Merit School of Music

Financial Statements
Years Ended June 30, 2016 and 2015

Merit School of Music

Financial Statements
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Merit School of Music

Contents

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Independent Auditor's Report

Board of Trustees
Merit School of Music
Chicago, Illinois

We have audited the accompanying financial statements of Merit School of Music, which comprise the statement of financial position as of June 30, 2016, and the related statement of activities and changes in net assets, functional expenses, and cash flows for the year 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 audit. We conducted our audit 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, 2016, and the changes in their net assets, functional expenses, and cash flows for the year then ended in accordance with accounting principles generally accepted in the United States of America.

Other Matter

The 2015 financial statements of Merit School of Music were audited by other auditors, whose report dated November 11, 2015 expressed an unmodified opinion on those statements.

BDO USA, LLP

Des Plaines, Illinois
November 16, 2016

Financial Statements

Merit School of Music

Statements of Financial Position

June 30,	**2016**	2015
Assets		
Current Assets		
Cash and cash equivalents	**$ 537,125**	$ 330,626
Pledges receivable, net - current portion	**591,231**	386,253
Tuition receivable, net	**149,171**	207,849
Total Current Assets	**1,277,527**	924,728
Property and Equipment, net	**8,791,949**	8,772,568
Other Assets		
Other Assets	**190,340**	181,285
Pledges receivable, net - long-term portion	**574,200**	86,130
Investments	**11,701,403**	12,587,944
Total Other Assets	**12,465,943**	12,855,359
Total Assets	**$ 22,535,419**	$ 22,552,655
Liabilities and Net Assets		
Current Liabilities		
Accounts payable	**$ 34,244**	$ 46,214
Accrued expenses	**152,540**	123,223
Line of credit	**325,000**	325,000
Deferred tuition revenue	**220,629**	335,129
Total Current Liabilities	**732,413**	829,566
Long-term Liabilities		
Annuity contract obligation	**55,027**	38,393
Total Long-term Liabilities	**55,027**	38,393
Total Liabilities	**787,440**	867,959
Net Assets		
Unrestricted	**7,463,572**	7,872,528
Unrestricted, board designated	**7,109,161**	7,331,354
	14,572,733	15,203,882
Temporarily restricted	**1,250,587**	556,155
Permanently restricted	**5,924,659**	5,924,659
Total Net Assets	**21,747,979**	21,684,696
Total Liabilities and Net Assets	**$ 22,535,419**	$ 22,552,655

See accompanying notes to financial statements.

Merit School of Music

Statement of Activities and Change in Net Assets

Year ended June 30, 2016	Unrestricted	Unrestricted Board Designated	Unrestricted Total	Temporarily Restricted	Permanently Restricted	**Total**
Revenues, Gains and Other Support						
Contributions	$ 1,469,383	$ 1,599	$ 1,470,982	$ 1,067,653	$ -	$ 2,538,635
Government grants	-	-	-	6,000	-	6,000
Student fees	1,232,042	-	1,232,042	-	-	1,232,042
School contracts	622,106	-	622,106	-	-	622,106
Fundraising events, net of expenses of $186,945	913,926	-	913,926	5,000	-	918,926
Rental income	284,578	-	284,578	-	-	284,578
Miscellaneous income	19,116	51	19,167	-	-	19,167
Interest and dividends, net	-	365,779	365,779	5,192	-	370,971
Total Revenues, Gains and Other Support Before Net Assets Released from Restrictions	4,541,151	367,429	4,908,580	1,083,845	-	5,992,425
Net Assets Released from Restrictions	893,115	(536,664)	356,451	(356,451)	-	-
Total Revenues, Gains, and Other Support	5,434,266	(169,235)	5,265,031	727,394	-	5,992,425
Expenses						
Program services:						
Tuition-free Conservatory	637,675	-	637,675	-	-	637,675
Bridges: Partners in Music	1,083,301	-	1,083,301	-	-	1,083,301
Instrumental Music Program	696,073	-	696,073	-	-	696,073
Private lessons	1,560,086	-	1,560,086	-	-	1,560,086
Other programs	537,872	-	537,872	-	-	537,872
Total program services	4,515,007	-	4,515,007	-	-	4,515,007
Support services:						
General and administration	735,824	16,810	752,634	-	-	752,634
Fundraising	592,391	-	592,391	-	-	592,391
Total support services	1,328,215	16,810	1,345,025	-	-	1,345,025
Total expenses	5,843,222	16,810	5,860,032	-	-	5,860,032
Change in net assets before investment and annuity loss	(408,956)	(186,045)	(595,001)	727,394	-	132,393
Realized and change in unrealized loss on investments	-	(36,148)	(36,148)	(4,722)	-	(40,870)
Change in value of chartiable remainder annuity trust	-	-	-	(28,240)	-	(28,240)
Change in Net Assets	(408,956)	(222,193)	(631,149)	694,432	-	63,283
Net Assets, beginning of year	7,872,528	7,331,354	15,203,882	556,155	5,924,659	21,684,696
Net Assets, end of year	$ 7,463,572	$ 7,109,161	$ 14,572,733	$ 1,250,587	$ 5,924,659	$ 21,747,979

