

Consolidated Financial Statements

Lutheran Social Services of the South, Inc.

*d/b/a* Upbring

*As of and for the years ended March 31, 2017 and 2016  
with Report of Independent Auditors*

Lutheran Social Services of the South, Inc.  
*d/b/a* Upbring

Consolidated Financial Statements

As of and for the years ended March 31, 2017 and 2016

Contents

Report of Independent Auditors.....	1
<b>Audited Consolidated Financial Statements</b>	
Consolidated Statements of Financial Position.....	2
Consolidated Statements of Activities .....	3-4
Consolidated Statements of Cash Flows .....	5
Notes to Consolidated Financial Statements.....	6

## Report of Independent Auditors

The Board of Directors  
Lutheran Social Services of the South, Inc., *d/b/a* Upbring

We have audited the accompanying consolidated statements of financial position of Lutheran Social Services of the South, Inc. (the “Organization”) *d/b/a* Upbring as of March 31, 2017 and 2016, and the related consolidated statements of activities and cash flows for the years then ended.

### **Management’s Responsibility for the Financial Statements**

Management is responsible for the preparation and fair presentation of these consolidated financial statements in accordance with accounting principles generally accepted in the United States of America; 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 consolidated 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 audits to obtain reasonable assurance about whether the consolidated financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the auditor’s judgment, including the assessment of the risks of material misstatement of the consolidated 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 consolidated 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 consolidated financial statements.

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

### **Opinion**

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Lutheran Social Services of the South, Inc. as of March 31, 2017 and 2016, and the changes in its net assets and its cash flows for the years then ended, in conformity with accounting principles generally accepted in the United States of America.

*Holtzman Partners, LLP*

August 11, 2017

Lutheran Social Services of the South, Inc.  
d/b/a Upbring  
Consolidated Statements of Financial Position

As of March 31, 2017 and 2016

	Donor Restricted			2017 Total	2016 Total
	Unrestricted	Temporarily Restricted	Permanently Restricted		
<b>Assets</b>					
<b>Current assets:</b>					
Cash and cash equivalents	\$ 4,265,050	\$ -	\$ -	\$ 4,265,050	\$ 8,714,211
Accounts receivable, net of allowance for uncollectible accounts	4,837,240	-	-	4,837,240	6,702,876
Prepaid expenses and other current assets	401,900	-	-	401,900	343,668
<b>Total current assets</b>	<b>9,504,190</b>	<b>-</b>	<b>-</b>	<b>9,504,190</b>	<b>15,760,755</b>
<b>Investments</b>					
Marketable securities, including restricted investments	24,200,169	9,425,103	4,006,401	37,631,673	25,630,642
Interest in donor-established trusts	-	502,832	2,965,229	3,468,061	3,423,158
<b>Total investments</b>	<b>24,200,169</b>	<b>9,927,935</b>	<b>6,971,630</b>	<b>41,099,734</b>	<b>29,053,800</b>
Property, buildings, and equipment, net	11,654,238	-	-	11,654,238	23,137,208
Other long-term assets	958,486	-	-	958,486	998,937
<b>Total assets</b>	<b>\$ 46,317,083</b>	<b>\$ 9,927,935</b>	<b>\$ 6,971,630</b>	<b>\$ 63,216,648</b>	<b>\$ 68,950,700</b>
<b>Liabilities and net assets</b>					
<b>Current liabilities:</b>					
Accounts payable	\$ 871,748	\$ -	\$ -	\$ 871,748	\$ 1,221,943
Accrued expenses	4,010,212	-	-	4,010,212	4,212,713
Interfund and intercompany payable (receivable)	(103,587)	104,489	(902)	-	-
Current portion of deferred income	185,732	-	-	185,732	144,044
Current portion of long-term debt	10,407	-	-	10,407	9,258
<b>Total current liabilities</b>	<b>4,974,512</b>	<b>104,489</b>	<b>(902)</b>	<b>5,078,099</b>	<b>5,587,958</b>
Long-term debt, less current portion	76,254	-	-	76,254	112,241
Deferred income	-	-	-	-	496,619
Entrance fees and deposits	-	-	-	-	9,530,757
<b>Total liabilities</b>	<b>5,050,766</b>	<b>104,489</b>	<b>(902)</b>	<b>5,154,353</b>	<b>15,727,575</b>
<b>Net assets:</b>					
Unrestricted	41,266,317	-	-	41,266,317	36,540,856
Temporarily restricted	-	9,823,446	-	9,823,446	9,917,857
Permanently restricted	-	-	6,972,532	6,972,532	6,764,412
<b>Total net assets</b>	<b>41,266,317</b>	<b>9,823,446</b>	<b>6,972,532</b>	<b>58,062,295</b>	<b>53,223,125</b>
<b>Total liabilities and net assets</b>	<b>\$ 46,317,083</b>	<b>\$ 9,927,935</b>	<b>\$ 6,971,630</b>	<b>\$ 63,216,648</b>	<b>\$ 68,950,700</b>

