

ARMS OF HOPE

CONSOLIDATED FINANCIAL STATEMENTS

**Years ended June 30, 2016 and 2015
with Report of Independent Auditors**

ARMS OF HOPE
CONSOLIDATED FINANCIAL STATEMENTS
Years Ended June 30, 2016 and 2015

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REPORT OF INDEPENDENT AUDITORS

To the Board of Directors of
Arms of Hope

We have audited the accompanying consolidated financial statements of Arms of Hope which comprise the consolidated statements of financial position as of June 30, 2016 and 2015, and the related consolidated statements of activities 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 consolidated financial statements in accordance with accounting principles generally accepted in the United States of America ("GAAP"); this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of consolidated 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 consolidated financial statements referred to above present fairly, in all material respects, the financial position of Arms of Hope as of June 30, 2016 and 2015, and the results of their activities and their cash flows for the years then ended in conformity with GAAP.



Dallas, Texas
December 12, 2016

ARMS OF HOPE

CONSOLIDATED STATEMENTS OF FINANCIAL POSITION

	June 30,	
	2016	2015
Assets		
Cash and cash equivalents	\$ 409,723	\$ 853,226
Other assets	453,712	424,603
Beneficial interests in charitable remainder annuity trusts	742,345	858,839
Investments, at fair value	16,117,180	18,164,687
Investments, other	31,935	31,935
Contributed assets	122,193	144,349
Property and equipment, net of accumulated depreciation	11,256,513	11,386,316
 Total assets	 \$ 29,133,601	 \$ 31,863,955
 Liabilities and Net Assets		
Liabilities:		
Accounts payable	\$ 101,828	\$ 339,448
Accrued expenses	238,392	278,705
Notes payable	33,468	75,940
Deferred compensation	195,566	214,743
Liability under charitable remainder annuity trusts	383,219	404,722
Charitable gift annuities	986,537	976,378
Total liabilities	1,939,010	2,289,936
 Commitments and contingencies		
 Net assets:		
Unrestricted	25,602,915	27,858,409
Temporarily restricted	454,925	578,859
Permanently restricted	1,136,751	1,136,751
Total net assets	27,194,591	29,574,019
 Total liabilities and net assets	 \$ 29,133,601	 \$ 31,863,955

See accompanying notes to consolidated financial statements.

ARMS OF HOPE
CONSOLIDATED STATEMENT OF ACTIVITIES

Year ended June 30, 2016

	<u>Unrestricted</u>	<u>Temporarily Restricted</u>	<u>Permanently Restricted</u>	<u>Total</u>
Support and Revenue				
Public support:				
Contributions - individuals	\$ 1,532,749	\$ 323,987	\$ -	\$ 1,856,736
Contributions - congregations	755,420	-	-	755,420
Contributions - special gifts	1,155,283	13,599	-	1,168,882
Special events	565,185	-	-	565,185
Non-cash contributions	663,466	-	-	663,466
Total public support	<u>4,672,103</u>	<u>337,586</u>	-	<u>5,009,689</u>
Revenue:				
Grocery revenue	42,495	-	-	42,495
Thrift store, net	2,594,803	-	-	2,594,803
Resident support fees assistance	183,769	-	-	183,769
Oil and gas income	213,424	-	-	213,424
Interest and dividend investment income	410,937	-	-	410,937
Unrealized loss on investments	(740,886)	-	-	(740,886)
Realized loss on investments	(355,365)	-	-	(355,365)
Change in value of split-interest agreements	(101,418)	-	-	(101,418)
Loss on sale of assets	(57,670)	-	-	(57,670)
Miscellaneous income	5,882	-	-	5,882
Total revenue	<u>2,195,971</u>	<u>-</u>	<u>-</u>	<u>2,195,971</u>
Total support and revenue	6,868,074	337,586	-	7,205,660
Expenses:				
Program services	7,980,294	13,584	-	7,993,878
Supporting services:				
General and administrative	516,622	-	-	516,622
Public relations and development	1,074,588	-	-	1,074,588
Total supporting services	<u>1,591,210</u>	<u>-</u>	<u>-</u>	<u>1,591,210</u>
Total expenses	<u>9,571,504</u>	<u>13,584</u>	<u>-</u>	<u>9,585,088</u>
Change in net assets from activities	(2,703,430)	324,002	-	(2,379,428)
Other changes in net assets:				
Net assets released from restrictions	447,936	(447,936)	-	-
Changes in net assets	<u>(2,255,494)</u>	<u>(123,934)</u>	<u>-</u>	<u>(2,379,428)</u>
Net assets beginning of year	<u>27,858,409</u>	<u>578,859</u>	<u>1,136,751</u>	<u>29,574,019</u>
Net assets end of year	<u>\$ 25,602,915</u>	<u>\$ 454,925</u>	<u>\$ 1,136,751</u>	<u>\$ 27,194,591</u>

See accompanying notes to consolidated financial statements.

