Merit School of Music

Financial Statements
Years Ended June 30, 2018 and 2017

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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 statements of financial position as of June 30, 2018 and 2017, and the related statements of activities and changes in net assets, 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, 2018 and 2017, 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.

BDO USA, LLP

Chicago Illinois
November 5, 2018

Financial Statements

Merit School of Music

Statements of Financial Position

June 30,		2018		2017
Assets				
Current Assets				
Cash and cash equivalents	**$**	**495,272**	$	395,186
Pledges receivable, net - current portion		**600,530**		910,961
Tuition receivable, net		**127,339**		135,803
Total Current Assets		**1,223,141**		1,441,950
Property and Equipment, net		**8,751,740**		8,815,079
Other Assets				
Other assets		**210,187**		138,198
Pledges receivable, net		**170,405**		337,948
Investments		**13,639,863**		12,640,859
Total Other Assets		**14,020,455**		13,117,005
Total Assets	**$**	**23,995,336**	$	23,374,034
Liabilities and Net Assets				
Current Liabilities				
Current maturities of capital lease obligation	**$**	**14,780**	$	-
Accounts payable		**167,194**		47,530
Accrued expenses		**167,048**		173,039
Line of credit		**250,000**		135,000
Deferred tuition revenue		**163,776**		221,803
Total Current Liabilities		**762,798**		577,372
Long-Term Liabilities				
Annuity contract obligation		**42,471**		54,078
Capital lease obligation		**63,226**		-
Total Long-Term Liabilities		**105,697**		54,078
Total Liabilities		**868,495**		631,450
Net Assets				
Unrestricted		**7,165,669**		7,306,629
Unrestricted, board designated		**9,439,021**		8,330,843
Total Unrestricted		**16,604,690**		15,637,472
Temporarily restricted (Note 8)		**597,492**		1,180,453
Permanently restricted (Note 8)		**5,924,659**		5,924,659
Total Net Assets		**23,126,841**		22,742,584
Total Liabilities and Net Assets	**$**	**23,995,336**	$	23,374,034

See accompanying notes to financial statements.

Merit School of Music

Statements of Activities and Changes in Net Assets

Year ended June 30, 2018	Unrestricted	Unrestricted Board Designated	Unrestricted Total	Temporarily Restricted	Permanently Restricted	Total
Revenues, Gains and Other Support						
Contributions	$ 1,251,479	$ 317,265	$ 1,568,744	$ 117,650	$ -	$ 1,686,394
Government grants	41,200	-	41,200	-	-	41,200
Student fees	1,279,529	-	1,279,529	-	-	1,279,529
School contracts	581,309	-	581,309	-	-	581,309
Fundraising events, net of expenses of $202,933	1,021,188	-	1,021,188	-	-	1,021,188
Rental income	375,167	-	375,167	-	-	375,167
Miscellaneous income	8,563	-	8,563	-	-	8,563
Interest and dividends, net	-	371,435	371,435	6,920	-	378,355
Total Revenues, Gains and Other Support Before Net Assets Released from Restrictions	4,558,435	688,700	5,247,135	124,570	-	5,371,705
Net Assets Released from Restrictions	1,335,834	(628,500)	707,334	(707,334)	-	-
Total Revenues, Gains, and Other Support	5,894,269	60,200	5,954,469	(582,764)	-	5,371,705
Expenses						
Program services:						
Tuition-free Conservatory	832,875	-	832,875	-	-	832,875
Merit Music in Communities	965,908	-	965,908	-	-	965,908
Instrumental Music Program	597,591	-	597,591	-	-	597,591
Private lessons	1,276,395	-	1,276,395	-	-	1,276,395
Other programs	715,604	-	715,604	-	-	715,604
Total program services	4,388,373	-	4,388,373	-	-	4,388,373
Support services:						
General and administration	988,912	-	988,912	-	-	988,912
Fundraising	657,944	-	657,944	-	-	657,944
Total support services	1,646,856	-	1,646,856	-	-	1,646,856
Total expenses	6,035,229	-	6,035,229	-	-	6,035,229
Change in Net Assets Before Investment and Annuity Loss	(140,960)	60,200	(80,760)	(582,764)	-	(663,524)
Realized and change in unrealized gain on investments	-	1,047,978	1,047,978	(197)	-	1,047,781
Change in value of charitable remainder annuity trust	-	-	-	-	-	-
Change in Net Assets	(140,960)	1,108,178	967,218	(582,961)	-	384,257
Net Assets, beginning of year	7,306,629	8,330,843	15,637,472	1,180,453	5,924,659	22,742,584
Net Assets, end of year	$ 7,165,669	$ 9,439,021	$ 16,604,690	$ 597,492	$ 5,924,659	$ 23,126,841

