## Statement of Activities
## Year Ended June 30, 2013

| | Unrestricted | | | | | |
|---|---|---|---|---|---|---|
| | Undesignated | Board Designated | Total | Temporarily Restricted | Permanently Restricted | **Total** |
| Revenue: | | | | | | |
| Contributions | $ 1,264,350 | $ 42,278 | $ 1,306,628 | $ 366,783 | $ - | **$ 1,673,411** |
| Government grants | 36,000 | - | 36,000 | - | - | **36,000** |
| Student fees | 1,070,039 | - | 1,070,039 | - | - | **1,070,039** |
| School contracts | 571,500 | - | 571,500 | - | - | **571,500** |
| Fundraising events, net of expenses of $203,386 | 53,549 | 540,846 | 594,395 | 25,500 | - | **619,895** |
| Rental income | 310,410 | - | 310,410 | - | - | **310,410** |
| Miscellaneous income | 39,919 | (26,058) | 13,861 | - | - | **13,861** |
| Interest and dividends | 209 | 288,331 | 288,540 | 1,709 | - | **290,249** |
| Net assets released from restrictions | 3,636,492 | (3,042,629) | 593,863 | (593,863) | - | **-** |
| | 6,982,468 | (2,197,232) | 4,785,236 | (199,871) | - | **4,585,365** |
| Expenses: | | | | | | |
| Program services: | | | | | | |
| Tuition-free Conservatory | 689,723 | 3,901 | 693,624 | - | - | **693,624** |
| Bridges: Partners in Music | 940,858 | 1,691 | 942,549 | - | - | **942,549** |
| Instrumental Music Program | 762,748 | 4,258 | 767,006 | - | - | **767,006** |
| Private lessons | 1,162,470 | 7,210 | 1,169,680 | - | - | **1,169,680** |
| Other programs | 630,502 | 1,594 | 632,096 | - | - | **632,096** |
| | 4,186,301 | 18,654 | 4,204,955 | - | - | **4,204,955** |
| Support services: | | | | | | |
| General and administration | 812,846 | 5,647 | 818,493 | - | - | **818,493** |
| Fundraising | 510,012 | 2,754 | 512,766 | - | - | **512,766** |
| | 1,322,858 | 8,401 | 1,331,259 | - | - | **1,331,259** |
| | 5,509,159 | 27,055 | 5,536,214 | - | - | **5,536,214** |
| **Increase (decrease) in net assets before investment income** | 1,473,309 | (2,224,287) | (750,978) | (199,871) | - | **(950,849)** |
| Realized and unrealized gain on investments | - | 1,164,367 | 1,164,367 | 17,408 | - | **1,181,775** |
| **Increase (decrease) in net assets** | 1,473,309 | (1,059,920) | 413,389 | (182,463) | - | **230,926** |
| Net assets: | | | | | | |
| Beginning of year | 6,395,936 | 6,942,493 | 13,338,429 | 1,027,586 | 5,924,659 | **20,290,674** |
| End of year | $ 7,869,245 | $ 5,882,573 | $ 13,751,818 | $ 845,123 | $ 5,924,659 | **$ 20,521,600** |

See Notes to Financial Statements.

**Merit School of Music**

**Statement of Functional Expenses**
**Year Ended June 30, 2014**

| | Program Services | | | | | |
|---|---|---|---|---|---|---|
| | Tuition-free Conservatory | Bridges: Partners in Music | Instrumental Music Program | Private Lessons | Other Programs | Total Program Services |
| Salaries and contract instructors | $ 466,400 | $ 739,229 | $ 441,979 | $ 1,065,769 | $ 281,200 | $ 2,994,577 |
| Payroll taxes and employee benefits | 77,679 | 119,046 | 81,223 | 165,781 | 49,052 | 492,781 |
| Outside marketing and fundraising services | 569 | 72 | 1,227 | 1,419 | 1,510 | 4,797 |
| Other outside services and professional fees | 830 | 2,213 | 101 | - | 4,926 | 8,070 |
| Printing and production costs | 19,039 | 3,406 | 6,832 | 5,692 | 4,913 | 39,882 |
| College, camp and endowed scholarships | - | - | - | - | 22,927 | 22,927 |
| Program supplies and sheet music | 8,124 | 38,623 | 12,755 | - | 7,874 | 67,376 |
| Instrument costs, including depreciation | 2,098 | 44,249 | 3,234 | - | 87,588 | 137,169 |
| Other direct program costs | 10,902 | 64,477 | 1,032 | - | 37,421 | 113,832 |
| Office expenses | 11,842 | 5,098 | 11,024 | 31,399 | 8,806 | 68,169 |
| Technology expenses | 4,236 | 6,364 | 4,835 | 10,697 | 9,911 | 36,043 |
| Occupancy costs | 40,270 | 16,919 | 38,231 | 109,044 | 26,700 | 231,164 |
| Staff development and local meetings | 723 | 2,674 | 101 | - | 17,808 | 21,306 |
| Office depreciation and amortization | 23,118 | 14,373 | 23,126 | 62,930 | 18,927 | 142,474 |
| Interest expense | - | - | - | - | - | - |
| Bad debt expense | - | 633 | 408 | 5,030 | 291 | 6,362 |
| Miscellaneous | 1,216 | 1,830 | 323 | - | 1,360 | 4,729 |
| | $ 667,046 | $ 1,059,206 | $ 626,431 | $ 1,457,761 | $ 581,214 | $ 4,391,658 |

See Notes to Financial Statements.