*See accompanying notes to consolidated financial statements.*

Lutheran Social Services of the South, Inc.  
*d/b/a* Upbring  
 Consolidated Statement of Activities

For the Year Ended March 31, 2017

	Unrestricted	Temporarily Restricted	Permanently Restricted	Total
Revenues, gains and other support:				
Therapeutic foster care	\$ 16,211,519	\$ —	\$ —	\$ 16,211,519
Residential treatment	25,614,813	—	—	25,614,813
Adoption	673,466	—	—	673,466
Education	3,006,219	—	—	3,006,219
Contribution, grants and bequests	4,708,330	1,699,967	93,883	6,502,180
Net senior services revenue	5,650,966	—	—	5,650,966
Investment income	2,517,604	273,974	128,906	2,920,484
Revenue from other sources	125,598	—	—	125,598
Net assets released from restrictions	2,065,365	(2,051,615)	(13,750)	—
Total revenues, gains and other support	<u>60,573,880</u>	<u>(77,674)</u>	<u>209,039</u>	<u>60,705,245</u>
Expenses:				
Salaries and employee benefits	33,785,733	—	—	33,785,733
Program services	15,935,735	—	—	15,935,735
Assistance to others	1,444,900	—	—	1,444,900
Professional and contract services	3,663,376	16,737	919	3,681,032
Facility and equipment expense	4,677,979	—	—	4,677,979
Depreciation and amortization	1,618,443	—	—	1,618,443
Interest	6,156	—	—	6,156
Travel and meeting expense	973,467	—	—	973,467
Other expenses	1,499,259	—	—	1,499,259
Total expenses	<u>63,605,048</u>	<u>16,737</u>	<u>919</u>	<u>63,622,704</u>
Gain on sale of senior service facilities	7,756,629	—	—	7,756,629
Change in net assets	4,725,461	(94,411)	208,120	4,839,170
Net assets at beginning of year	36,540,856	9,917,857	6,764,412	53,223,125
Net assets at end of year	<u>\$ 41,266,317</u>	<u>\$ 9,823,446</u>	<u>\$ 6,972,532</u>	<u>\$ 58,062,295</u>

*See accompanying notes to consolidated financial statements.*

Lutheran Social Services of the South, Inc.  
*d/b/a* Upbring  
 Consolidated Statement of Activities

