

# **Merit School of Music**

Financial Report  
June 30, 2015

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RSM US LLP

## 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, 2015 and 2014, 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, 2015 and 2014, 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.

*RSM US LLP*

Chicago, Illinois  
November 11, 2015

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**Merit School of Music**

**Statements of Financial Position  
June 30, 2015 and 2014**

	2015	2014
<b>Assets</b>		
Cash and cash equivalents	\$ 330,626	\$ 518,028
Pledges receivable, net	472,383	763,650
Tuitions receivable, net	207,849	148,485
Other assets	181,285	179,060
Investments	12,587,944	12,449,000
Property and equipment, net	8,772,568	8,754,282
	<u>\$ 22,552,655</u>	<u>\$ 22,812,505</u>
<b>Liabilities and Net Assets</b>		
Liabilities		
Accounts payable	\$ 46,214	\$ 178,361
Accrued expenses	123,315	159,667
Line of credit	325,000	55,000
Deferred tuition revenue	335,037	286,289
Annuity contract obligation	38,393	50,000
	<u>867,959</u>	<u>729,317</u>
Net Assets		
Unrestricted		
Undesignated	7,872,528	7,828,276
Board designated	7,331,354	7,238,649
	<u>15,203,882</u>	<u>15,066,925</u>
Temporarily restricted	556,155	1,091,604
Permanently restricted	5,924,659	5,924,659
	<u>21,684,696</u>	<u>22,083,188</u>
	<u>\$ 22,552,655</u>	<u>\$ 22,812,505</u>

See Notes to Financial Statements.

## Merit School of Music

### Statement of Activities Year Ended June 30, 2015

	Unrestricted			Temporarily Restricted	Permanently Restricted	Total
	Undesignated	Board Designated	Total			
<b>Revenue:</b>						
Contributions	\$ 1,237,934	\$ 460	\$ 1,238,394	\$ 344,225	\$ -	\$ 1,582,619
Government grants	18,340	-	18,340	-	-	18,340
Student fees	1,149,304	-	1,149,304	-	-	1,149,304
School contracts	549,072	-	549,072	-	-	549,072
Fundraising events, net of expenses of \$248,420	955,445	-	955,445	35,500	-	990,945
Rental income	309,623	-	309,623	-	-	309,623
Miscellaneous income	12,809	324	13,133	-	-	13,133
Interest and dividends	129	385,099	385,228	6,656	-	391,884
Net assets released from restrictions	1,482,860	(568,403)	914,457	(914,457)	-	-
	<u>5,715,516</u>	<u>(182,520)</u>	<u>5,532,996</u>	<u>(528,076)</u>	<u>-</u>	<u>5,004,920</u>
<b>Expenses:</b>						
Program services:						
Tuition-free Conservatory	605,451	-	605,451	-	-	605,451
Bridges: Partners in Music	1,028,677	-	1,028,677	-	-	1,028,677
Instrumental Music Program	664,915	-	664,915	-	-	664,915
Private lessons	1,380,683	-	1,380,683	-	-	1,380,683
Other programs	605,376	-	605,376	-	-	605,376
	<u>4,285,102</u>	<u>-</u>	<u>4,285,102</u>	<u>-</u>	<u>-</u>	<u>4,285,102</u>
Support services:						
General and administration	817,177	53,564	870,741	-	-	870,741
Fundraising	568,985	-	568,985	-	-	568,985
	<u>1,386,162</u>	<u>53,564</u>	<u>1,439,726</u>	<u>-</u>	<u>-</u>	<u>1,439,726</u>
	<u>5,671,264</u>	<u>53,564</u>	<u>5,724,828</u>	<u>-</u>	<u>-</u>	<u>5,724,828</u>
<b>Increase (decrease) in net assets before investment income</b>	44,252	(236,084)	(191,832)	(528,076)	-	(719,908)
Realized and change in unrealized gain on investments	-	328,789	328,789	(7,373)	-	321,416
<b>Increase (decrease) in net assets</b>	44,252	92,705	136,957	(535,449)	-	(398,492)
Net assets:						
Beginning of year	7,828,276	7,238,649	15,066,925	1,091,604	5,924,659	22,083,188
End of year	<u>\$ 7,872,528</u>	<u>\$ 7,331,354</u>	<u>\$ 15,203,882</u>	<u>\$ 556,155</u>	<u>\$ 5,924,659</u>	<u>\$ 21,684,696</u>

See Notes to Financial Statements.