**Merit School of Music**

**Statement of Functional Expenses (Continued)**
**Year Ended June 30, 2014**

| | Supporting Services | | | |
|---|---|---|---|---|
| | General and Administration | Fundraising | Total Supporting Services | **Total** |
| Salaries and contract instructors | $ 390,206 | $ 314,111 | $ 704,317 | **$ 3,698,894** |
| Payroll taxes and employee benefits | 68,137 | 86,811 | 154,948 | **647,729** |
| Outside marketing and fundraising services | 15,039 | 23,626 | 38,665 | **43,462** |
| Other outside services and professional fees | 112,581 | 1,236 | 113,817 | **121,887** |
| Printing and production costs | 21,806 | 52,456 | 74,262 | **114,144** |
| College, camp and endowed scholarships | - | - | - | **22,927** |
| Program supplies and sheet music | - | 864 | 864 | **68,240** |
| Instrument costs, including depreciation | 19,405 | - | 19,405 | **156,574** |
| Other direct program costs | - | - | - | **113,832** |
| Office expenses | 23,239 | 18,250 | 41,489 | **109,658** |
| Technology expenses | 44,282 | 24,921 | 69,203 | **105,246** |
| Occupancy costs | 65,830 | 33,237 | 99,067 | **330,231** |
| Staff development and local meetings | 44,742 | 6,737 | 51,479 | **72,785** |
| Office depreciation and amortization | 47,126 | 28,307 | 75,433 | **217,907** |
| Interest expense | 1,713 | - | 1,713 | **1,713** |
| Bad debt expense | 18,263 | - | 18,263 | **24,625** |
| Miscellaneous | 7,963 | 6,670 | 14,633 | **19,362** |
| | $ 880,332 | $ 597,226 | $ 1,477,558 | **$ 5,869,216** |

See Notes to Financial Statements.

**Merit School of Music**

**Statement of Functional Expenses**
**Year Ended June 30, 2013**

| | Program Services | | | | | |
|---|---|---|---|---|---|---|
| | Tuition-free Conservatory | Bridges: Partners in Music | Instrumental Music Program | Private Lessons | Other Programs | Total Program Services |
| Salaries and contract instructors | $ 489,622 | $ 664,889 | $ 520,068 | $ 875,848 | $ 242,518 | $ 2,792,945 |
| Payroll taxes and employee benefits | 82,242 | 104,398 | 100,689 | 123,764 | 49,475 | 460,568 |
| Outside marketing and fundraising services | 1,175 | 416 | 1,609 | 2,103 | 11,818 | 17,121 |
| Other outside services and professional fees | 62 | 1,216 | - | 245 | 5,090 | 6,613 |
| Printing and production costs | 9,152 | 2,489 | 6,370 | 8,417 | 40,319 | 66,747 |
| College, camp and endowed scholarships | - | - | - | - | 24,045 | 24,045 |
| Program supplies and sheet music | 8,692 | 34,536 | 11,096 | 24 | 19,760 | 74,108 |
| Instrument costs, including depreciation | 1,520 | 24,722 | 22,097 | - | 86,228 | 134,567 |
| Other direct program costs | 9,402 | 59,142 | 1,471 | - | 101,347 | 171,362 |
| Office expenses | 17,410 | 10,690 | 20,775 | 27,581 | 10,913 | 87,369 |
| Occupancy costs | 39,264 | 16,929 | 42,620 | 72,173 | 15,976 | 186,962 |
| Office depreciation and amortization | 28,806 | 16,957 | 34,010 | 46,600 | 7,938 | 134,311 |
| Staff development and local meetings | 2,376 | 3,015 | 96 | - | 16,998 | 22,485 |
| Interest expense | 392 | 170 | 428 | 724 | 161 | 1,875 |
| Bond underwriting and carrying costs | 3,509 | 1,521 | 3,830 | 6,486 | 1,433 | 16,779 |
| Bad debt expense | - | 766 | 1,585 | 5,715 | (3,150) | 4,916 |
| Miscellaneous | - | 693 | 262 | - | 1,227 | 2,182 |
| | $ 693,624 | $ 942,549 | $ 767,006 | $ 1,169,680 | $ 632,096 | $ 4,204,955 |

See Notes to Financial Statements.

**Merit School of Music**

**Statement of Functional Expenses (Continued)**
**Year Ended June 30, 2013**

| | Supporting Services | | | |
|---|---|---|---|---|
| | General and Administration | Fundraising | Total Supporting Services | **Total** |
| Salaries and contract instructors | $ 383,911 | $ 317,321 | $ 701,232 | **$ 3,494,177** |
| Payroll taxes and employee benefits | 51,732 | 80,812 | 132,544 | **593,112** |
| Outside marketing and fundraising services | 9,781 | 4,761 | 14,542 | **31,663** |
| Other outside services and professional fees | 88,677 | 4,623 | 93,300 | **99,913** |
| Printing and production costs | 13,488 | 14,962 | 28,450 | **95,197** |
| College, camp and endowed scholarships | - | - | - | **24,045** |
| Program supplies and sheet music | - | 207 | 207 | **74,315** |
| Instrument costs, including depreciation | 14,340 | - | 14,340 | **148,907** |
| Other direct program costs | 211 | 246 | 457 | **171,819** |
| Office expenses | 70,746 | 26,519 | 97,265 | **184,634** |
| Occupancy costs | 53,492 | 27,567 | 81,059 | **268,021** |
| Office depreciation and amortization | 50,306 | 27,739 | 78,045 | **212,356** |
| Staff development and local meetings | 45,339 | 2,870 | 48,209 | **70,694** |
| Interest expense | 567 | 277 | 844 | **2,719** |
| Bond underwriting and carrying costs | 5,080 | 2,477 | 7,557 | **24,336** |
| Bad debt expense | 2,600 | - | 2,600 | **7,516** |
| Miscellaneous | 28,223 | 2,385 | 30,608 | **32,790** |
| | $ 818,493 | $ 512,766 | $ 1,331,259 | **$ 5,536,214** |