For the Year Ended March 31, 2016

	Unrestricted	Temporarily Restricted	Permanently Restricted	Total
Revenues, losses, gains and other support:				
Therapeutic foster care	\$ 15,830,922	\$ —	\$ —	\$ 15,830,922
Residential treatment	25,041,815	—	—	25,041,815
Adoption	780,759	—	—	780,759
Education	2,255,791	—	—	2,255,791
Contribution, grants and bequests	4,979,482	2,716,978	44,660	7,741,120
Net senior services revenue	17,682,280	—	—	17,682,280
Investment income (loss)	250,562	(613,741)	(265,628)	(628,807)
Revenue (loss) from other sources	(93,523)	—	—	(93,523)
Net assets released from restrictions	2,759,372	(2,744,372)	(15,000)	—
Total revenues, losses, gains and other support	69,487,460	(641,135)	(235,968)	68,610,357
Expenses:				
Salaries and employee benefits	35,075,379	—	—	35,075,379
Program expenses	17,190,592	—	—	17,190,592
Assistance to others	1,595,233	—	—	1,595,233
Professional and contract services	3,428,965	56,562	—	3,485,527
Facility and equipment expense	6,160,831	—	—	6,160,831
Depreciation and amortization	3,392,633	—	—	3,392,633
Interest	1,893,341	—	—	1,893,341
Travel and meeting expense	931,158	—	—	931,158
Other expenses	999,213	—	—	999,213
Total expenses	70,667,345	56,562	—	70,723,907
Loss on early retirement of debt	(4,249,950)	—	—	(4,249,950)
Gain on sale of senior service facilities	37,902,385	—	—	37,902,385
Change in net assets	32,472,550	(697,697)	(235,968)	31,538,885
Net assets at beginning of year	4,068,306	10,615,554	7,000,380	21,684,240
Net assets at end of year	\$ 36,540,856	\$ 9,917,857	\$ 6,764,412	\$ 53,223,125

*See accompanying notes to consolidated financial statements.*

Lutheran Social Services of the South, Inc.  
d/b/a Upbring  
Consolidated Statements of Cash Flows

For the years ended March 31, 2017 and 2016

	2017	2016
<b>Operating activities</b>		
Change in net assets	<b>\$4,839,170</b>	\$31,538,885
Adjustment to reconcile change in net assets to cash used in operating activities:		
Change in donor-established trusts	4,055	(2,022)
Amortization of deferred income for life leases	<b>(243,938)</b>	(761,150)
Amortization of bond premium on debt	-	(27,405)
Amortization of deferred financing costs	-	75,173
Amortization of capitalized marketing costs	-	319,445
Depreciation and amortization	<b>1,618,443</b>	2,997,096
Net realized and unrealized (gains) losses on investments	<b>(1,818,262)</b>	1,256,505
Net (gain) loss on sale of property, buildings, and equipment	<b>(7,531)</b>	244,386
Net gain on divestiture of senior service facilities	<b>(7,756,629)</b>	(37,902,385)
Net loss on early retirement of debt	-	4,249,950
Changes in operating assets and liabilities:		
Accounts receivable, net	<b>1,604,587</b>	(2,617,648)
Prepaid expenses and other current assets	<b>(106,715)</b>	139,139
Other long-term assets	<b>30,463</b>	76,827
Accounts payable	<b>(350,194)</b>	(502,382)
Accrued expenses	<b>(55,993)</b>	(2,634,555)
Deferred income	<b>19,230</b>	49,695
Net cash used in operating activities	<b>(2,223,314)</b>	(3,500,446)
<b>Investing activities</b>		
Purchase of property, buildings and equipment and other assets, net	<b>(848,081)</b>	(1,315,785)
Proceeds from sale of property, buildings, and equipment	<b>16,775</b>	39,500
Proceeds from divestiture of senior service facilities	<b>7,996,711</b>	51,450,000
Net purchases of investments	<b>(10,221,740)</b>	(430,220)
Decrease in assets whose use is limited	<b>48,484</b>	13,429,972
Net cash provided by (used in) investing activities	<b>(3,007,851)</b>	63,173,467
<b>Financing activities</b>		
Life lease deposits received	<b>1,428,000</b>	4,472,074
Life lease deposits refunded	<b>(601,260)</b>	(4,152,460)
Resident deposits received	<b>41,602</b>	98,805
Resident deposits refunded	<b>(51,500)</b>	(224,965)
Payments on capital leases	-	(7,924)
Payments on long-term debt	<b>(34,838)</b>	(60,064,715)
Penalty for early retirement of debt	-	(2,206,798)
Net cash provided by (used in) financing activities	<b>782,004</b>	(62,085,983)
<b>Net change in cash and cash equivalents</b>	<b>(4,449,161)</b>	(2,412,962)
<b>Cash and cash equivalents, beginning of year</b>	<b>8,714,211</b>	11,127,173
<b>Cash and cash equivalents, end of year</b>	<b>\$ 4,265,050</b>	<b>\$ 8,714,211</b>
<b>Supplemental disclosure of cash flow information:</b>		
Cash paid for interest	<b>\$ 2,662</b>	<b>\$ 4,480,281</b>