ARMS OF HOPE
CONSOLIDATED STATEMENT OF ACTIVITIES
Year ended June 30, 2015

	<u>Unrestricted</u>	<u>Temporarily Restricted</u>	<u>Permanently Restricted</u>	<u>Total</u>
Support and Revenue				
Public support:				
Contributions - individuals	\$ 1,555,703	\$ 147,626	\$ -	\$ 1,703,329
Contributions - congregations	791,699	450	-	792,149
Contributions - special gifts	1,037,458	141,903	-	1,179,361
Special events	642,377	-	-	642,377
Non-cash contributions	973,417	51,375	-	1,024,792
Total public support	<u>5,000,654</u>	<u>341,354</u>	<u>-</u>	<u>5,342,008</u>
Revenue:				
Grocery revenue	40,942	-	-	40,942
Thrift store, net	2,587,865	-	-	2,587,865
Resident support fees assistance	315,760	-	-	315,760
Oil and gas income	289,738	-	-	289,738
Interest and dividend investment income	382,791	-	-	382,791
Unrealized gain on investments	(109,736)	-	-	(109,736)
Realized gain on investments	315,004	-	-	315,004
Change in value of split-interest agreements	18,663	-	-	18,663
Loss on sale of assets	(5,463)	-	-	(5,463)
Miscellaneous income	12,427	-	-	12,427
Total revenue	<u>3,847,991</u>	<u>-</u>	<u>-</u>	<u>3,847,991</u>
Total support and revenue	8,848,645	341,354	-	9,189,999
Expenses:				
Program services	7,902,516	-	-	7,902,516
Supporting services:				
General and administrative	573,337	-	-	573,337
Public relations and development	1,200,902	-	-	1,200,902
Total supporting services	<u>1,774,239</u>	<u>-</u>	<u>-</u>	<u>1,774,239</u>
Total expenses	<u>9,676,755</u>	<u>-</u>	<u>-</u>	<u>9,676,755</u>
Change in net assets from activities	(828,110)	341,354	-	(486,756)
Other changes in net assets:				
Net assets released from restrictions	150,383	(150,383)	-	-
Changes in net assets	(677,727)	190,971	-	(486,756)
Net assets beginning of year	<u>28,536,136</u>	<u>387,888</u>	<u>1,136,751</u>	<u>30,060,775</u>
Net assets end of year	<u>\$ 27,858,409</u>	<u>\$ 578,859</u>	<u>\$ 1,136,751</u>	<u>\$ 29,574,019</u>

See accompanying notes to consolidated financial statements.

ARMS OF HOPE

CONSOLIDATED STATEMENTS OF CASH FLOWS

	Years Ended June 30,	
	2016	2015
Cash flows from operating activities:		
Change in net assets	\$ (2,379,428)	\$ (486,756)
Adjustments to reconcile change in net assets to net cash (used in) provided by operating activities:		
Depreciation	730,629	735,909
Loss on sale of assets	57,670	5,463
Net realized loss (gain) on investments	355,365	(315,004)
Unrealized loss on investments	740,886	109,736
Charitable remainder annuity trust	116,494	41,400
Change in liability under split-interest agreements	(11,344)	(28,839)
Changes in net assets and liabilities:		
Other assets	(101,684)	(43,889)
Accounts payable	(237,620)	150,647
Accrued expenses	(40,313)	3,138
Deferred compensation	(19,177)	(18,220)
Net cash (used in) provided by operating activities	(788,522)	153,585
Cash flows from investing activities:		
Purchases of investments	(431,635)	(919,077)
Proceeds from sale of investments	1,577,701	1,736,342
Payments on charitable gift annuities	(146,810)	(147,550)
Payments on charitable remainder annuity trusts	(48,000)	(48,000)
Proceeds from sale of property and equipment	33,780	38,000
Purchases of property and equipment	(597,545)	(385,280)
Net cash provided by investing activities	387,491	274,435
Cash flows from financing activities:		
Borrowings from securities-based loan	865,000	630,000
Payments on securities-based loan	(865,000)	(630,000)
Payments on notes payable	(42,472)	(45,553)
Net cash used in financing activities	(42,472)	(45,553)
Net (decrease) increase in cash and cash equivalents	(443,503)	382,467
Cash and cash equivalents at beginning of year	853,226	470,759
Cash and cash equivalents at end year	\$ 409,723	\$ 853,226

See accompanying notes to consolidated financial statements.