See Notes to Financial Statements.

**Merit School of Music**

**Statements of Cash Flows**
**Years Ended June 30, 2014 and 2013**

| | **2014** | 2013 |
|---|---|---|
| Cash Flows from Operating Activities | | |
| Increase in net assets | **$ 1,561,588** | $ 230,926 |
| Adjustments to reconcile increase in net assets to net cash provided by (used in) operating activities: | | |
| Provision for (reduction of) allowance for bad debts | **14,620** | (3,700) |
| Depreciation and amortization | **318,020** | 298,507 |
| Change in present value of annuity contract | **27,008** | 13,008 |
| Realized and unrealized gain on investments | **(1,648,965)** | (1,181,775) |
| Contributions of donated stock | **(189,862)** | (55,855) |
| Changes in: | | |
| Pledges receivable | **(219,470)** | 185,316 |
| Tuitions receivable | **52,964** | (27,393) |
| Other assets | **9,436** | (1,962) |
| Accounts payable and accrued expenses | **107,627** | 43,911 |
| Deferred tuition revenue | **(19,356)** | 54,348 |
| **Net cash provided by (used in) operating activities** | **13,610** | (444,669) |
| | | |
| Cash Flows from Investing Activities | | |
| Purchases of property and equipment | **(372,435)** | (324,512) |
| Purchases of investments | **(1,619,057)** | (705,237) |
| Proceeds from sales and maturities of investments | **2,099,857** | 2,515,800 |
| **Net cash provided by investing activities** | **108,365** | 1,486,051 |
| | | |
| Cash Flows from Financing Activities | | |
| Bond sinking fund deposits, interest and payment on bonds payable | **-** | (1,198,619) |
| Proceeds from line of credit | **55,000** | - |
| Annuity contract obligation payment | **(11,608)** | (11,608) |
| **Net cash provided by (used in) financing activities** | **43,392** | (1,210,227) |
| | | |
| **Increase (decrease) in cash and equivalents** | **165,367** | (168,845) |
| | | |
| Cash and equivalents: | | |
| Beginning of year | **352,661** | 521,506 |
| | | |
| End of year | **$ 518,028** | $ 352,661 |
| | | |
| Supplemental Disclosure of Cash Flow Information | | |
| Interest paid | **$ 1,713** | $ 2,719 |
| | | |
| Supplemental Schedule of Noncash Investing and Operating Activities | | |
| Contributions of donated stock | **$ 189,862** | $ 55,855 |

See Notes to Financial Statements.

## Note 1. Nature of Organization and Significant Accounting Policies

**Nature of organization**: Merit School of Music (Merit) is a nonprofit organization providing music education primarily to underserved communities in Chicago. Its main objective is to provide music training from basic introduction at the in-school level to college preparatory programming with the Alice S. Pfaelzer Tuition-free Conservatory. Merit's programs offer music theory, private lessons, ensemble classes and performance opportunities. Merit’s administrative and program facility is the Joy Faith Knapp Music Center at 38 S. Peoria in Chicago, Illinois.

The Tuition-free Conservatory provides students, selected by audition, with a curriculum in music theory, instrumental technique and mixed ensemble. Students attend classes including a weekly assembly where student, faculty and guest artist performances are featured.

The Bridges: Partners in Music program (Bridges) brings Merit's faculty to Chicago public schools, private schools and other community centers each year, where they provide instruction in winds, brass, percussion, strings, chorus, piano and general music.

The Instrumental Music Program provides musical preparation for the Tuition-free Conservatory to primary school age students. Included in the programs are music theory, instrumental technique and ensemble classes. In addition, several specialty camps for interested students provide instruction during the summer months.

Merit's Private Lesson Program makes private instruction available to all students from the very beginner to the most advanced musician. Financial aid is available to children. Students gain additional experience through participation in private lesson recitals.

Other programs include Early Childhood classes for preschoolers, and special outreach programs such as the Suzuki-Alegre Strings Program, which is a Suzuki-based strings performance group with special focus on Chicago's Latino community, and the Regenstein Scholarship Program which provides free music education to children from extremely low income families.

Merit's Bridges contracts are predominantly with the Chicago Board of Education, which accounted for approximately 7 percent and 6 percent of Merit's revenue for the years ended June 30, 2014 and 2013, respectively. Financial aid is available to all students.

**Basis of accounting**: The financial statements have been prepared on the accrual basis of accounting and, accordingly, reflect all significant receivables, payables and other liabilities.