See accompanying notes to financial statements.

Merit School of Music

Statement of Activities and Change in Net Assets

Year ended June 30, 2015	Unrestricted	Unrestricted Board Designated	Unrestricted Total	Temporarily Restricted	Permanently Restricted	Total
Revenues, Gains and Other Support						
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
Total Revenues, Gains and Other Support Before Net Assets Released from Restrictions	4,232,656	385,883	4,618,539	386,381	-	5,004,920
Net Assets Released from Restrictions	1,482,860	(568,403)	914,457	(914,457)	-	-
Total Revenues, Gains, and Other Support	5,715,516	(182,520)	5,532,996	(528,076)	-	5,004,920
Expenses						
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	605,375	-	605,375	-	-	605,375
Total program services	4,285,101	-	4,285,101	-	-	4,285,101
Support services:						
General and administration	817,178	53,564	870,742	-	-	870,742
Fundraising	568,985	-	568,985	-	-	568,985
Total support services	1,386,163	53,564	1,439,727	-	-	1,439,727
Total expenses	5,671,264	53,564	5,724,828	-	-	5,724,828
Change in net assets before investment income (loss)	44,252	(236,084)	(191,832)	(528,076)	-	(719,908)
Realized and change in unrealized gain (loss) on investments	-	328,789	328,789	(7,373)	-	321,416
Change in Net Assets	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
Net Assets, end of year	$ 7,872,528	$ 7,331,354	$ 15,203,882	$ 556,155	$ 5,924,659	$ 21,684,696

See accompanying notes to financial statements.

Merit School of Music

Statement of Functional Expenses

Year ended June 30, 2016	Program Services Tuition-free Conservatory	Bridges: Partners in Music	Instrumental Music Program	Private Lessons	Other Programs	Total Program Services
Functional Expenses						
Salaries and contract instructors	**$ 429,351**	**$ 748,093**	**$ 473,695**	**$ 1,139,510**	**$ 281,603**	**$ 3,072,252**
Payroll taxes and employee benefits	**67,422**	**122,340**	**77,837**	**176,671**	**35,032**	**479,302**
Program supplies and sheet music	**20,040**	**28,660**	**21,579**	**-**	**5,467**	**75,746**
Instrument costs, including depreciation	**11,156**	**70,597**	**15,727**	**-**	**56,752**	**154,232**
College, camp and endowed scholarships	**-**	**-**	**-**	**-**	**29,309**	**29,309**
Other direct program costs	**14,825**	**66,255**	**11,538**	**-**	**39,174**	**131,792**
Staff development and local meetings	**3,177**	**2,929**	**10**	**-**	**19,355**	**25,471**
Outside marketing services	**220**	**18**	**449**	**591**	**394**	**1,672**
Printing and production costs	**12,107**	**3,395**	**9,210**	**10,420**	**8,412**	**43,544**
Other outside services and professional fees	**-**	**1,241**	**-**	**-**	**1,997**	**3,238**
Office expenses	**13,107**	**3,388**	**13,079**	**36,761**	**9,348**	**75,683**
Technology expenses	**4,320**	**12,910**	**6,053**	**12,229**	**8,124**	**43,636**
Occupancy costs	**37,926**	**9,992**	**39,107**	**110,164**	**22,667**	**219,856**
Office depreciation and amortization	**24,024**	**9,259**	**26,174**	**69,812**	**17,783**	**147,052**
Interest expense	**-**	**-**	**-**	**-**	**-**	**-**
Bad debt expense	**-**	**2,941**	**1,385**	**3,928**	**2,181**	**10,435**
Miscellaneous	**-**	**1,283**	**230**	**-**	**274**	**1,787**
Total Functional Expenses	**$ 637,675**	**$ 1,083,301**	**$ 696,073**	**$ 1,560,086**	**$ 537,872**	**$ 4,515,007**