ARMS OF HOPE

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

June 30, 2016 and 2015

A. Nature of Activities

Arms of Hope (the "Organization") is a not-for-profit organization which was formed for the purpose of establishing, maintaining, and operating Christian homes for the care of children. The Organization has two wholly owned subsidiaries: Medina Children's Home ("Medina"), which was established in 1958 and operates a campus near Medina, Texas, and Boles Children's Home, Inc. ("Boles") which was established in 1924 and operates a campus in Quinlan, Texas. Boles Children's Home Realty Corporation is consolidated with Boles. Both campuses are supported principally by public contributions and supplemented with some agency support and investment income. The Organization's administrative offices are located in Medina, Texas.

B. Summary of Significant Accounting Policies

A summary of the Organization's significant accounting policies consistently applied in the preparation of the accompanying consolidated financial statements follows:

Basis of Accounting

The accompanying consolidated financial statements are presented on the accrual basis of accounting in accordance with accounting principles generally accepted in the United States of America ("GAAP"). The Organization is required to report information regarding its consolidated financial position and activities according to three classes of net assets: unrestricted net assets, temporarily restricted net assets, and permanently restricted net assets.

Use of Estimates

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the amounts reported in the consolidated financial statements and accompanying notes. Actual results could differ from those estimates.

Principles of Consolidation

The consolidated financial statements include the accounts of the Organization and its subsidiaries, all of which are wholly owned. Significant intercompany accounts and transactions have been eliminated in consolidation.

Cash and Cash Equivalents

The Organization considers all highly liquid investments with a maturity of three months or less when purchased to be cash equivalents. The Organization maintains deposits in financial institutions, which may at times exceed amounts covered by insurance provided by the U.S. Federal Deposit Insurance Corporation ("FDIC"). The Organization has not experienced any losses related to amounts in excess of FDIC limits.

ARMS OF HOPE

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS *(continued)*

B. Summary of Significant Accounting Policies – continued

Investments

Investments with readily determinable fair values are stated at fair value with realized and unrealized gains and losses included in the statements of activities of the respective period. Investments in equity securities and debt securities with readily determinable fair values are recorded at fair value. Investments, other is an oil and gas interest which is recorded at the lower of cost or fair value. Fluctuations in fair value are recorded in the year in which they occur by adjusting the carrying value of such investments each month and recognizing net unrealized and realized gains and losses in the accompanying consolidated statements of activities.

Fair Value Measurements

GAAP establishes a framework for measuring fair value. That framework provides a fair value hierarchy that prioritizes the inputs to valuation techniques used to measure fair value. The hierarchy gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (Level 1 measurements), and lowest priority to unobservable inputs (Level 3 measurements). The three levels of the fair value hierarchy are described below:

Level 1 Inputs to the valuation methodology are unadjusted quoted prices for identical assets or liabilities in active markets that the Organization has the ability to access.

Level 2 Observable inputs other than Level 1 which include:

- Quoted prices for similar assets or liabilities in active markets;
- Quoted prices for identical or similar assets or liabilities in inactive markets;
- Inputs other than quoted prices that are observable for the asset or liability;
- Inputs that are derived principally from or corroborated by observable market data by correlation or other means.

If the asset or liability has a specified (contractual) term, the Level 2 input must be observable for substantially the full term of the asset or liability.

Level 3 Inputs to the valuation methodology are unobservable and significant to the fair value measurements.

The preceding methods described may produce fair value measurements that may not be indicative of net realizable value or reflective of future fair values. Furthermore, although the Organization believes its valuation methods are appropriate and consistent with other market participants, the use of different methodologies or assumptions to determine the fair value of certain financial instruments could result in a different fair value measurement at the reporting date.