**Basis of presentation**: The financial statements of Merit have been prepared in conformity with accounting principles generally accepted in the United States of America as applicable to nonprofit organizations. Merit maintains its financial accounts in accordance with the principles and practices of fund accounting, the procedure by which resources for various purposes are classified for accounting purposes in accordance with Merit's activities or objectives. For financial reporting purposes, Merit's funds and its activities are classified as unrestricted, temporarily restricted or permanently restricted based on the existence or absence of donor-imposed restrictions, as follows:

<u>Unrestricted net assets:</u> Net assets that are not subject to donor-imposed restrictions including the carrying value of all physical properties (property and equipment). Items that increase or decrease this net asset category include amounts received from government agencies, student fees, school contracts and all expenses associated with the core activities of Merit. In addition to these transactions, changes in this category of net assets include certain types of philanthropic support, namely unrestricted contributions and foundation grants, investment income and restricted contributions and foundation grants whose donor-imposed restrictions were met during the fiscal period. Board-designated amounts are part of unrestricted net assets (See Note 8).

**Note 1. Nature of Organization and Significant Accounting Policies (Continued)**

Temporarily restricted net assets: Net assets subject to donor-imposed restrictions that may or will be met either by actions of Merit or the passage of time. Items that affect this net asset category are restricted contributions and grants, including pledges for future years. These amounts are reclassified to unrestricted net assets when such restrictions are met or have expired.

Permanently restricted net assets: Net assets subject to donor-imposed restrictions which require they be maintained permanently (i.e., in perpetuity) by Merit. Merit is required to maintain the historical value of the initial investment, with earnings from the investment available for operations. Earnings from permanently restricted net assets are recorded as temporarily restricted, then released to unrestricted net assets as related expenditures are incurred.

**Revenue recognition**: Merit records tuition and student fees in the period in which they are earned. Tuition and student fees received in advance (principally tuition deposits) are recorded as deferred tuition revenue in the statements of financial position.

Contributions received and unconditional pledges are recognized as revenue in the fiscal year received and are measured at their fair values and reported as an increase in net assets. Conditional promises to give are not recognized as revenue until the conditions on which they depend are substantially met. Merit reports gifts of cash and other assets as restricted support if they are received with donor stipulations that limit the use of the assets, or if they are designated as support for future periods. When a donor restriction expires, that is, when a stipulated time restriction ends or purpose restriction is accomplished, temporarily restricted net assets are reclassified to unrestricted net assets and reported in the statements of activities as net assets released from restrictions. Donor-restricted contributions whose restrictions are met in the same reporting period are reported as unrestricted support.

Deferred tuition revenue represents tuition fees collected in advance for program activities which will be conducted in the subsequent fiscal year.

**Cash and equivalents**: Merit considers all highly liquid investments, with a maturity of less than three months at date of purchase, to be cash equivalents. Merit maintains its cash in bank accounts which at times may exceed federally insured limits. Merit has not experienced any losses in such accounts and believes it is not exposed to any significant credit risk on cash.

**Pledges receivable**: Pledges receivable represent promises to give which have been made by donors but are unpaid as of the fiscal year-end and consist primarily of unconditional pledges from individuals, corporations and foundations. Pledges receivable are recorded net of an allowance for uncollectible pledges and are also recorded net of a discount to present value applied to the long-term portion of any multi-year pledge. The discount rate used is an estimate made by management and represents a risk-free rate of return. The discount is amortized over the term of the pledge, and amortization is recorded as contribution revenue. Management determines the allowance based on historical experience and an analysis of specific accounts. Uncollectible accounts are written off in the year they are deemed to be worthless.

**Tuitions receivable**: Tuitions receivable represent uncollateralized customer obligations due under normal trade terms and consist of amounts due from schools and students for music education classes. Uncollectible amounts are written off at the time the individual receivable is determined to be uncollectible. An allowance for doubtful accounts has been recorded in the amount of $27,320 as of June 30, 2014 (2013 - $12,700) and is based on estimates made by management and Merit's historical collection experience.

## Note 1. Nature of Organization and Significant Accounting Policies (Continued)

**Investments**: Investments are stated at fair value as of the reporting date. Investments received as contributions are recorded at fair value which is based upon quoted market prices and which is the basis for the amount of contribution revenue recognized by Merit. Investment income and realized and unrealized gains and losses are reported as increases or decreases in net assets and are reflected as changes in board-designated unrestricted or temporarily restricted net assets, as appropriate.

**Property and equipment**: Property and equipment are stated at cost or, in the case of contributions, at fair value at the date of receipt and are being depreciated over estimated useful lives of the assets, using the straight-line method. In general, Merit capitalizes all property and equipment purchases over $1,000. Major repairs and improvements are also capitalized (general maintenance and repairs which do not improve or extend the lives of the assets are expensed).

**Annuity contract obligation**: In fiscal 2006, Merit entered into a charitable remainder annuity trust agreement. Upon the issuance of the annuity, a liability was recorded at the present value of the estimated future payments to be made to the annuitants and revenue was recognized to the extent the amount of the annuity gift received exceeded the computed liability. The liability portion of the annuity was computed using discount rates established by the Internal Revenue Service, which approximated market rates. The difference between the amount of the annuity and the computed liability, representing the gift portion, was recorded as temporarily restricted revenue.