Merit School of Music

Statements of Activities and Changes in Net Assets

Year ended June 30, 2017	Unrestricted: Unrestricted	Unrestricted: Board Designated	Unrestricted: Total	Temporarily Restricted	Permanently Restricted	Total
Revenues, Gains and Other Support						
Contributions	$ 1,314,286	$ 50,210	$ 1,364,496	$ 475,758	$ -	$ 1,840,254
Government grants	10,246	-	10,246	5,280	-	15,526
Student fees	1,208,603	-	1,208,603	-	-	1,208,603
School contracts	553,908	-	553,908	-	-	553,908
Fundraising events, net of expenses of $186,945	1,109,486	-	1,109,486	15,000	-	1,124,486
Rental income	296,939	-	296,939	-	-	296,939
Miscellaneous income	17,224	10	17,234	-	-	17,234
Interest and dividends, net	-	275,916	275,916	5,914	-	281,830
Total Revenues, Gains and Other Support Before Net Assets Released from Restrictions	4,510,692	326,136	4,836,828	501,952	-	5,338,780
Net Assets Released from Restrictions	1,120,387	(552,244)	568,143	(568,143)	-	-
Total Revenues, Gains, and Other Support	5,631,079	(226,108)	5,404,971	(66,191)	-	5,338,780
Expenses						
Program services:						
Tuition-free Conservatory	714,215	-	714,215	-	-	714,215
Merit Music in Communities	1,048,307	-	1,048,307	-	-	1,048,307
Instrumental Music Program	704,947	-	704,947	-	-	704,947
Private lessons	1,471,292	-	1,471,292	-	-	1,471,292
Other programs	525,948	-	525,948	-	-	525,948
Total program services	4,464,709	-	4,464,709	-	-	4,464,709
Support services:						
General and administration	782,565	4,900	787,465	-	-	787,465
Fundraising	540,747	-	540,747	-	-	540,747
Total support services	1,323,312	4,900	1,328,212	-	-	1,328,212
Total expenses	5,788,022	4,900	5,792,922	-	-	5,792,922
Change in Net Assets Before Investment and Annuity Loss	(156,943)	(231,008)	(387,951)	(66,191)	-	(454,142)
Realized and change in unrealized loss on investments	-	1,452,690	1,452,690	6,715	-	1,459,405
Change in value of charitable remainder annuity trust	-	-	-	(10,658)	-	(10,658)
Change in Net Assets	(156,943)	1,221,682	1,064,739	(70,134)	-	994,605
Net Assets, beginning of year	7,463,572	7,109,161	14,572,733	1,250,587	5,924,659	21,747,979
Net Assets, end of year	$ 7,306,629	$ 8,330,843	$ 15,637,472	$ 1,180,453	$ 5,924,659	$ 22,742,584

See accompanying notes to financial statements.