Merit School of Music

Statement of Functional Expenses

Year ended June 30, 2016	Supporting Services: General and Administration	Supporting Services: Fundraising	Supporting Services: Total Supporting Services	Total
Functional Expenses				
Salaries and contract instructors	$ 357,484	$ 314,208	$ 671,692	$ 3,743,944
Payroll taxes and employee benefits	77,848	77,382	155,230	634,532
Program supplies and sheet music	-	-	-	75,746
Instrument costs, including depreciation	19,045	-	19,045	173,277
College, camp and endowed scholarships	-	-	-	29,309
Other direct program costs	-	3,367	3,367	135,159
Staff development and local meetings	43,465	7,358	50,823	76,294
Outside marketing services	34,409	3,613	38,022	39,694
Printing and production costs	9,715	62,201	71,916	115,460
Other outside services and professional fees	56,962	-	56,962	60,200
Office expenses	20,078	26,492	46,570	122,253
Technology expenses	38,911	31,595	70,506	114,142
Occupancy costs	33,837	32,373	66,210	286,066
Office depreciation and amortization	42,271	31,281	73,552	220,604
Interest expense	13,965	-	13,965	13,965
Bad debt expense	-	-	-	10,435
Miscellaneous	4,644	2,521	7,165	8,952
Total Functional Expenses	$ 752,634	$ 592,391	$ 1,345,025	$ 5,860,032

See accompanying notes to financial statements.

Merit School of Music

Statement of Functional Expenses

Year ended June 30, 2015	Program Services: Tuition-free Conservatory	Bridges: Partners in Music	Instrumental Music Program	Private Lessons	Other Programs	Total Program Services
Functional Expenses						
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
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
College, camp and endowed scholarships	-	-	-	-	22,383	22,383
Other direct program costs	13,066	65,530	2,863	-	61,147	142,606
Staff development and local meetings	2,082	2,936	173	-	14,996	20,187
Outside marketing services	510	44	1,143	1,419	1,122	4,238
Printing and production costs	8,683	2,312	5,598	6,785	8,634	32,012
Other outside services and professional fees	-	1,240	-	-	11,753	12,993
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
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
Total Functional Expenses	$ 605,451	$ 1,028,677	$ 664,915	$ 1,380,683	$ 605,375	$ 4,285,101

Merit School of Music

Statement of Functional Expenses

Year ended June 30, 2015	Supporting Services: General and Administration	Supporting Services: Fundraising	Supporting Services: Total Supporting Services	Total
Functional Expenses				
Salaries and contract instructors	$ 368,812	$ 298,072	$ 666,884	$ 3,523,509
Payroll taxes and employee benefits	67,117	84,865	151,982	615,234
Program supplies and sheet music	-	-	-	78,945
Instrument costs, including depreciation	19,320	-	19,320	200,228
College, camp and endowed scholarships	-	-	-	22,383
Other direct program costs	-	255	255	142,861
Staff development and local meetings	45,605	5,537	51,142	71,329
Outside marketing services	40,039	5,043	45,082	49,320
Printing and production costs	16,546	55,909	72,455	104,467
Other outside services and professional fees	122,869	3,384	126,253	139,246
Office expenses	26,246	18,855	45,101	117,940
Technology expenses	37,047	30,503	67,550	106,656
Occupancy costs	63,813	32,231	96,044	308,337
Office depreciation and amortization	51,272	30,590	81,862	224,754
Interest expense	7,909	-	7,909	7,909
Bad debt expense	-	-	-	(1,999)
Miscellaneous	4,147	3,741	7,888	13,709
Total Functional Expenses	$ 870,742	$ 568,985	$ 1,439,727	$ 5,724,828

See accompanying notes to financial statements.