The present value discount used at the time the annuity was issued was based on Internal Revenue Service regulations and the rate paid the annuitants was based on the ages of the annuitants. Each year, payments to the annuitants are recorded as a reduction of the liability. In addition, the liability is adjusted at the end of each fiscal year for the recomputed present value of estimated future payments using a discount rate determined by management. Upon the death of the annuitants, the residuum remains the property of Merit.

**Income taxes**: The accounting standard on accounting for uncertainty in income taxes addresses the determination of whether tax benefits should be recorded in the financial statements. Under this guidance, Merit may recognize the tax benefit from an uncertain tax position only if it is more likely than not that the tax position will be sustained on examination by taxing authorities, based on the technical merits of the position. Examples of tax positions include the tax-exempt status of Merit, and various positions related to the potential sources of unrelated business taxable income. The tax benefits recognized in the financial statements from such a position are measured based on the largest benefit that has a greater than 50 percent likelihood of being realized upon ultimate settlement. Management has determined that there are no uncertain tax positions during the reporting periods covered by these financial statements.

Merit is exempt from income taxes under Section 501(c)(3) of the Internal Revenue Code and applicable state law. Merit files annual information returns in the U.S. federal jurisdiction and the State of Illinois. Merit is generally no longer subject to examination by the Internal Revenue Service for tax years before 2011.

**Functional expenses**: Operating expenses directly identified with a functional area are charged to that area and, where those expenses affect more than one area, are allocated to the respective areas on the basis of ratios estimated by management.

**Use of estimates**: In preparing financial statements in conformity with accounting principles generally accepted in the United States of America, management makes estimates and assumptions affecting the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities at the date of the financial statements, as well as the reported amounts of revenue and expenses during the reporting period. Actual results could differ from those estimates.

## Note 1. Nature of Organization and Significant Accounting Policies (Continued)

**Reclassifications**: Certain 2013 amounts have been reclassified to conform to the current year presentation. These reclassifications have no effect on the 2013 net assets or changes in net assets.

**Subsequent events**: Merit has evaluated subsequent events for potential recognition and/or disclosure through November 14, 2014, the date the financial statements were available to be issued.

## Note 2. Pledges Receivable

Pledges receivable as of June 30, 2014 and 2013 consisted of the following:

| | 2014 | 2013 |
|---|---|---|
| 2014 | $ - | $ 440,900 |
| 2015 | 751,530 | 115,910 |
| 2016 | 60,390 | 35,640 |
| 2017 | 26,730 | 26,730 |
| | 838,650 | 619,180 |
| Allowance for doubtful pledges | (75,000) | (75,000) |
| | $ 763,650 | $ 544,180 |

The pledge discount recorded at June 30, 2014 and 2013 was $14,270 and $18,940, respectively.

## Note 3. Fair Value Disclosures

Merit records its assets and liabilities at fair value. Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. Merit utilizes valuation techniques to maximize the use of observable inputs and minimize the use of unobservable inputs. Assets and liabilities recorded at fair value are categorized within the fair value hierarchy based upon the level of judgment associated with the inputs used to measure their value. The fair value hierarchy gives the highest priority to quoted prices in active markets for identical assets or liabilities (Level 1) and the lowest priority to unobservable inputs (Level 3). Inputs are broadly defined as assumptions market participants would use in pricing an asset or liability. The three levels of the fair value hierarchy are described below:

Level 1. Valuations based on unadjusted quoted prices in active markets for identical assets or liabilities that Merit has the ability to access.

Level 2. Valuations based on quoted prices in markets that are not active or for which all significant inputs are observable, either directly or indirectly.

Level 3. Valuations based on inputs that are unobservable and significant to the overall fair value measurement. The inputs into the determination of fair value are based upon the best information in the circumstances and may require significant management judgment or estimation.

In certain cases, the inputs used to measure fair value may fall into different levels of the fair value hierarchy. In such cases, an investment's level within the fair value hierarchy is based on the lowest level of input that is significant to the fair value measurement. Merit's assessment of the significance of a particular input to the fair value measurement in its entirety requires judgment, and considers factors specific to the investment. The inputs or methodology used for valuing financial instruments are not necessarily an indication of the risks associated with investing in those instruments. Investments are exposed to various risks such as interest rate, market and credit risks. It is reasonably possible that changes in values of investments will occur in the near term and that such changes could materially affect the amounts reported.

**Note 3. Fair Value Disclosures (Continued)**

Merit assesses the levels of the investments at each measurement date and transfers between levels are recognized on the actual date of the event or change in circumstances that caused the transfer in accordance with Merit's accounting policy regarding recognition of transfers between levels of the fair value hierarchy. There were no such transfers for the years ended June 30, 2014 and 2013.

Merit's investments in common stocks and mutual funds traded on a national securities exchange, or reported on the NASDAQ national market, are stated at the last reported sales price on the day of valuation. Merit's investments in corporate notes and U.S. government agency notes are traded on a national securities exchange or market and are valued at the mean between the current "bid" and "asked' quotations on that day.

Each year the annuity contract obligation is adjusted at the end of each fiscal year for the recomputed present value of estimated future payments using a discount rate determined by management.