ARMS OF HOPE

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS *(continued)*

B. Summary of Significant Accounting Policies – continued

Split-Interest Agreements

The Organization is the beneficiary of, or holds a beneficial interest in various split-interest agreements which consist of charitable remainder annuity trusts and charitable gift annuities.

Trusts, Legacies, and Bequests

The Organization is the beneficiary under various wills and trust agreements, the total realizable amount of which cannot presently be determined. Such amounts are excluded from the accompanying consolidated financial statements until clear title is established and the ultimate realizable amount is reasonably determinable.

Property and Equipment

Property and equipment are stated at cost and depreciated over the estimated useful lives of the various assets using the straight-line method. Major renewals and improvements are capitalized while expenditures for maintenance and repairs are expensed as incurred. Assets retired or otherwise disposed of and the related accumulated depreciation are eliminated from the respective accounts and any resulting gain or loss is reflected in the unrestricted revenues and gains (losses) in the accompanying consolidated statement of activities of the respective period. Assets which are donated and used by the Organization are recorded at their fair market value on the date received by the Organization. The estimated useful lives are as follows:

Buildings and improvements	4-50 years
Furniture and fixtures	5-10 years
Automotive equipment	3-7 years
Other equipment	5-30 years

Donated Assets and Services

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

Donated services are recognized as contributions if the services, (a) create or enhance non-financial assets or (b) require specialized skills, are performed by people with those skills, and would otherwise be purchased by the Organization. The Organization pays for most services requiring specialized services. However, a number of individuals volunteer their time and perform a variety of tasks that assist the Organization with specific program functions and various other activities that are not recognized as contributions in the consolidated financial statements, because the recognition criteria under GAAP were not met.

ARMS OF HOPE

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS *(continued)*

B. Summary of Significant Accounting Policies – continued

Thrift Shop Revenue

The Organization gathers and delivers donated items to a network of thrift stores and is reimbursed for the cost of collecting and delivering these items and receives a percentage of gross sales from a retail contract partnership and is earned upon sale.

Contributions

Contributions received are recorded as unrestricted, temporarily restricted, or permanently restricted support depending on the existence and/or nature of any donor restrictions. When a restriction expires (that is, when a stipulated time restriction ends or the purpose restriction is accomplished), temporarily restricted net assets are reclassified to unrestricted net assets and reported in the consolidated statements of activities of the respective period as net assets released from restrictions. All contributions are considered to be available for unrestricted use unless specifically restricted by the donor.

Net Assets

Unrestricted net assets are available for general use by the Organization.

Temporarily restricted net assets are restricted as to use and, where applicable, are transferred from temporarily restricted net assets to unrestricted net assets when expended.

Permanently restricted net assets require that the original gift amount be invested in perpetuity. Income and appreciation in the value of these funds are restricted for specified purposes and reported in the accompanying consolidated statement of activities as temporarily restricted investment income as earned and appropriated.

Endowment Funds

The Organization operates under an enacted version of the Uniform Prudent Management of Institutional Funds Act (“UPMIFA”) since the Texas State Legislature enacted UPMIFA on September 1, 2007 (“TUPMIFA”). Net assets associated with endowment funds are classified and reported based on the existence or absence of donor-imposed restrictions.

Income Taxes

The Organization is exempt from federal income taxes under Section 501(c)(3) of the Internal Revenue Code (“IRC”), except to the extent that they have unrelated business income. There was no material unrelated business income reflected in the accompanying consolidated financial statements for the years ended June 30, 2016 and 2015. Accordingly, no provision for income taxes has been provided in the accompanying consolidated financial statements.

ARMS OF HOPE

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS *(continued)*

B. Summary of Significant Accounting Policies – continued

Income Taxes – continued

GAAP prescribes a comprehensive model for the financial statement recognition, measurement, presentation, and disclosure of uncertain income tax positions taken or expected to be taken in income tax returns. Management believes that it has not taken a tax position that, if challenged, would have a material effect on the Organization's consolidated financial statements. The Organization files Form 990 in the United States federal jurisdiction within the United States and no tax returns are currently under examination by any tax authorities.

Fair Value of Financial Instruments

The financial instruments recorded in the consolidated statements of financial position include other assets and accrued expenses. Due to their short-term maturities, the carrying amounts of these items are believed to approximate fair market values. The carrying value of the notes payable approximates fair value since these instruments bear a market rate of interest.