Merit School of Music

Statements of Cash Flows

Years Ended June 30,		**2016**		2015
Operating Activities				
Change in net assets	**$**	**63,283**	$	(398,492)
Adjustments to reconcile change in net assets to net cash for operating activities:				
Provisions for allowance for bad debts		**10,435**		(1,999)
Depreciation and amortization		**304,558**		338,971
Realized and change in unrealized loss (gain) on investments		**40,870**		(321,416)
Change in value of charitable remainder annuity trust		**28,240**		-
Contributions of donated stock		**(243,260)**		(167,098)
Changes in operating assets and liabilities:				
Pledges Receivable		**(693,048)**		291,267
Tuitions receivable		**48,243**		(57,365)
Other assets		**(9,055)**		(2,225)
Accounts payable and accrued expenses		**17,347**		(168,449)
Deferred tuition revenue		**(114,500)**		48,748
Net cash for operating activities		**(546,887)**		(438,058)
Investing Activities				
Purchases of property and equipment		**(323,939)**		(517,212)
Proceeds from sale of property and equipment		**-**		159,955
Purchases of investments		**(143,093)**		(1,317,336)
Proceeds from sales and maturities of investments		**1,232,024**		1,666,856
Net cash from (for) investing activities		**764,992**		(7,737)
Financing Activities				
Proceeds from line of credit		**475,000**		270,000
Repayment of line of credit		**(475,000)**		-
Annuity contract obligation payment		**(11,606)**		(11,607)
Net cash (for) from financing activities		**(11,606)**		258,393
Net Increase (Decrease) in Cash and Cash Equivalents		**206,499**		(187,402)
Cash and Cash Equivalents, beginning of year		**330,626**		518,028
Cash and Cash Equivalents, end of year	**$**	**537,125**	$	330,626
Cash Paid During the Year for Interest	**$**	**13,965**	$	7,909

See accompanying notes to financial statements.

1. Summary of Significant Accounting Policies

Nature of Activities

Merit School of Music (Merit) is a nationally accredited nonprofit organization in Chicago that removes barriers to high quality music education. 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, band, strings, chorus, and general music.

The Instrumental and Vocal 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. Students gain additional experience through participation in private lesson recitals.

Other programs include early childhood classes for preschoolers and special school and community based 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 Chicago Public Schools, which accounted for approximately 6 percent of Merit's revenue for the years ended June 30, 2016 and 2015, respectively. Financial aid is available to all students.

Basis of Presentation

The accompanying financial statements are prepared on the accrual basis of accounting in accordance with accounting principles generally accepted in the United States of America (GAAP).

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 7).

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.

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.

Revenue Recognition

Merit records tuition and student fees in the period in which they are earned. Tuition and student fees received in advance for program activities which will be conducted in the subsequent fiscal year (principally tuition deposits) are recorded as deferred tuition revenue in the statements of financial position. Rental income is recognized on a monthly basis when earned.

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 and changes in net assets as net assets released from restrictions. Donor-restricted contributions whose restrictions are met in the same reporting period are reported as unrestricted support.

Cash and Cash Equivalents

Merit considers highly liquid investments with initial maturities of three months or less to be cash equivalents. Money markets funds maintained in investment accounts are included with cash.

Concentration of Credit Risk

Merit maintains its cash at several financial institutions. All deposit accounts at Federal Deposit Insurance Corporation insured institutions are insured up to $250,000. At times during the year, Merit's bank balances may have exceeded the federally insured limits; however, it has not experienced any losses with respect to its bank balances in excess of government provided insurance and management believes Merit is not exposed to any unusual credit risk.

Pledges receivable

Pledges receivable represents 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.

As of June 30, 2016 and 2015, respectively, 74% and 70% of total pledges receivable was receivable from four donors.

Tuition Receivable

Tuition receivable represents uncollateralized customer obligations due under normal trade terms and consists 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. Allowance for doubtful accounts for the years ended June 30, 2016 and 2015 was $9,100 and $20,320, respectively, and is based on estimates made by management and Merit's historical collection experience.

Investments

Investments are stated at fair value as of the reporting date. Investments received as contributions of $243,260 and $167,098 for the years ended June 30, 2016 and 2015, 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.

Investment income is shown net of management fees on the statements of activities and changes in net assets. Total investment fees were $61,223 and $63,157 for the years ended June 30, 2016 and 2015, respectively.

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.

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.