The following tables present Merit's assets and liabilities measured at fair value on a recurring basis as of June 30, 2014 and 2013:

| | 2014 | | | |
|---|---|---|---|---|
| | Fair Value Measurement Using | | | |
| Description | Quoted Prices In Active Markets for Identical Assets Level 1 | Significant Other Observable Inputs Level 2 | Significant Unobservable Inputs Level 3 | Total |
| Assets | | | | |
| Common stock | $ 5,971,811 | $ - | $ - | $ 5,971,811 |
| Mutual funds | 5,612,497 | - | - | 5,612,497 |
| Corporate notes | - | 366,028 | - | 366,028 |
| U.S. government agency notes | - | 498,664 | - | 498,664 |
| | $ 11,584,308 | $ 864,692 | $ - | $ 12,449,000 |
| Liabilities | | | | |
| Annuity contract obligation | $ - | $ (50,000) | $ - | $ (50,000) |

| | 2013 | | | |
|---|---|---|---|---|
| | Fair Value Measurement Using | | | |
| Description | Quoted Prices In Active Markets for Identical Assets Level 1 | Significant Other Observable Inputs Level 2 | Significant Unobservable Inputs Level 3 | Total |
| Assets | | | | |
| Common stock | $ 5,478,753 | $ - | $ - | $ 5,478,753 |
| Mutual funds | 4,398,663 | - | - | 4,398,663 |
| Corporate notes | - | 386,377 | - | 386,377 |
| U.S. government agency notes | - | 827,180 | - | 827,180 |
| | $ 9,877,416 | $ 1,213,557 | $ - | $ 11,090,973 |
| Liabilities | | | | |
| Annuity contract obligation | $ - | $ (34,600) | $ - | $ (34,600) |

## Note 4. Investments

As of June 30, 2014 and 2013, the cost and related fair value of investments were as follows:

| | 2014 | | 2013 | |
|---|---|---|---|---|
| | Cost | Fair Value | Cost | Fair Value |
| Common stock | | | | |
| Domestic | $ 3,083,368 | $ 5,872,711 | $ 3,468,040 | $ 5,382,228 |
| International | 53,988 | 99,100 | 73,620 | 96,525 |
| Mutual funds | | | | |
| Domestic stock funds | 1,521,067 | 2,238,897 | 1,490,769 | 1,901,773 |
| International stock funds | 860,226 | 989,291 | 876,750 | 855,705 |
| Bond funds | 2,383,587 | 2,384,309 | 1,671,396 | 1,641,185 |
| Corporate notes, at rates ranging from 5.500% to 6.500%, maturing at various dates through fiscal 2036 | 332,944 | 366,028 | 345,514 | 386,377 |
| U.S. government agency notes, at rates ranging from 4.625% to 4.875%, maturing at various dates through fiscal 2017 | 449,623 | 498,664 | 746,771 | 827,180 |
| | $ 8,684,803 | $ 12,449,000 | $ 8,672,860 | $ 11,090,973 |

## Note 5. Property and Equipment

Property and equipment as of June 30, 2014 and 2013 consisted of the following:

| | 2014 | 2013 | Depreciable Lives |
|---|---|---|---|
| Land | $ 4,450,000 | $ 4,450,000 | |
| Building and improvements | 4,800,082 | 4,776,373 | 7 - 40 |
| Furniture and fixtures | 471,061 | 468,185 | 5 - 10 |
| Office equipment | 372,787 | 410,563 | 3 - 7 |
| Musical instruments | 1,167,348 | 1,047,177 | 5 - 10 |
| Construction in process | 159,955 | - | |
| | 11,421,233 | 11,152,298 | |
| Accumulated depreciation | (2,666,951) | (2,452,431) | |
| | $ 8,754,282 | $ 8,699,867 | |

Depreciation and amortization expense for the years ended June 30, 2014 and 2013 totaled $318,020 and $298,507, respectively. Fully depreciated equipment totaling $103,500 and $81,249 was removed from the accounting records during 2014 and 2013, respectively.

## Note 6. Bonds Payable and Other Financing

On September 29, 2004, Merit received financing through the issuance by the Illinois Finance Authority (IFA) of its Variable Rate Demand Revenue Bonds, Series 2004, in the amount of $4,000,000. The bonds were scheduled to mature on October 1, 2024 and bore interest at a weekly rate (as defined), payable monthly. During fiscal 2013, the bonds payable balance of $1,500,000 was repaid in full. Interest expense during 2013 (prior to pay-off) totaled $2,719. In addition, the $4,059,179 letter of credit which Merit had obtained from Bank of America in favor of IFA was terminated.

During 2014, Merit obtained a line of credit with MB Financial Bank, N.A. which allows for borrowings up to $500,000 and matures on February 15, 2015. Outstanding borrowings bear interest at the prime rate and are secured by a certain investment account of Merit up to a maximum of $670,000. At June 30, 2014, the outstanding balance on the line of credit was $55,000.

## Note 7. Endowment Funds

Merit's endowment fund is comprised contributions from donors for the creation of Merit’s permanent endowment consisting of the Joy Faith Knapp Endowment Fund, the General Purposes Fund and the Scholarship Fund. Income from the Joy Faith Knapp Endowment Fund and the General Purposes Fund is unrestricted, with the income from the Scholarship Fund being restricted for scholarships. In addition, unrestricted assets which are subject to the oversight of Merit’s Board of Trustees are also included in Merit’s endowment fund. All endowment assets are invested in Merit's investment portfolio. As required by accounting principles generally accepted in the United States of America, net assets associated with endowment funds are classified and reported based on the existence or absence of donor-imposed restrictions.