Management evaluates credit risk for all financial instruments based on the nature of the transaction. The Organization has credit exposure within the investment portfolio; however, management believes they have mitigated this risk by diversifying the investments in which the Organization invests based on such criteria as industry, geographic region, length of maturity, and credit ratings.

Impairment of Long-Lived Assets

Depreciable long-lived assets that are held and used are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. If such assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the assets exceeds their fair value. Assets to be disposed of are reported at the lower of the carrying amount or fair value less selling costs. No impairments were recorded in the years ended 2016 and 2015 and no assets were being held for disposal at June 30, 2016 or 2015.

ARMS OF HOPE

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS *(continued)*

C. Investments

Investments at fair value refer to those amounts held at third party financial institutions and are reported at fair value. Unrealized gains or losses are recorded each year to adjust to fair value. Realized and unrealized gains or losses are determined by comparison of cost to proceeds or market, respectively.

A summary of investments, at fair value, at June 30, 2016, is as follows:

	<u>Cost</u>	<u>Fair Value</u>	<u>Unrealized Appreciation (Depreciation)</u>
Cash equivalents	\$ 249,636	\$ 249,636	\$ -
Fixed income securities	4,996,455	4,632,346	(364,109)
Mutual funds	3,770,154	4,177,668	407,514
Equities	6,065,086	6,467,958	402,872
Government securities	560,778	589,572	28,794
Total investments	<u>\$15,642,109</u>	<u>\$16,117,180</u>	<u>\$ 475,071</u>

A summary of investments, at fair value, at June 30, 2015, is as follows:

	<u>Cost</u>	<u>Fair Value</u>	<u>Unrealized Appreciation</u>
Cash equivalents	\$ 595,768	\$ 595,768	\$ -
Fixed income securities	4,654,608	5,197,071	542,463
Mutual funds	4,429,076	4,812,340	383,264
Equities	5,979,302	6,264,223	284,921
Government securities	1,289,976	1,295,285	5,309
Total investments	<u>\$16,948,730</u>	<u>\$18,164,687</u>	<u>\$ 1,215,957</u>

Investment, other, represents an oil and gas interest which is recorded at cost of \$31,935 at both June 30, 2016 and 2015.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS *(continued)*

D. Fair Value of Investments

The following is a summary of the estimated fair value of the Organization's Level 1 investments at June 30:

	<u>2016</u>	<u>2015</u>
Cash equivalents	\$ 249,636	\$ 595,768
Fixed income securities	4,632,346	5,197,071
Mutual funds	4,177,668	4,812,340
Equities	6,467,958	6,264,223
Government securities	<u>589,572</u>	<u>1,295,285</u>
Total investments	<u>\$16,117,180</u>	<u>\$18,164,687</u>

There were no Level 2 or 3 investments as of June 30, 2016 or 2015.

E. Contributed Assets

Contributed assets consist of contributed real estate, which is real property interests not used in the activities of the Organization. For some items, a value of \$1 is recorded since a value was not available. Contributed real estate was approximately \$122,000 and \$144,000 as of June 30, 2016 and 2015, respectively.

F. Charitable Remainder Annuity Trusts

The Organization is the remainder beneficiary of irrevocable charitable trusts. Under charitable remainder annuity trusts, donors establish and fund a trust with specific distributions to be made to beneficiaries over the trust's terms. At the end of the trust's term, the remaining assets are available for the Organization's use. The Organization is the trustee for the charitable remainder annuity trusts and records the assets at fair value and the related liabilities at the discounted present value of the estimated future cash flows. The discount rate used by the Organization to calculate the present value of the estimated future payments at June 30, 2016 and 2015, was 1.8% and 2.0%, the IRC Section 7520 charitable federal midterm rates, respectively. The actuarial assumptions used in calculating the present value include the life expectancy of the beneficiaries, the weighted average of which was 7.9 and 8.3 years, respectively, at June 30, 2016 and 2015. These trusts are included in beneficial interests in charitable remainder annuity trusts in the accompanying consolidated statements of financial position at June 30, 2016 and 2015, in amounts of \$742,345 and \$858,839, respectively. The present value of the estimated future payments to beneficiaries at June 30, 2016 and 2015, is \$383,219 and \$404,722, respectively, included in liabilities on the accompanying consolidated statements of financial position.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS *(continued)*

F. Charitable Remainder Annuity Trusts – continued

On an annual basis, the Organization revalues the liabilities to make distributions to the designated beneficiaries based on life expectancy and the discount rate based on the IRC Section 7520. These revaluations are reflected in the consolidated statement of activities as change in the value of split-interest agreements.