See accompanying notes to consolidated financial statements

Lutheran Social Services of the South, Inc.  
*d/b/a Upbring*  
Notes to Consolidated Financial Statements

As of and for the years ended March 31, 2017 and 2016

**1. Organization**

Lutheran Social Services of the South, Inc. (the “Organization”) is a 135 year-old nonprofit organization with a rich legacy of serving vulnerable children, families and communities throughout Texas through a strong net of programs and services.

The Organization operates under the DBA “Upbring”, in order to reflect its new mission: to break the cycle of child abuse by empowering children, families and communities. Upbring has faith in every future and serves more than 27,000 people annually — providing innovative programs and social services for children and families including foster care, adoption, education, residential treatment, community services, and care and residence for the elderly.

Upbring provides children services and disaster relief through the following wholly-owned affiliates: Lutheran Social Services Disaster Response, Inc., Lutheran Properties, Inc. (“LPI”), and Peace Lake Towers, Inc. Upbring and affiliates are hereinafter referred to as the “Organization”.

The Organization is governed by a Board of Directors where (i) thirteen (13) of the seats on the Board of Directors of the Organization shall be endorsed by either the appropriate Bishop or District President of the Lutheran jurisdictional units of the Evangelical Lutheran Church in America; the Lutheran Church - Missouri Synod or by the pastor of the congregation of the elected board member; and (ii) three At Large seats shall be elected by the Board of Directors as it is constituted from time to time. The jurisdictional units are known as: Texas District; Texas-Louisiana Gulf Coast Synod; Northern Texas - Northern Louisiana Synod; Southwestern Texas Synod; Southern District; Rocky Mountain District; and Rocky Mountain Synod.

**2. Summary of Significant Accounting Policies**

**Basis of Presentation**

The consolidated financial statements of the Organization have been prepared on the accrual basis of accounting. All significant intercompany accounts and transactions have been eliminated in consolidation.

**Use of Estimates**

The preparation of the consolidated financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates that affect the amounts reported in the consolidated financial statements and accompanying notes. Significant estimates include the allowance for doubtful accounts and accrued professional liability amounts. Actual results could differ from those estimates.

Lutheran Social Services of the South, Inc.  
*d/b/a* Upbring  
Notes to Consolidated Financial Statements

**2. Summary of Significant Accounting Policies (continued)**

**Display of Net Assets by Class**

The net assets of the Organization are reported in each of the following classes: (a) unrestricted net assets, (b) temporarily restricted net assets, and (c) permanently restricted net assets. Net assets of the two restricted classes are created only by donor-imposed restrictions on their use. All other net assets, including Board designated, are legally unrestricted and are reported as part of the unrestricted class.

**Contributions**

The Organization reports gifts of cash and other assets as restricted support if they are received with donor stipulations that limit the use of the donated asset. A donor restriction expires when a stipulated time restriction ends or purpose restriction is accomplished. Upon expiration of a donor restriction, temporarily restricted net assets are reclassified to unrestricted net assets and reported in the consolidated statement of activities as “net assets released from restrictions”.

The Organization recognizes gifts of land and buildings at the fair market value at time of donation, and reports the gifts as unrestricted support unless explicit donor stipulations specify how the donated assets must be used. Gifts of long-lived assets with explicit restrictions that specify how the assets are to be used and gifts of cash or other assets that must be used to acquire long-lived assets are reported as restricted support. Absent explicit donor stipulations about how long those long-lived assets must be maintained, the Organization reports expirations of donor restrictions when the donated or acquired long-lived assets are placed in service. Donor-restricted contributions whose restrictions are met in the same year are reported as unrestricted support.

Management considers the donation of perpetual trusts to represent an intention to give and, accordingly, recognizes distributions received from the trusts as contribution revenue in the appropriate net asset class according to the trust restrictions. The perpetual trust held by third parties is reported under permanently restricted investments as “Marketable securities” in the accompanying consolidated statements of financial position.