*Interpretation of Relevant Law*

Merit follows the Illinois Uniform Prudent Management of Institutional Funds Act (UPMIFA). The Board of Trustees of Merit has interpreted UPMIFA as requiring the preservation of the fair value of the original gift as of the gift date of the donor-restricted endowment funds absent explicit donor stipulations to the contrary.

As a result of this interpretation, Merit continues to classify as permanently restricted net assets (a) the original value of gifts donated to the permanent endowment, (b) the original value of subsequent gifts to the permanent endowment, and (c) accumulations to the permanent endowment made in accordance with the direction of the applicable donor gift instrument at the time the accumulation was added to the fund. The remaining portion of the donor-restricted endowment fund that is not classified in permanently restricted net assets is classified as temporarily restricted net assets until those amounts are appropriated for expenditure by Merit in a manner consistent with the standard of prudence prescribed by UPMIFA. In accordance with UPMIFA, Merit considers the following factors in making a determination to appropriate or accumulate earnings on its donor-restricted endowment fund:

1) The duration and preservation of the fund;
2) The purpose of Merit and the donor-restricted endowment fund;
3) General economic conditions;
4) The possible effect of inflation and deflation;
5) The expected total return from income and the appreciation of investments;
6) Other resources of Merit; and
7) The investment policies of Merit.

## Note 7. Endowment Funds (Continued)

*Return Objectives and Risk Parameters*

The Investment Committee of the Board, which oversees the investment portfolio of Merit with the assistance of Merit's investment consultants, operates under an investment policy that attempts to provide a predictable stream of income and investment returns. Under these policies, the endowment assets are invested. To satisfy its long-term rate-of-return objectives, Merit relies on a total return strategy in which investment returns are achieved through both capital appreciation (realized and unrealized) and current yield (interest and dividends). Merit targets a diversified asset allocation that may place a greater emphasis on equity and fixed-income-based investments to achieve its long-term return objectives within prudent risk constraints. The 4.5 percent annual distribution (spending policy) on the investment portfolio of Merit is attributable to the endowment assets as these assets are pooled with the unrestricted assets within the investment portfolio. In 2014 and 2013, all investment earnings (realized and unrealized) from the permanent endowment were appropriately transferred into the unrestricted and temporarily restricted funds based upon donor stipulation.

*Funds with Deficiencies*

From time to time, the fair value of assets associated with the endowment fund may fall below the level that the donor or Illinois UPMIFA requires Merit to retain as a fund of perpetual duration. This deficiency would result from unfavorable market fluctuations, the timing of new contributions received, and continued appropriation from the permanent endowment. Deficiencies of this nature would be reported in unrestricted or temporarily restricted net assets depending on the existence of any donor restrictions applicable to the investment earnings of the permanent gifts.

*Spending Policy and How the Investment Objectives Relate to Spending Policy*

Merit’s policy is to preserve the historical dollar value of permanently restricted contributions, and to use any of the investment returns as is prudent, taking into consideration donor restrictions for the usage of investment earnings.

The endowment fund composition, by type, is as follows for the years ended June 30, 2014 and 2013:

| | 2014 | | | |
|---|---|---|---|---|
| | Unrestricted | Temporarily Restricted | Permanently Restricted | Total |
| Donor-restricted | $ - | $ 23,560 | $ 5,924,659 | $ 5,948,219 |
| Board designated | 7,238,649 | - | - | 7,238,649 |
| | $ 7,238,649 | $ 23,560 | $ 5,924,659 | $ 13,186,868 |

| | 2013 | | | |
|---|---|---|---|---|
| | Unrestricted | Temporarily Restricted | Permanently Restricted | Total |
| Donor-restricted | $ - | $ 23,560 | $ 5,924,659 | $ 5,948,219 |
| Board designated | 5,272,169 | - | - | 5,272,169 |
| | $ 5,272,169 | $ 23,560 | $ 5,924,659 | $ 11,220,388 |

## Note 7. Endowment Funds (Continued)

The changes in endowment net assets were as follows for the years ended June 30, 2014 and 2013:

| | 2014 | | | |
|---|---|---|---|---|
| | Board Designated | Temporarily Restricted | Permanently Restricted | Total |
| Endowment net assets, beginning of year | $ 5,272,169 | $ 23,560 | $ 5,924,659 | $ 11,220,388 |
| Contributions and other revenue | 32,558 | - | - | 32,558 |
| Investment earnings | 858,498 | - | 1,053,997 | 1,912,495 |
| Other changes: | | | | |
| Releases of restrictions | (23,864) | (31,666) | - | (55,530) |
| Endowment distribution | (533,447) | - | - | (533,447) |
| Addition by board resolution | 610,404 | - | - | 610,404 |
| Transfer of investment earnings to operations as stipulated by donors | 1,022,331 | 31,666 | (1,053,997) | - |
| | 1,075,424 | - | (1,053,997) | 21,427 |
| Endowment net assets, end of year | $ 7,238,649 | $ 23,560 | $ 5,924,659 | $ 13,186,868 |

| | 2013 | | | |
|---|---|---|---|---|
| | Board Designated | Temporarily Restricted | Permanently Restricted | Total |
| Endowment net assets, beginning of year | $ 6,278,014 | $ - | $ 5,924,659 | $ 12,202,673 |
| Contributions and other revenue | 9,331 | - | - | 9,331 |
| Investment earnings | 628,161 | - | 796,867 | 1,425,028 |
| Other changes: | | | | |
| Releases of restrictions | (1,902,883) | (612) | - | (1,903,495) |
| Endowment distribution | (513,149) | - | - | (513,149) |
| Transfer of investment earnings to operations as stipulated by donors | 772,695 | 24,172 | (796,867) | - |
| | (1,643,337) | 23,560 | (796,867) | (2,416,644) |
| Endowment net assets, end of year | $ 5,272,169 | $ 23,560 | $ 5,924,659 | $ 11,220,388 |