Merit School of Music

Statements of Functional Expenses

Year ended June 30, 2018	Program Services: Tuition-free Conservatory	Program Services: Merit Music in Communities	Program Services: Instrumental Music Program	Program Services: Private Lessons	Program Services: Other Programs	Program Services: Total Program Services	Support Services: General and Administration	Support Services: Fundraising	Support Services: Total Support Services	Total
Functional Expenses										
Salaries and contract instructors	$ 530,074	$ 656,937	$ 424,995	$ 1,022,549	$ 337,914	$ 2,972,469	$ 439,302	$ 374,157	$ 813,459	$ 3,785,928
Payroll taxes and employee benefits	90,730	110,411	75,093	153,106	44,498	473,838	110,401	100,053	210,454	684,292
Program supplies and sheet music	10,545	18,981	9,198	-	22,217	60,941	390	-	390	61,331
Instrument costs, including depreciation	6,245	32,011	4,584	-	153,264	196,104	-	825	825	196,929
College, camp and endowed scholarships	-	-	9,100	-	40,903	50,003	-	-	-	50,003
Other direct program costs	18,803	67,318	6,293	-	30,183	122,597	-	343	343	122,940
Staff development and local meetings	882	679	1,160	-	34,198	36,919	29,327	7,578	36,905	73,824
Outside marketing services	-	-	-	-	710	710	42,561	2,272	44,833	45,543
Printing and production costs	7,750	5,589	10,691	5,830	18,734	48,594	27,650	35,598	63,248	111,842
Other outside services and professional fees	-	12	-	90	-	102	67,868	11,587	79,455	79,557
Office expenses	9	168	-	-	1,895	2,072	60,320	11,472	71,792	73,864
Technology expenses	11,858	19,493	11,258	23,292	3,064	68,965	13,937	14,385	28,322	97,287
Occupancy costs	91,484	17,626	24,084	35,089	15,006	183,289	117,252	4,967	122,219	305,508
Office depreciation and amortization	64,014	15,918	20,342	29,304	12,771	142,349	56,043	11,154	67,197	209,546
Interest expense	-	-	-	-	-	-	11,063	-	11,063	11,063
Bad debt expense	(126)	20,765	793	7,135	31	28,598	6,462	81,175	87,637	116,235
Miscellaneous	607	-	-	-	216	823	6,336	2,378	8,714	9,537
Total Functional Expenses	$ 832,875	$ 965,908	$ 597,591	$ 1,276,395	$ 715,604	$ 4,388,373	$ 988,912	$ 657,944	$ 1,646,856	$ 6,035,229

Merit School of Music

Statements of Functional Expenses

Year ended June 30, 2017	Program Services						Support Services			
	Tuition-free Conservatory	Merit Music in Communities	Instrumental Music Program	Private Lessons	Other Programs	Total Program Services	General and Administration	Fundraising	Total Support Services	Total
Functional Expenses										
Salaries and contract instructors	$ 490,146	$ 694,493	$ 483,484	$ 1,103,035	$ 236,417	$ 3,007,575	$ 399,614	$ 320,839	$ 720,453	$ 3,728,028
Payroll taxes and employee benefits	78,658	112,726	74,842	159,248	58,407	483,881	84,659	83,274	167,933	651,814
Program supplies and sheet music	21,672	14,355	27,455	-	5,840	69,322	-	-	-	69,322
Instrument costs, including depreciation	6,054	97,488	15,589	-	75,172	194,303	1,160	-	1,160	195,463
College, camp and endowed scholarships	-	-	-	-	33,477	33,477	-	-	-	33,477
Other direct program costs	15,427	59,409	4,784	-	36,180	115,800	-	315	315	116,115
Staff development and local meetings	1,076	2,315	90	-	19,063	22,544	23,857	5,536	29,393	51,937
Outside marketing services	-	-	-	-	-	-	35,773	9,415	45,188	45,188
Printing and production costs	11,487	3,458	6,839	8,435	6,243	36,462	8,890	17,857	26,747	63,209
Other outside services and professional fees	-	-	-	-	1,974	1,974	84,486	2,390	86,876	88,850
Office expenses	15,277	6,685	15,494	34,458	9,694	81,608	18,541	24,583	43,124	124,732
Technology expenses	7,003	7,790	7,794	10,786	6,947	40,320	30,028	23,852	53,880	94,200
Occupancy costs	40,019	17,264	39,526	91,318	20,503	208,630	45,203	26,845	72,048	280,678
Office depreciation and amortization	27,263	14,833	27,545	59,025	15,455	144,121	36,384	23,158	59,542	203,663
Interest expense	-	-	-	-	-	-	12,301	-	12,301	12,301
Bad debt expense	133	15,524	1,122	4,987	202	21,968	-	-	-	21,968
Miscellaneous	-	1,967	383	-	374	2,724	6,569	2,684	9,253	11,977
Total Functional Expenses	$ 714,215	$ 1,048,307	$ 704,947	$ 1,471,292	$ 525,948	$ 4,464,709	$ 787,465	$ 540,749	$ 1,328,213	$ 5,792,922

See accompanying notes to financial statements.