**Interest in Donor-Established Trusts**

Donors have established trusts for the benefit of the Organization at Lutheran Foundation of the Southwest, Lutheran Foundation of Texas, Lutheran Community Foundation, and Lutheran Church Missouri Synod Foundation (collectively the “Lutheran Foundations”). The assets held by the Lutheran Foundations consist primarily of investments in debt and equity securities.

The Organization receives income and is the principal beneficiary of certain perpetual trusts held by the Lutheran Foundations where the trustee has no discretion regarding the beneficiaries’ participation in the trust. The Organization’s proportionate share of the estimated market value of the trust is reported as an asset and as temporarily restricted contribution revenue at the formation of the trust. Certain perpetual trusts are invested in equity securities with a readily determinable fair value and are measured at fair value (based on quoted market prices) as of the balance sheet date. Changes in the Organization’s proportionate share of the fair market value of the trusts are reported as unrealized gains or losses of donor-established trusts in the appropriate net asset class according to trust restrictions.

Lutheran Social Services of the South, Inc.  
*d/b/a* Upbring  
Notes to Consolidated Financial Statements

**2. Summary of Significant Accounting Policies (continued)**

The Organization's proportionate share of the market value of the trust, which approximates the net present value of the estimated future cash flows receivable by the Organization, is calculated using the estimated life span of the original donor as determined by actuarial statistics obtained by the trustee, and reported as an asset and as a permanently restricted contribution revenue at the formation of the trust. Annual income distributions from the trust are recognized as investment income in the appropriate net asset class according to the restrictions of the trust.

**Deferred Income, Entrance Fees and Deposits**

The Organization recognizes revenue for resident services in the period earned, which includes the amortization of entrance fees. Entrance fees are paid by residents as they take occupancy of their reserved units. Of this entrance fee, a portion is non-refundable and is recorded as "Deferred income" and amortized using the straight-line method over the estimated remaining life expectancy of the resident or 5 years, depending on the facility. The remaining life expectancy is re-evaluated annually and amortization periods are prospectively adjusted accordingly. The remaining portion of the entrance fee is refundable to the resident (or appointed estate) upon vacancy from their respective unit, and is recorded as "Entrance fees and deposits," a liability in the accompanying consolidated statements of financial position. This portion of the fee is refunded once the resident is deceased or moves out of the community, and sufficient entrance fees have been received from the next re-sale and occupancy of any residence of the community.

**Discounted Services**

The Organization provides certain services to clients on a sliding scale based on the client's ability to pay. Revenues are reported in the consolidated statements of activities based on the net amounts received.

**Contributed Services and Facilities**

The Organization recorded approximately \$248,000 and \$192,000 for donated services and donated use of facilities in the consolidated statements of activities for the years ended March 31, 2017 and 2016, respectively. The Organization has a substantial number of donors who have contributed significant amounts of time and resources in support of LSSS. For the years ended March 31, 2017 and 2016, the Organization received credit for approximately \$300,000 and \$192,000 for contributed services related to its Head Start Program, respectively.

**Net Senior Services Revenue**

Net senior service revenue was approximately \$5.7 million and \$17.7 million for the years ended March 31, 2017 and 2016, respectively, and was reported at the estimated net realizable amounts from residents, third-party payers, and others for services rendered. Services provided to Medicare beneficiaries are reimbursed at flat rates as determined by the Medicare fiscal intermediary. Services rendered to Medicaid program beneficiaries are reimbursed at a flat daily rate, as determined by the responsible state agency.

**Advertising Costs**

Advertising costs are expensed as incurred. Advertising costs for the years ended March 31, 2017 and 2016 were approximately \$305,000 and \$240,000, respectively, and are included in program expenses in the accompanying consolidated statements of activities.

Lutheran Social Services of the South, Inc.  
*d/b/a* Upbring  
Notes to Consolidated Financial Statements

**2. Summary of Significant Accounting Policies (continued)**

**Property Taxes**

As a condition of the sale of Village of Gleannloch Farms, the Organization has retained a charity care liability. The Organization has recorded a charity accrual of approximately \$621,000 and \$792,000 as of March 31, 2017 and 2016, respectively.