## Merit School of Music

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

	Unrestricted			Temporarily Restricted	Permanently Restricted	Total
	Undesignated	Board Designated	Total			
<b>Revenue:</b>						
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)	-	-
	<u>5,825,247</u>	<u>(276,324)</u>	<u>5,548,923</u>	<u>232,916</u>	<u>-</u>	<u>5,781,839</u>
<b>Expenses:</b>						
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
	<u>4,391,658</u>	<u>-</u>	<u>4,391,658</u>	<u>-</u>	<u>-</u>	<u>4,391,658</u>
Support services:						
General and administration	877,332	3,000	880,332	-	-	880,332
Fundraising	597,226	-	597,226	-	-	597,226
	<u>1,474,558</u>	<u>3,000</u>	<u>1,477,558</u>	<u>-</u>	<u>-</u>	<u>1,477,558</u>
	<u>5,866,216</u>	<u>3,000</u>	<u>5,869,216</u>	<u>-</u>	<u>-</u>	<u>5,869,216</u>
<b>Increase (decrease) in net assets before investment income</b>	(40,969)	(279,324)	(320,293)	232,916	-	(87,377)
Realized and change in unrealized gain on investments	-	1,635,400	1,635,400	13,565	-	1,648,965
<b>Increase (decrease) in net assets</b>	(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	<u>\$ 7,828,276</u>	<u>\$ 7,238,649</u>	<u>\$ 15,066,925</u>	<u>\$ 1,091,604</u>	<u>\$ 5,924,659</u>	<u>\$ 22,083,188</u>

See Notes to Financial Statements.

**Merit School of Music**

**Statement of Functional Expenses  
Year Ended June 30, 2015**

	Program Services					Total Program Services
	Tuition-free Conservatory	Bridges: Partners in Music	Instrumental Music Program	Private Lessons	Other Programs	
Salaries and contract instructors	\$ 426,464	\$ 710,820	\$ 445,218	\$ 994,547	\$ 279,576	\$ 2,856,625
Payroll taxes and employee benefits	74,052	120,273	80,887	158,788	29,252	463,252
Outside marketing and fundraising services	510	44	1,143	1,419	1,122	4,238
Other outside services and professional fees	-	1,240	-	-	11,753	12,993
Printing and production costs	8,683	2,312	5,598	6,785	8,634	32,012
College, camp and endowed scholarships	-	-	-	-	22,383	22,383
Program supplies and sheet music	5,601	37,539	23,118	-	12,687	78,945
Instrument costs, including depreciation	1,115	49,825	21,074	-	108,894	180,908
Other direct program costs	13,066	65,530	2,863	-	61,147	142,606
Office expenses	11,912	3,826	12,955	34,730	9,416	72,839
Technology expenses	4,081	7,386	5,868	11,526	10,245	39,106
Occupancy costs	35,174	11,197	38,600	103,605	23,717	212,293
Staff development and local meetings	2,082	2,936	173	-	14,996	20,187
Office depreciation and amortization	22,520	10,381	25,834	65,933	18,224	142,892
Interest expense	-	-	-	-	-	-
Bad debt expense	69	84	1,584	3,350	(7,086)	(1,999)
Miscellaneous	122	5,284	-	-	415	5,821
	<u>\$ 605,451</u>	<u>\$ 1,028,677</u>	<u>\$ 664,915</u>	<u>\$ 1,380,683</u>	<u>\$ 605,375</u>	<u>\$ 4,285,101</u>

See Notes to Financial Statements.