Merit School of Music

Statements of Cash Flows

Year ended June 30,	**2018**	2017
Operating Activities		
Change in net assets	**$ 384,257**	$ 994,605
Adjustments to reconcile change in net assets to net cash provided by (used in) operating activities:		
Provisions for allowance for bad debts	**116,235**	21,968
Depreciation and amortization	**306,008**	295,846
Loss on disposal of asset	**-**	1,832
Realized and unrealized gain on investments	**(1,047,781)**	(1,459,405)
Change in value of charitable remainder annuity trust	**-**	10,658
Contributions of donated stock	**(102,093)**	(143,719)
Changes in operating assets and liabilities:		
Pledges receivable	**396,799**	(83,478)
Tuitions receivable	**(26,596)**	(8,598)
Other assets	**(71,989)**	52,142
Accounts payable and accrued expenses	**113,672**	33,785
Deferred tuition revenue	**(58,027)**	1,174
Net cash provided by (used in) operating activities	**10,485**	(283,190)
Investing Activities		
Purchases of property and equipment	**(162,264)**	(320,808)
Proceeds from sale of property and equipment	**-**	-
Purchases of investments	**(1,217,998)**	(775,439)
Proceeds from sales and maturities of investments	**1,368,869**	1,439,105
Net cash (used in) provided by investing activities	**(11,393)**	342,858
Financing Activities		
Net proceeds from (repayment of) line of credit	**115,000**	(190,000)
Annuity contract obligation payment	**(11,607)**	(11,607)
Principal payments on capital lease obligations	**(2,399)**	-
Net cash provided by (used in) financing activities	**100,994**	(201,607)
Net Increase (Decrease) in Cash and Cash Equivalents	**100,086**	(141,939)
Cash and Cash Equivalents, beginning of year	**395,186**	537,125
Cash and Cash Equivalents, end of year	**$ 495,272**	$ 395,186
Cash Paid During the Year for Interest	**$ 10,813**	$ 12,301
Supplemental Disclosure of Non-Cash Financing and Investing Activities		
Assets acquired under capital lease obligation	**$ 80,405**	$ -

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 offer sustained introductory, preparatory, and conservatory level music instruction—including classical and jazz, and featuring band, voice, and orchestra, as well as guitar and piano—to students from birth to 18 years of age. Merit's administrative and program facility is the Joy Faith Knapp Music Center at 38 S. Peoria in Chicago, Illinois.

Merit's programs include the following:

> The Alice S. Pfaelzer Tuition-free Conservatory (the Conservatory), which requires and represents the highest level of achievement, provides students, selected by audition, with a curriculum in music theory, chamber music, instrumental technique, and large ensembles. Students attend Saturday classes including a weekly assembly where student, faculty and guest artist performances are featured.
>
> The Merit Music in Communities Program, formerly Bridges: Partners in Music (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.

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 (U.S. GAAP).

Merit maintains its financial accounts internally 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 also 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

The preparation of the financial statements in conformity with U.S. GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and reported amounts of revenues 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 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 and cash equivalents.

Concentration of Credit Risk

Merit maintains its cash and cash equivalents 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 that ranges from 2.11% to 2.81% depending on the life of the pledge. 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, 2018 and 2017, 73% and 47% of total pledges receivable were receivable from four and three donors, respectively.

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, 2018 and 2017 was $22,150 and $10,900, 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 $102,093 and $143,719 for the years ended June 30, 2018 and 2017, respectively, 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 investment fees on the Statements of Activities and Changes in Net Assets. Total investment fees were $58,857 and $60,241 for the years ended June 30, 2018 and 2017, respectively.

Property and Equipment

Property and equipment are stated at cost or, in the case of contributions, fair value at the date of receipt, and are being depreciated over the 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 ("IRS"), 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 IRS 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 ("IRC") and applicable state law, except for net income derived from unrelated business activities. In addition, Merit 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's income tax filings are subject to audit by various taxing authorities. In evaluating Merit's activities, management believes its position of tax-exempt status is based on current facts and circumstances and there have been no uncertain positions taken related to recording income taxes. In the opinion of management, there are no activities unrelated to the purpose of the organization, and therefore no tax is to be recognized.