**Income Taxes**

The Organization is exempt from federal income tax under Section 501(c)(3) of the Internal Revenue Code.

The Organization accounts for income taxes under Financial Accounting Standards Board (“FASB”) Accounting Standards Codification (“ASC”) Topic 740, *Income Taxes*. The Organization evaluates uncertain tax positions, if any exist, under this topic. LSSS accounts for uncertainty of income taxes based on a “more-likely-than-not” threshold for the recognition and de-recognition of tax positions, which includes the accounting for interest and penalties relating to tax positions. LSSS currently does not have any tax positions that it would consider uncertain at March 31, 2017.

**Cash and Cash Equivalents**

The Organization considers certain liquid asset accounts with an original maturity of three months or less to be cash equivalents.

**Fair Value of Financial Instruments**

The Organization follows ASC 820, *Fair Value Measurements and Disclosures*. Those provisions relate to the Organization’s financial assets and liabilities carried at fair value and the Organization’s fair value disclosures related to financial assets and liabilities. ASC 820 defines fair value, expands related disclosure requirements and specifies a hierarchy of valuation techniques based on the nature of the inputs used to develop the fair value measures. Fair value is defined as 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.

There are three levels of inputs to fair value measurements - Level 1, meaning the use of quoted prices for identical instruments in active markets; Level 2, meaning the use of quoted prices for similar instruments in active markets or quoted prices for identical or similar instruments in markets that are not active or are directly or indirectly observable; and Level 3, meaning the use of unobservable inputs. Observable market data should be used when available.

The fair values of the Organization’s financial instruments, including cash and cash equivalents, restricted investments, accounts receivable and payable, prepaid expenses and other current assets, investments, accounts payable, accrued expenses and debt approximate their carrying amount due to the short maturity of these instruments. Investments held by trustee are carried at estimated fair market value based on quoted market prices.

Lutheran Social Services of the South, Inc.  
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Notes to Consolidated Financial Statements

**2. Summary of Significant Accounting Policies (continued)**

**Concentration of Credit Risk**

Cash and cash equivalents are placed with high quality financial institutions that from time to time exceed federally insured limits. No losses have been experienced with respect to such balances.

**Accounts Receivable, net**

Accounts receivable are recorded at invoiced amount, net of contractual adjustments and allowance for doubtful accounts. Additions to the allowance for doubtful accounts are made by means of the provision for doubtful accounts. The amount of the provision for doubtful accounts is based upon management's assessment of historical and expected net collections, business and economic conditions, trends in federal and state governmental health care coverage, and other collection indicators. As of March 31, 2017 and 2016, the allowance for doubtful accounts was approximately \$0 and \$115,000, respectively.

**Property, Buildings, and Equipment, Net**

Property, buildings, and equipment are recorded at cost. Depreciation on property, buildings and equipment is provided on the straight-line method over the estimated useful lives of the assets. The estimated useful lives are approximately 30 years for buildings, 10 years for improvements, and 5 years for equipment. Major additions and betterments are capitalized. Maintenance and repairs which do not materially improve or extend the lives of the respective assets are charged to operating expenses as incurred.

When events, circumstances, or operating results indicate that the carrying values of certain long-lived assets might be impaired, the Organization prepares projections of cash flows expected to result from the use of the assets and their eventual disposition. If the projections indicate that the recorded amounts are not expected to be recoverable, such amounts are reduced to estimated fair value. Fair value may be estimated based upon internal evaluations that include quantitative analysis of revenues and cash flows, reviews of recent sales of similar assets, and independent appraisals. To date, no such impairment charges have been recognized.

**Deferred Financing and Marketing Costs**

Bond issuance costs are capitalized and amortized over the life of the related bond issue. Amortization of the bond issuance costs was \$0 and \$75,173 for the years ended March 31, 2017 and 2016, respectively. Marketing costs are capitalized and amortized over 8 years, which approximates the average remaining actuarial life of the initial residents at entry to Village at Gleannloch Farms ("VGF"). There were no net capitalized marketing costs as of March 31, 2017 and 2016. Amortization of capitalized marketing costs was \$0 and \$319,445 for the years ended March 31, 2017 and 2016, respectively. During 2016, unamortized capitalized marketing costs were written off in conjunction with the sale of VGF. See further discussion of transactions related to these accounts in Note 3.