**Merit School of Music**

**Statement of Functional Expenses (Continued)**  
**Year Ended June 30, 2015**

	Supporting Services			Total
	General and Administration	Fundraising	Total Supporting Services	
Salaries and contract instructors	\$ 368,812	\$ 298,072	\$ 666,884	<b>\$ 3,523,509</b>
Payroll taxes and employee benefits	67,117	84,865	151,982	<b>615,234</b>
Outside marketing and fundraising services	40,039	5,043	45,082	<b>49,320</b>
Other outside services and professional fees	122,869	3,384	126,253	<b>139,246</b>
Printing and production costs	16,546	55,909	72,455	<b>104,467</b>
College, camp and endowed scholarships	-	-	-	<b>22,383</b>
Program supplies and sheet music	-	-	-	<b>78,945</b>
Instrument costs, including depreciation	19,320	-	19,320	<b>200,228</b>
Other direct program costs	-	255	255	<b>142,861</b>
Office expenses	26,246	18,855	45,101	<b>117,940</b>
Technology expenses	37,047	30,503	67,550	<b>106,656</b>
Occupancy costs	63,813	32,231	96,044	<b>308,337</b>
Staff development and local meetings	45,605	5,537	51,142	<b>71,329</b>
Office depreciation and amortization	51,272	30,590	81,862	<b>224,754</b>
Interest expense	7,909	-	7,909	<b>7,909</b>
Bad debt expense	-	-	-	<b>(1,999)</b>
Miscellaneous	4,147	3,741	7,888	<b>13,709</b>
	<b>\$ 870,742</b>	<b>\$ 568,985</b>	<b>\$ 1,439,727</b>	<b>\$ 5,724,828</b>

See Notes to Financial Statements.



**Merit School of Music**

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

	Program Services					Total Program Services
	Tuition-free Conservatory	Bridges: Partners in Music	Instrumental Music Program	Private Lessons	Other Programs	
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
	<u>\$ 667,046</u>	<u>\$ 1,059,206</u>	<u>\$ 626,431</u>	<u>\$ 1,457,761</u>	<u>\$ 581,214</u>	<u>\$ 4,391,658</u>

See Notes to Financial Statements.

**Merit School of Music**

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

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

See Notes to Financial Statements.

**Merit School of Music**

**Statements of Cash Flows**  
**Years Ended June 30, 2015 and 2014**

	2015	2014
Cash Flows from Operating Activities		
(Decrease) increase in net assets	\$ (398,492)	\$ 1,561,588
Adjustments to reconcile (decrease) increase in net assets to net cash (used in) provided by operating activities		
Provision for allowance for bad debts	-	14,620
Depreciation and amortization	338,971	318,020
Change in present value of annuity contract	-	27,008
Realized and change in unrealized gain on investments	(321,416)	(1,648,965)
Contributions of donated stock	(167,098)	(189,862)
Changes in:		
Pledges receivable	291,267	(219,470)
Tuitions receivable	(59,364)	52,964
Other assets	(2,225)	9,436
Accounts payable and accrued expenses	(168,449)	107,627
Deferred tuition revenue	48,748	(19,356)
<b>Net cash (used in) provided by operating activities</b>	<b>(438,058)</b>	<b>13,610</b>
Cash Flows from Investing Activities		
Purchases of property and equipment	(517,212)	(372,435)
Proceeds from the sale of equipment	159,955	-
Purchases of investments	(1,317,336)	(1,619,057)
Proceeds from sales and maturities of investments	1,666,856	2,099,857
<b>Net cash (used in) provided by investing activities</b>	<b>(7,737)</b>	<b>108,365</b>
Cash Flows from Financing Activities		
Proceeds from line of credit	270,000	55,000
Annuity contract obligation payment	(11,607)	(11,608)
<b>Net cash provided by (used in) financing activities</b>	<b>258,393</b>	<b>43,392</b>
<b>(Decrease) increase in cash and equivalents</b>	<b>(187,402)</b>	<b>165,367</b>
Cash and Cash Equivalents:		
Beginning of year	518,028	352,661
End of year	\$ 330,626	\$ 518,028
Supplemental Disclosure of Cash Flow Information		
Interest paid	\$ 7,909	\$ 1,713
Supplemental Schedule of Noncash Investing and Operating Activities		
Contributions of donated stock	\$ 167,098	\$ 189,862

See Notes to Financial Statements.

## Merit School of Music

### Notes to Financial Statements

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#### 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 (the Conservatory). Merit's programs offer music theory, private lessons, group 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 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 sites each year, where they provide instruction in early childhood, winds, brass, percussion, strings, chorus, piano and general music.

The Instrumental Music program provides musical preparation for the Conservatory to primary school age students. Curriculum is comprised of music theory, music history, musicianship as well as student participation in small technique and large 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 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 6 percent and 7 percent of Merit's revenue for the years ended June 30, 2015 and 2014, 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:

**Unrestricted net assets:** 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).

## Merit School of Music

### Notes to Financial Statements

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#### 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 \$20,320 as of June 30, 2015 (2014 - \$27,320), and is based on estimates made by management and Merit's historical collection experience.