For the fiscal year ended June 30, 2014, the permanent endowment's share of the total investment gain incurred by Merit's investment portfolio totaled $1,053,997. For the fiscal year ended June 30, 2013, the permanent endowment's share of the total investment gain incurred by Merit's investment portfolio totaled $796,867. These investment gains for 2014 and 2013 have been reflected in the statement of activities and reported in unrestricted or temporarily restricted net assets.

## Note 8. Board-Designated Funds

The following is a description of the composition of Merit's board-designated funds:

**Unrestricted gifts**: The Board has designated certain unrestricted net assets as being available for investment purposes. These unrestricted assets derived from unrestricted contributions from donors. From these assets the Board authorizes an annual 4.50 percent distribution to support current operations. The annual distribution for 2014 totaled $533,447 (2013 - $513,149) and is included in the net assets released from restrictions totals on the statements of activities.

**Named scholarship gifts**: Named scholarship gifts result from contributions received in honor or memory of an individual which the Board has designated the income earned from the contributions to be used to fund scholarships in the honoree's name. The named scholarship gift balances include accumulated investment income earned on the gifts.

**Deferred Gala revenue**: Deferred Gala revenue is the revenue earned from the annual event, normally held in May or June which the Board may direct to be used to support the following fiscal year's operations. In fiscal 2014, the Board passed a resolution to designate the 2013 Deferred Gala revenue of $610,404 as board designated unrestricted gifts.

A summary of board-designated net assets as of June 30, 2014 and 2013 is as follows:

| | 2014 | 2013 |
|---|---|---|
| Unrestricted gifts | $ 6,590,349 | $ 4,722,824 |
| Named Scholarship gifts | 648,300 | 549,345 |
| Deferred Gala revenue | - | 610,404 |
| | $ 7,238,649 | $ 5,882,573 |

## Note 9. Restricted Net Assets

Temporarily restricted net assets were available for the following purposes as of June 30, 2014 and 2013:

| | 2014 | 2013 |
|---|---|---|
| Unrestricted pledges and cash for subsequent fiscal years | $ 384,813 | $ 196,785 |
| Charitable remainder annuity trust | 50,331 | 59,311 |
| Restricted event donations | 102,315 | 25,500 |
| Restricted for building projects | 108,216 | 178,673 |
| Restricted for programming | 399,841 | 338,706 |
| Restricted for scholarships | 22,528 | 22,588 |
| Accumulated earnings on Scholarship Fund | 23,560 | 23,560 |
| | $ 1,091,604 | $ 845,123 |

### Note 9. Restricted Net Assets (Continued)

The following is a summary of permanently restricted net assets as of June 30, 2014 and 2013:

| | 2014 | 2013 |
|---|---|---|
| Joy Faith Knapp Endowment Fund | $ 4,000,000 | $ 4,000,000 |
| General Purposes Fund | 1,746,659 | 1,746,659 |
| Scholarship Fund | 178,000 | 178,000 |
| | $ 5,924,659 | $ 5,924,659 |

The Joy Faith Knapp Charitable Trust contributed $4 million to Merit in fiscal 2005 to establish an endowment fund. To recognize and honor the contribution, Merit named the facility at 38 S. Peoria in Chicago the Joy Faith Knapp Music Center.

### Note 10. Retirement Plans

Merit sponsors a Section 403(b) salary reduction retirement plan. The plan covers essentially all full-time employees who have completed one year of service. The plan provides for employer matching contributions in an amount equal to the employee's salary reduction contribution, ranging from 1 percent to 3 percent of compensation based upon the employee's tenure with Merit. Participants are fully vested in employer matching contributions made to the plan on their behalf. Merit's contributions for 2014 and 2013 were $22,334 and $43,114, respectively. This plan was terminated on December 31, 2013.

Effective January 1, 2014, Merit implemented the Merit School of Music 401(k) Plan & Trust, a defined contribution plan that provides retirement benefits to eligible employees of Merit. The 401(k) plan is subject to the provisions of the Employee Retirement income Security Act of 1974 (ERISA), as amended.

The 401(k) plan is designed as a qualified cash deferral arrangement pursuant to the Internal Revenue Code and provides for both employee-directed and employer contributions. Employee-directed contributions are made by Merit at the direction of the employee and deducted from the employee's direct compensation. The aggregate annual amount of each individual employee-directed contribution is limited to federal dollar limits. The 401(k) plan agreement provides for Merit to make a 3 percent safe harbor contribution based upon each participant's base compensation as specified in the 401(k) plan agreement. To be eligible to participate in the 401(k) plan, an employee must be 21 years of age and have one year of service. Participants are immediately vested in their employee-directed contributions and their safe harbor contribution received from Merit, including all related earnings thereon. For the year ended June 30, 2014, discretionary contributions to the 401(k) plan totaled $41,724.