Lutheran Social Services of the South, Inc.  
*d/b/a* Upbring  
Notes to Consolidated Financial Statements

**2. Summary of Significant Accounting Policies (continued)**

**Medical Malpractice Claims and Similar Liabilities**

The Organization accounts for medical malpractice and similar liabilities under ASC Topic 954 by recording estimated professional liability claims gross of anticipated insurance recoveries. The Organization recognizes an insurance receivable at the same time and on the same basis that it recognizes the liability, subject to a need for a valuation allowance for uncollectible amounts.

The Organization purchases medical malpractice insurance covering the Organization and its employed providers, subject to deductibles and to specific and aggregate policy limits. Management believes that the Organization has adequate coverage for any asserted and unasserted claims under applicable insurance. There were no claims made during the years ended March 31, 2017 or 2016.

**Charity Care**

The Organization accounts for charity care under ASC Topic 945, *Health Care Entities*, which requires an entity in the healthcare industry to use its direct and indirect costs of providing charity care as the measurement basis for charity care disclosures, and to provide additional disclosures of the method used to determine such costs. In order to satisfy the requirements of the property tax exemption disclosed above, the Organization renders services to residents who are financially unable to pay for care. Charity care is deducted from resident revenue and not included as bad debt expense. The estimated cost incurred by the Organization to provide these services to residents who are unable to pay was approximately \$225,000 and \$292,000 for the years ended March 31, 2017 and 2016, respectively. The estimated cost of these charity care services was determined using direct costs, where applicable, and indirect costs of providing the charity care. Indirect costs were allocated to each residential unit based on either the revenue on the type of unit as a percentage of total revenue or the number of the type of units as a percentage of total units.

**Employee Retirement Plan**

The Organization sponsors a 403(b) plan (the “Plan”) for the benefit of substantially all employees. The Organization is the administrator of the Plan. Participants may elect to contribute up to the annual maximum set by the Internal Revenue Service.

**Risks and Uncertainties**

The financial condition of the Organization depends significantly on revenues received from contracts with various departments of the government of the state of Texas (the “State Departments”). Such State Departments are, in turn, dependent almost exclusively on annual or biennial appropriations granted to them by the legislature of the state of Texas. If appropriations to the State Departments are materially reduced or eliminated or appropriations are required to cover more facilities or individuals, the financial condition of the Organization could be materially and adversely affected.

In addition, the revenue received from such contracts with Federal Departments and State Departments is dependent upon (i) the Organization’s fulfilling its obligations under such contracts, (ii) the Organization’s receipt of the appropriate certifications from the required licensing or certifying entity to provide the services required under such contracts, and (iii) the Organization’s ability to renew such contracts with the State Departments. Accounts receivable under these contracts were \$4,108,006 and \$4,146,266 at March 31, 2017 and 2016, respectively.

Lutheran Social Services of the South, Inc.  
*d/b/a Upbring*  
Notes to Consolidated Financial Statements

**2. Summary of Significant Accounting Policies (continued)**

The Organization provides health care services primarily to residents in its retirement care facilities. Laws and regulations governing the Medicare and Medicaid programs are complex and subject to interpretation. Management believes that it is in material compliance with all applicable laws and regulations and is not aware of any pending or threatened investigations involving allegations of potential wrongdoing. While no such material regulatory inquiries have been made, compliance with such laws and regulations can be subject to future government review and interpretation, as well as significant regulatory action, including fines, penalties, and exclusion from the Medicare and Medicaid programs.

**Subsequent Events**

Subsequent events have been evaluated through August 11, 2017, which represents the date the consolidated financial statements were available to be issued.