## Merit School of Music

### Notes to Financial Statements

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#### 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 year 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 2012.

**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.

## Merit School of Music

### Notes to Financial Statements

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

**Subsequent events:** Merit has evaluated subsequent events for potential recognition and/or disclosure through November 11, 2015 the date the financial statements were available to be issued.

#### Note 2. Pledges Receivable

Pledges receivable as of June 30, 2015 and 2014, consisted of the following:

	2015	2014
2015	\$ -	\$ 751,530
2016	461,253	60,390
2017	56,430	26,730
2018	29,700	-
	<u>547,383</u>	<u>838,650</u>
Allowance for doubtful pledges	(75,000)	(75,000)
	<u>\$ 472,383</u>	<u>\$ 763,650</u>

The pledge discount recorded at June 30, 2015 and 2014, was \$2,032 and \$14,270, 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.

## Merit School of Music

### Notes to Financial Statements

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

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.

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, 2015 and 2014.

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, 2015 and 2014:

Description	2015			Total
	Fair Value Measurement Using			
	Quoted Prices In Active Markets for Identical Assets Level 1	Significant Other Observable Inputs Level 2	Significant Unobservable Inputs Level 3	
<b>Assets</b>				
Common stock	\$ 6,060,642	\$ -	\$ -	\$ 6,060,642
Mutual funds	5,802,909	-	-	5,802,909
Corporate notes	-	243,172	-	243,172
U.S. government agency notes	-	481,221	-	481,221
	<u>\$ 11,863,551</u>	<u>\$ 724,393</u>	<u>\$ -</u>	<u>\$ 12,587,944</u>
<b>Liabilities</b>				
Annuity contract obligation	\$ -	\$ (38,393)	\$ -	\$ (38,393)



**Merit School of Music**

**Notes to Financial Statements**

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

Description	2014			
	Fair Value Measurement Using			
	Quoted Prices In Active Markets for Identical Assets Level 1	Significant Other Observable Inputs Level 2	Significant Unobservable Inputs Level 3	Total
<b>Assets</b>				
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
	<u>\$ 11,584,308</u>	<u>\$ 864,692</u>	<u>\$ -</u>	<u>\$ 12,449,000</u>
<b>Liabilities</b>				
Annuity contract obligation	\$ -	\$ (50,000)	\$ -	\$ (50,000)

**Note 4. Investments**

As of June 30, 2015 and 2014, the cost and related fair value of investments were as follows:

	2015		2014	
	Cost	Fair Value	Cost	Fair Value
<b>Common stock</b>				
Domestic	\$ 2,942,239	\$ 5,950,994	\$ 3,083,368	\$ 5,872,711
International	53,988	109,648	53,988	99,100
<b>Mutual funds</b>				
Domestic stock funds	1,561,634	2,231,549	1,521,067	2,238,897
International stock funds	885,302	989,473	860,226	989,291
Bond funds	2,621,652	2,581,887	2,383,587	2,384,309
Corporate notes, at rates ranging from 5.500% to 6.500%, maturing at various dates through fiscal year 2036	226,891	243,172	332,944	366,028
U.S. government agency notes, at rates ranging from 4.625% to 4.875%, maturing at various dates through fiscal year 2017	449,623	481,221	449,623	498,664
	<u>\$ 8,741,329</u>	<u>\$ 12,587,944</u>	<u>\$ 8,684,803</u>	<u>\$ 12,449,000</u>

## Merit School of Music

### Notes to Financial Statements

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#### Note 5. Property and Equipment

Property and equipment as of June 30, 2015 and 2014 consisted of the following:

	2015	2014	Depreciable Lives
Land	\$ 4,450,000	\$ 4,450,000	
Building and improvements	5,140,594	4,800,082	7 - 40
Furniture and fixtures	479,875	471,061	5 - 10
Office equipment	428,885	372,787	3 - 7
Musical instruments	1,279,136	1,167,348	5 - 10
Construction in process	-	159,955	
	<u>11,778,490</u>	<u>11,421,233</u>	
Accumulated depreciation	<u>(3,005,922)</u>	<u>(2,666,951)</u>	
	<u>\$ 8,772,568</u>	<u>\$ 8,754,282</u>	

Depreciation and amortization expense for the years ended June 30, 2015 and 2014 totaled \$338,971 and \$318,020, respectively. Fully depreciated equipment totaling \$159,995 and \$103,500 was removed from the accounting records during 2015 and 2014, respectively.