Income Taxes

Merit is exempt from income taxes under Section 501(c)(3) of the Internal Revenue Code and applicable state law, except for net income derived from unrelated business activities. In addition, the Organization qualifies for the charitable contribution deduction under Section 170(b)(1)(A) and has been classified as an organization other than a private foundation under IRC Section 509(a). 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 2013.

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.

New Accounting Standard Update

In August 2016, FASB issued ASU 2016-14, *Not-for-Profit Entities (Topic 958) and Health Care Entities (Topic 954) – Presentation of Financial Statements of Not-for-Profit Entities*. The ASU amends the current reporting model for nonprofit organizations and enhances their required disclosures. The major changes include: (a) requiring the presentation of only two classes of net assets now entitled "net assets without donor restrictions" and "net assets with donor restrictions", (b) modifying the presentation of underwater endowment funds and related disclosures, (c) requiring the use of the placed in service approach to recognize the expirations of restrictions on gifts used to acquire or construct long-lived assets absent explicit donor stipulations otherwise, (d) requiring that all nonprofits present an analysis of expenses by function and nature in either the statement of activities, a separate statement, or in the notes and disclose a summary of the allocation methods used to allocate costs, (e) requiring the disclosure of quantitative and qualitative information regarding liquidity and availability of resources, (f) presenting investment return net of external and direct expenses, and (g) modifying other financial statement reporting requirements and disclosures intended to increase the usefulness of nonprofit financial statements. The ASU is effective for the Organization's financial statements for fiscal years beginning after December 15, 2017. Early adoption is permitted. The provisions of the ASU must be applied on a retrospective basis for all years presented although certain optional practical expedients are available for periods prior to adoption. Management is currently evaluating the impact of this ASU on their financial statements.

Reclassifications

Certain items in the financial statements as of and for the year ended June 30, 2015 have been reclassified for presentation purposes. Such reclassification had no impact on the change in net assets.

Subsequent Events

Merit has evaluated subsequent events for potential recognition and/or disclosure through November 16, 2016 the date the financial statements were available to be issued.

2. Pledges Receivable

Pledges receivable consists of the following:

June 30,	2016	2015
2016	$ -	$ 463,285
2017	670,803	56,430
2018	410,000	29,700
2019	85,000	-
2020	85,000	-
Total Pledges Receivable	1,250,803	549,415
Less allowance for doubtful pledges	(75,000)	(75,000)
Less unamortized discount on pledges	(10,372)	(2,032)
	$ 1,165,431	$ 472,383

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.

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, 2016 and 2015.

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, 2016 and 2015:

	2016			
		Fair Value Measurement		
	Level 1	Level 2	Level 3	Total
Assets				
Common stock	**$ 5,823,476**	**$ -**	**$ -**	**$ 5,823,476**
Mutual funds	**5,287,060**	**-**	**-**	**5,287,060**
Corporate notes	**-**	**128,561**	**-**	**128,561**
U.S. government agency notes	**-**	**462,306**	**-**	**462,306**
	$11,110,536	**$ 590,867**	**$ -**	**$11,701,403**
Liabilities				
Annuity contract obligation	**$ -**	**$ (55,027)**	**$ -**	**$ (55,027)**

	2015			
	Fair Value Measurement			
	Level 1	Level 2	Level 3	Total
Assets				
Common stock	$ 6,060,644	$ -	$ -	$ 6,060,644
Mutual funds	5,802,909	-	-	5,802,909
Corporate notes	-	243,172	-	243,172
U.S. government agency notes	-	481,221	-	481,221
	$ 11,863,553	$ 724,393	$ -	$ 12,587,946
Liabilities				
Annuity contract obligation	$ -	$ (38,393)	$ -	$ (38,393)

4. Property and Equipment

Property and equipment consists of the following:

June 30,	Depreciable Lives	**2016**	2015
Land		**$ 4,450,000**	$ 4,450,000
Building and improvements	7 - 40	**5,142,579**	5,140,594
Furniture and fixtures	5 – 10	**481,113**	479,875
Office equipment	3 – 7	**436,279**	399,692
Musical instruments and equipment	5 – 10	**1,424,045**	1,308,329
Asset not placed in service		**140,000**	-
		12,074,016	11,778,490
Less accumulated depreciation		**(3,282,067)**	(3,005,922)
		$ 8,791,949	$ 8,772,568

Depreciation expense for the years ended June 30, 2016 and 2015 totaled $304,558 and $338,971, respectively. Fully depreciated equipment totaling $28,413 and $159,995 was removed from the accounting records during 2016 and 2015, respectively. The asset not placed in service relates to an HVAC unit not fully installed as of June 30, 2016.