It is the policy of Merit to include in management and general expenses penalties and interest assessed by income taxing authorities. There are no penalties or interest from taxing authorities included in management and general expenses for the years ended June 30, 2018 and 2017.

New Accounting Standard Update

In May 2014, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") 2014-09, "*Revenue from Contracts with Customers (Topic 606)*," which is a comprehensive new revenue recognition standard that will supersede existing revenue recognition guidance. The core principle of the guidance is that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. FASB issued ASU 2015-14 that deferred the effective date for the organization until annual periods beginning after December 15, 2018. Earlier adoption is permitted after December 15, 2016, subject to certain limitations. The amendments in this update are required to be applied retrospectively to each prior reporting period presented or with the cumulative effect being recognized at the date of initial application. Merit is currently evaluating the potential impact of this ASU on its financial statements.

In February 2016, FASB issued ASU 2016-02, "*Leases (Topic 842),"* to increase transparency and comparability among organizations by recognizing lease assets and lease liabilities on the statement of financial positon and disclosing key information about leasing arrangements for lessees and lessors. The new standard applies a right-of-use (ROU) model that requires, for all leases with a lease term of more than 12 months, an asset representing its right to use the underlying asset for the lease term and a liability to make lease payments to be recorded. The ASU is effective for the organization's fiscal years beginning after December 15, 2019 with early adoption permitted. Merit is currently evaluating the impact of this ASU on its financial statements.

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. Merit is currently evaluating the impact of this ASU on its financial statements.

Subsequent Events

Merit has evaluated subsequent events through November 5, 2018, the date the financial statements were available to be issued. No events have occurred subsequent to June 30, 2018 that required recognition or disclosure in the financial statements.

2. Pledges Receivable

Pledges receivable consists of the following:

June 30,	**2018**	2017
2018	**$ -**	$ 991,431
2019	**735,530**	153,000
2020	**112,000**	107,000
2021	**26,000**	26,000
2022	**16,000**	16,000
2023	**16,000**	16,000
Thereafter	**24,000**	24,000
Total pledges receivable	**929,530**	1,333,431
Less allowance for doubtful accounts	**(150,000)**	(75,000)
Less unamortized discount on pledges	**(8,595)**	(9,522)
	$ 770,935	$ 1,248,909

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, 2018 and 2017.

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, 2018 and 2017:

	2018 Fair Value Measurements			
	Level 1	Level 2	Level 3	Total
Assets				
Common stock	$ 6,572,563	$ -	$ -	$ 6,572,563
Mutual funds	3,514,236	-	-	3,514,236
Fixed income	3,535,269	-	-	3,535,269
Corporate notes	-	17,795	-	17,795
	$ 13,622,068	$ 17,795	$ -	$ 13,639,863
Liabilities				
Annuity contract obligation	$ -	$ (42,471)	$ -	$ (42,471)

	2017 Fair Value Measurements			
	Level 1	Level 2	Level 3	Total
Assets				
Common stock	$ 6,230,442	$ -	$ -	$ 6,230,442
Mutual funds	6,388,922	-	-	6,388,922
Corporate notes	-	21,495	-	21,495
	$ 12,619,364	$ 21,495	$ -	$ 12,640,859
Liabilities				
Annuity contract obligation	$ -	$ (54,078)	$ -	$ (54,078)

4. Property and Equipment

Property and equipment consists of the following:

June 30,	Depreciable Lives	**2018**	2017
Land		**$ 4,450,000**	$ 4,450,000
Building and improvements	7-40	**5,498,446**	5,411,582
Furniture and fixtures	5-10	**489,931**	487,140
Office equipment	3-7	**545,787**	463,643
Musical instruments and equipment	5-10	**1,648,589**	1,577,719
		12,632,753	12,390,084
Less accumulated depreciation		**(3,881,013)**	(3,575,005)
		$ 8,751,740	$ 8,815,079

Depreciation expense for the years ended June 30, 2018 and 2017 totaled $306,008 and $295,846, respectively.