#### Note 6. Line of Credit

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, 2016. 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, 2015, the outstanding balance on the line of credit was \$325,000.

#### Note 7. Endowment Funds

Merit's endowment fund is comprised of 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.

## Merit School of Music

### Notes to Financial Statements

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#### Note 7. Endowment Funds (Continued)

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.

#### *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 2015 and 2014, 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.

**Merit School of Music**

**Notes to Financial Statements**

**Note 7. Endowment Funds (Continued)**

The endowment fund composition, by type, is as follows for the years ended June 30, 2015 and 2014:

	2015			
	Unrestricted	Temporarily Restricted	Permanently Restricted	Total
Donor-restricted	\$ -	\$ 23,560	\$ 5,924,659	\$ 5,948,219
Board designated	7,331,354	-	-	7,331,354
	<u>\$ 7,331,354</u>	<u>\$ 23,560</u>	<u>\$ 5,924,659</u>	<u>\$ 13,279,573</u>

  

	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
	<u>\$ 7,238,649</u>	<u>\$ 23,560</u>	<u>\$ 5,924,659</u>	<u>\$ 13,186,868</u>

The changes in endowment net assets were as follows for the years ended June 30, 2015 and 2014:

	2015			
	Board Designated	Temporarily Restricted	Permanently Restricted	Total
Endowment net assets, beginning of year	\$ 7,238,649	\$ 23,560	\$ 5,924,659	\$ 13,186,868
Contributions and other revenue	784	-	-	784
Investment earnings	367,295	-	346,593	713,888
Other changes:				
Releases of restrictions	(43,151)	(10,413)	-	(53,564)
Endowment distribution	(568,403)	-	-	(568,403)
Transfer of investment earnings to operations as stipulated by donors	336,180	10,413	(346,593)	-
	<u>(275,374)</u>	<u>-</u>	<u>(346,593)</u>	<u>(621,967)</u>
Endowment net assets, end of year	<u>\$ 7,331,354</u>	<u>\$ 23,560</u>	<u>\$ 5,924,659</u>	<u>\$ 13,279,573</u>

**Merit School of Music**

**Notes to Financial Statements**

**Note 7. Endowment Funds (Continued)**

	2014			Total
	Board Designated	Temporarily Restricted	Permanently Restricted	
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)
Transfer of investment earnings to operations as stipulated by donors	610,404	-	-	610,404
	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

For the fiscal year ended June 30, 2015, the permanent endowment's share of the total investment gain incurred by Merit's investment portfolio totaled \$346,593. 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. These investment gains for 2015 and 2014 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 2015 totaled \$568,403 (2014 - \$533,447) 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.

A summary of board-designated net assets as of June 30, 2015 and 2014 is as follows:

	2015	2014
Unrestricted gifts	\$ 6,672,398	\$ 6,590,349
Named scholarship gifts	658,956	648,300
	\$ 7,331,354	\$ 7,238,649

## Merit School of Music

### Notes to Financial Statements

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#### Note 9. Restricted Net Assets

Temporarily restricted net assets were available for the following purposes as of June 30, 2015 and 2014:

	2015	2014
Unrestricted pledges and cash for subsequent fiscal years	\$ 152,760	\$ 384,813
Charitable remainder annuity trust	19,500	50,331
Restricted event donations	202,983	102,315
Restricted for building projects	72,279	108,216
Restricted for programming	35,595	399,841
Restricted for scholarships	49,478	22,528
Accumulated earnings on Scholarship Fund	23,560	23,560
	<u>\$ 556,155</u>	<u>\$ 1,091,604</u>

The following is a summary of permanently restricted net assets as of June 30, 2015 and 2014:

	2015	2014
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
	<u>\$ 5,924,659</u>	<u>\$ 5,924,659</u>

The Joy Faith Knapp Charitable Trust contributed \$4 million to Merit in fiscal year 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 sponsored a Section 403(b) salary reduction retirement plan. The plan covered essentially all full-time employees who had completed one year of service. The plan provided 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 were fully vested in employer-matching contributions made to the plan on their behalf. Merit's contributions for 2015 and 2014 were \$0 and \$22,334, 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, 2015, discretionary contributions to the 401(k) plan totaled \$75,700.