5. Line of Credit

During fiscal year 2016, Merit renewed its revolving line of credit with its existing bank which allows for maximum borrowings up to $500,000 with a maturity date of February 15, 2017. Outstanding borrowings bear interest at the prime rate (3.50% and 3.25 % at June 30, 2016 and 2015, respectively) and are secured by a certain investment account of Merit up to a maximum of $670,000. At June 30, 2016 and 2015, the outstanding balance on the line of credit was $325,000.

6. 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.

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 2016 and 2015, 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, 2016 and 2015:

	2016			
	Unrestricted	Temporarily Restricted	Permanently Restricted	Total
Donor-restricted	**$ -**	**$ 23,560**	**$ 5,924,659**	**$ 5,948,219**
Board designated	**7,109,161**	**-**	**-**	**7,109,161**
	$ 7,109,161	**$ 23,560**	**$ 5,924,659**	**$ 13,057,380**

	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
	$ 7,331,354	$ 23,560	$ 5,924,659	$ 13,279,573

The changes in endowment net assets were as follows for the years ended June 30, 2016 and 2015:

2016	Board Designated	Temporarily Restricted	Permanently Restricted	Total
Endowment net assets, beginning of year	**$ 7,331,354**	**$ 23,560**	**$ 5,924,659**	**$13,279,573**
Contributions and other revenue	**1,650**	**-**	**-**	**1,650**
Investment earnings	**169,665**	**-**	**159,966**	**329,631**
Other changes:				
Releases of restrictions	**(12,004)**	**(4,806)**	**-**	**(16,810)**
Endowment distribution	**(536,664)**	**-**	**-**	**(536,664)**
Transfer of investment earnings to operations as stipulated by donors	**155,160**	**4,806**	**(159,966)**	**-**
	(393,508)	**-**	**(159,966)**	**(553,474)**
Endowment net assets, end of year	**$ 7,109,161**	**$ 23,560**	**$ 5,924,659**	**$13,057,380**

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)	-
	(275,374)	-	(346,593)	(621,967)
Endowment net assets, end of year	$ 7,331,354	$ 23,560	$ 5,924,659	$13,279,573

For the fiscal year ended June 30, 2016, the permanent endowment's share of the total investment gain earned by Merit's investment portfolio totaled $159,966. For the fiscal year ended June 30, 2015, the permanent endowment's share of the total investment gain earned by Merit's investment portfolio totaled $346,593. These investment gains for 2016 and 2015 have been reflected in the statement of activities and changes in net assets and reported in unrestricted or temporarily restricted net assets.

7. 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 are 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 June 30, 2016 and 2015 totaled $536,664 and $568,403, respectively, and is included in the net assets released from restrictions totals on the statements of activities and changes in net assets.
>
> Named scholarship gifts: Named scholarship gifts result from contributions received in honor or memory of an individual which from the Board has designated the income earned 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 is as follows:

June 30,	**2016**	2015
Unrestricted gifts	**$ 6,456,555**	$ 6,672,398
Named scholarship gifts	**652,606**	658,956
	$ 7,109,161	$ 7,331,354

8. Restricted Net Assets

Temporarily restricted net assets were available for the following purposes:

June 30,	**2016**	2015
Unrestricted pledges and cash for subsequent fiscal years	**$ 399,651**	$ 152,760
Charitable remainder annuity trust	**49,928**	49,478
Restricted event donations	**5,095**	35,595
Restricted for building projects	**36,299**	72,279
Restricted for programming	**717,190**	202,983
Restricted for scholarships	**47,104**	19,500
Accumulated earnings on Scholarship Fund	**23,560**	23,560
	$ 1,278,827	$ 556,155

The following is a summary of permanently restricted net assets:

June 30,	**2016**	2015
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 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.

9. Retirement Plans

The Merit School of Music 401(k) Plan & Trust, a defined-contribution plan, 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 three 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 years ended June 30, 2016 and 2015, discretionary contributions to the 401(k) plan totaled $73,792 and $75,700, respectively.