G. Charitable Gift Annuities

The Organization receives charitable gift annuities from time to time. Under charitable gift annuities donors transfer assets to beneficiaries in exchange for a promise to pay an annuity to the donor. The Organization records the assets at fair value and the related liabilities at the discounted present value of the estimated future cash flows. The discount rate used by the Organization to calculate the present value of the estimated future payments at June 30, 2016 and 2015, was 1.8% and 2.0%, the IRC Section 7520 charitable federal midterm rates, respectively. The actuarial assumptions used in calculating the present value include the life expectancy of the beneficiaries, the weighted average of which was 8.6 and 8.5 years at June 30, 2016 and 2015, respectively. Charitable gift annuity assets are held as general assets and are available for unrestricted use. The related liabilities at June 30, 2016 and 2015, were \$986,537 and \$976,378, respectively.

H. Property and Equipment

Property and equipment consisted of the following at June 30:

	<u>2016</u>	<u>2015</u>
Land	\$ 1,275,524	\$ 1,275,524
Buildings and improvements	17,957,594	17,603,711
Furniture and fixtures	151,864	232,371
Automotive equipment	1,324,463	1,311,384
Construction in progress	459,168	304,456
Other equipment	1,687,085	2,547,705
	<u>22,855,698</u>	<u>23,275,151</u>
Less accumulated depreciation	<u>11,599,185</u>	<u>11,888,835</u>
	<u>\$ 11,256,513</u>	<u>\$ 11,386,316</u>

ARMS OF HOPE

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS *(continued)*

I. Temporarily Restricted Net Assets

Temporarily restricted net assets are gifts which are received for the donor specified purpose of funding specific projects, such as construction, major repairs, equipment purchases, and unexpected needs. Earnings from these funds may be used to supplement the specific project authorized by the board of directors. Activity in temporarily restricted net assets is reflected in the temporarily restricted net assets column of the statement of changes in net assets for the years ended June 30, 2016 and 2015.

All temporarily restricted net assets as of June 30, 2016 and 2015, are for capital projects.

J. Securities-Based Loan and Notes Payable

On March 12, 2014, the Company entered into a securities-based loan agreement with Morgan Stanley Bank, N.A. ("Morgan Stanley"). The agreement is collateralized by certain designated investments held by Morgan Stanley, and the maximum availability under the facility is determined by Morgan Stanley from time to time based primarily on the value of the investments pledged as collateral. As of June 30, 2016 and 2015, the total investments that serve as collateral under the agreement were approximately \$11,300,000 and \$12,400,000, respectively. The securities-based loan bears interest at 2.25% and has no set maturity date. Payments of amounts advanced and accrued interest are made periodically, and Morgan Stanley may demand full or partial payment at their discretion. As of June 30, 2016 and 2015, no amounts were outstanding under the securities-based loan agreement.

On March 21, 2014, the Company entered into two loan agreements with Texas Heritage Bank, each for approximately \$46,000. Each loan bears interest at 6% and specifies monthly principal and interest payments beginning April 20, 2014. Unpaid principal and interest are due upon maturity on March 20, 2017. The balance outstanding as of June 30, 2016 and 2015, was approximately \$12,000 each and \$28,000 each, respectively.

On April 29, 2014, the Company entered into a third loan agreement with Texas Heritage Bank, for approximately \$33,000. The loan bears interest at 6% and specifies monthly principal and interest payments beginning May 29, 2014. Unpaid principal and interest are due upon maturity on April 29, 2017. The balance outstanding as of June 30, 2016 and 2015, was approximately \$10,000 and \$21,000, respectively.

As of June 30, 2016, future maturities of the remaining notes payable are approximately as follows:

2017	\$ 33,468
Thereafter	-
	<hr/>
	\$ 33,468
	<hr/>

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS *(continued)*

K. Commitments and Contingencies

The Organization leases equipment under non-cancelable operating leases that expire in various years through 2019. Rent expense for each of the years ended June 30, 2016 and 2015, was approximately \$107,000 and 120,000, respectively.