5. Line of Credit

During fiscal year 2018, Merit renewed its revolving line of credit with its existing bank which allows for maximum borrowings up to $750,000 with a maturity date of December 15, 2018. Outstanding borrowings, which amounted to $250,000 of an available $750,000 at March 31, 2018, bear interest at the prime rate (5% and 4.25% at June 30, 2018 and 2017, respectively) and are secured by a certain investment account of Merit.

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 U.S. GAAP, 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 2018 and 2017, 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, 2018 and 2017:

	2018			
	Unrestricted	**Temporarily Restricted**	**Permanently Restricted**	**Total**
Donor restricted	**$ -**	**$ 23,560**	**$ 5,924,659**	**$ 5,948,219**
Board designated	**9,439,021**	**-**	**-**	**9,439,021**
	$ 9,439,021	**$ 23,560**	**$ 5,924,659**	**$ 15,387,240**

	2017			
	Unrestricted	Temporarily Restricted	Permanently Restricted	Total
Donor restricted	$ -	$ 23,560	$ 5,924,659	$ 5,948,219
Board designated	8,330,843	-	-	8,330,843
	$ 8,330,843	$ 23,560	$ 5,924,659	$ 14,279,062

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The changes in endowment net assets were as follows for the years ended June 30, 2018 and 2017:

	2018			
	Board Designated	**Temporarily Restricted**	**Permanently Restricted**	**Total**
Endowment net assets, beginning of year	**$ 8,330,843**	**$ 23,560**	**$ 5,924,659**	**$ 14,279,062**
Contributions and other revenue	**242,264**	**-**	**-**	**242,264**
Investment earnings	**748,743**	**-**	**670,671**	**1,419,414**
Other changes				
Releases of restrictions	**20,150**	**(20,150)**	**-**	**-**
Endowment distribution	**(553,500)**	**-**	**-**	**(553,500)**
Transfer of investment earnings to operations as stipulated by donors	**650,521**	**20,150**	**(670,671)**	**-**
	117,171	**-**	**(670,671)**	**(553,500)**
Endowment Net Assets, end of year	**$ 9,439,021**	**$ 23,560**	**$ 5,924,659**	**$ 15,387,240**

	2017			
	Board Designated	**Temporarily Restricted**	**Permanently Restricted**	**Total**
Endowment net assets, beginning of year	$ 7,109,161	$ 23,560	$ 5,924,659	$ 13,057,380
Contributions and other revenue	50,220	-	-	50,220
Investment earnings	829,835	-	898,771	1,728,606
Other changes				
Releases of restrictions	22,103	(27,003)	-	(4,900)
Endowment distribution	(552,244)	-	-	(552,244)
Transfer of investment earnings to operations as stipulated by donors	871,768	27,003	(898,771)	-
	341,627	-	(898,771)	(557,144)
Endowment Net Assets, end of year	$ 8,330,843	$ 23,560	$ 5,924,659	$ 14,279,062

For the fiscal years ended June 30, 2018 and 2017, the permanent endowment's share of the total investment gain earned by Merit's investment portfolio totaled $670,671 and $898,771, respectively. These investment gains 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, 2018 and 2017 totaled $553,500 and $552,244, 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,	**2018**	2017
Unrestricted gifts	**$ 8,610,027**	$ 7,575,084
Named scholarship gifts	**828,994**	755,759
	$ 9,439,021	$ 8,330,843

8. Restricted Net Assets

Temporarily restricted net assets were available for the following purposes:

June 30,	**2018**	2017
Unrestricted pledges and cash for subsequent fiscal years	**$ 290,332**	$ 435,542
Charitable remainder annuity trust	**30,501**	23,654
Restricted event donations	**-**	15,000
Restricted for building projects	**304**	304
Restricted for programming	**139,295**	547,893
Restricted for scholarships	**113,500**	134,500
Accumulated earnings on Scholarship Fund	**23,560**	23,560
	$ 597,492	$ 1,180,453

The following is a summary of permanently restricted net assets:

June 30,	**2018**	2017
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 IRC 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, 2018 and 2017, employer contributions to the 401(k) plan totaled $78,065 and $79,504, respectively.