Future minimum lease payments consist of the following at June 30, 2016:

2017	\$ 114,824
2018	33,574
2019	12,233
Thereafter	<u>-</u>
	<u>\$ 160,631</u>

From time to time, the Organization is involved in various lawsuits and claims arising in the normal course of business. In management's opinion, the ultimate outcome of these items will not have a material adverse effect on the Organization's consolidated financial position and results of activities.

L. Endowment Fund

As of June 30, 2016 and 2015, the Organization has a donor-restricted endowment fund which provides for operations of the Organization. This endowment fund is classified within permanently restricted net assets on the accompanying statements of financial position. The Organization does not have any board-designated endowments.

The Organization's management has interpreted the UPMIFA as requiring the preservation of the fair value of the original gift as of the gift date of donor-restricted endowment fund absent explicit donor stipulations to the contrary. Accordingly, the Organization classifies the original value of all endowment gifts as permanently restricted net assets. Accumulated net earnings on endowment funds are classified as temporarily restricted net assets until those amounts are appropriated for expenditure in accordance with any applicable donor designations and in a manner consistent with the standard of prudence prescribed by the UPMIFA. The Organization had no accumulated earnings on the endowment fund for the years ended June 30, 2016 and 2015, as all earnings had been appropriated for operations.

In accordance with UPMIFA, the Organization considers the following factors in making a determination to appropriate or accumulate donor-restricted endowment funds:

- The duration and preservation of the fund,
- The purposes of the organization and the donor-restricted endowment fund,
- General economic conditions,

ARMS OF HOPE

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS *(continued)*

L. Endowment Fund – continued

- The possible effect of inflation and deflation,
- The expected total return from income and the appreciation of investments,
- Other resources of the Organization, and
- The investment policies of the Organization.

The Organization’s primary investment objectives are growth with income and preservation of capital. Management defines risk as the probability of not meeting these objectives. Accordingly, endowment assets are invested in a manner that is intended to minimize risk.

The Organization has a policy of appropriating for distribution each year a maximum of 5% on its average balance on endowment fund principal at the end of the previous three fiscal years. Any deficiencies in the actual rate above 5% will be advanced by the Organization’s unrestricted net assets. Future earnings on endowments will be used to repay the advances from the unrestricted funds.

Changes in endowment net assets for the years ended June 30, 2016 and 2015, are as follows:

	Temporarily Restricted	Permanently Restricted	Total Net Endowment Assets
Endowment net assets at June 30, 2014	\$ -	\$ 1,136,751	\$ 1,136,751
Investment income, net	15,665	-	15,665
Net appreciation	17,434	-	17,434
Amount appropriated for expenditure	(33,099)	-	(33,099)
Endowment net assets at June 30, 2015	-	1,136,751	1,136,751
Investment income, net	18,447	-	18,447
Net depreciation	(67,960)	-	(67,960)
Amount appropriated for expenditure	49,513	-	49,513
Endowment net assets, end of year	\$ -	\$ 1,136,751	\$ 1,136,751

M. Retirement Plans

The Organization adopted a 401(k) plan effective December 15, 2007, which covers substantially all of its employees. Once eligibility requirements are met, employees may voluntarily contribute a percentage of their gross salaries into the plan. The Organization may make a discretionary matching contribution of up to 7% of gross salary. Employees are vested in matching funds after five years of service. Retirement plan expense for the years ended June 30, 2016 and 2015, totaled approximately \$90,000 and \$157,000, respectively.

ARMS OF HOPE

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS *(continued)*

M. Retirement Plans – continued

During the year ended June 30, 1997, a deferred compensation plan under Section 457 of the IRC was adopted for another key employee, which allows for monthly payments of \$2,644 commencing February 2009. This plan was subsequently adjusted as of January 1, 2006. The present value of this liability, calculated to be approximately \$196,000 and \$215,000 at June 30, 2016 and 2015, respectively, is reported in the consolidated statements of financial position as part of the deferred compensation liability.

N. Related Party Transactions

A member of the Board of Directors administers the health plan and life insurance for all of the Organization's employees and dependents.

The spouse of a board member is employed by the Organization in a marketing and development function and reports to the Chief Executive Officer.

The Organization has and may continue to purchase vehicles from an auto dealership of a Director.

The Organization has and may continue to use the legal services of a Director's legal firm.

O. Subsequent Events

In preparing the consolidated financial statements, the Organization has evaluated all subsequent events and transactions for potential recognition or disclosure through December 12, 2016, the date the consolidated financial statements were available for issuance.