**Recent Accounting Pronouncements**

In August 2016, the FASB issued Accounting Standards Update (“ASU”) No. 2016-14, *Not-for-Profit Entities (Topic 958): Presentation of Financial Statements of Not-for-Profit Entities*, which changes how a not-for-profit organization classifies its net assets, as well as the information it presents in financial statements and notes about its liquidity, financial performance, and cash flows. The ASU requires amended presentation and disclosures to help not-for-profits provide more relevant information about their resources (and the changes in those resources) to donors, grantors, creditors, and other users. The guidance is effective for annual financial statements issued for fiscal years beginning after December 15, 2017. Early application is permitted. Management is currently evaluating the effect of these provisions on the Organization’s financial position and results of operations.

In May 2014, the FASB issued ASU No. 2014-09, *Revenue from Contracts with Customers (Topic 606)*. This ASU will supersede the revenue recognition requirements in Topic 605, Revenue Recognition, and most industry-specific guidance, and creates guidance for when revenue should be recognized from the exchange of goods or services. For private companies, this standard is effective for annual reporting periods beginning after December 15, 2018. A nonpublic entity may elect to apply the guidance in this ASU early with certain restrictions. Management is currently evaluating the effect of these provisions on LSSS’s consolidated financial position and results of operations.

In August 2014, the FASB issued ASU No. 2014-15, *Presentation of Financial Statements - Going Concern (Subtopic 205-40)*. This ASU defines management’s responsibility to evaluate whether there is substantial doubt about an organization’s ability to continue as a going concern and to provide related footnote disclosures. Prior to this ASU, U.S. generally accepted accounting principles lacked guidance about management’s responsibility to evaluate whether there is substantial doubt about the organization’s ability to continue as a going concern or to provide related footnote disclosures and all guidance was included in generally accepted auditing standards (“GAAS”). This guidance is effective for annual periods ending after December 15, 2017. Early adoption is permitted. This standard has been adopted beginning with the reporting period ended December 31, 2016. The adoption of ASU 2014-15 did not have a material effect on the Organization’s consolidated financial statements and related disclosures, although it could have an impact on disclosures in future periods.

Lutheran Social Services of the South, Inc.  
d/b/a Upbring  
Notes to Consolidated Financial Statements

**2. Summary of Significant Accounting Policies (continued)**

In February 2016, the FASB issued ASU No. 2016-02, *Leases (Topic 842)*. This standard requires lessees to recognize a lease liability and a lease asset for all leases, including operating leases, with a term greater than 12 months on its balance sheet. The standard also expands the required quantitative and qualitative disclosures surrounding leases. This standard is effective for annual periods beginning after December 15, 2019. Early adoption is permitted. This standard will be applied using a modified retrospective transition approach for leases existing at, or entered into after, the beginning of the earliest comparative period presented in the financial statements. Management is currently evaluating the effect of these provisions on the LSSS's consolidated financial position and results of operations.

In June 2016, the FASB issued ASU No. 2016-13, *Financial Instruments – Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments*. This standard is intended to improve financial reporting by requiring timelier recording of credit losses on loans and other financial instruments. For trade and other receivables, held-to-maturity debt securities, loans and other instruments, entities will be required to use a new forward-looking “expected loss” model that generally will result in the earlier recognition of allowances for losses. This guidance is effective for annual periods beginning after December 15, 2020. Early adoption is permitted. This standard will be applied as a cumulative-effect adjustment to retained earnings as of the beginning of the first reporting period in which the guidance is adopted. Management is currently evaluating the effect of these provisions on the Organization's financial position and results of operations.

In August 2016, the FASB issued ASU No. 2016-15, *Statement of Cash Flows (Topic 230): Classification of Certain Cash Receipts and Cash Payments — a consensus of the Emerging Issues Task Force*. This standard promotes consistency in the presentation of certain items on the Statement of Cash Flows. In November 2016 the FASB issued ASU No. 2016-18, *Statement of Cash Flows (Topic 230): Restricted Cash (a consensus of the FASB Emerging Issues Task Force)*. This standard clarifies restricted cash and restricted cash equivalents should be presented in the statement of cash flows. These new standards are effective for annual periods beginning after December 15, 2018. Early adoption is permitted. Management is currently evaluating the effect of these provisions on the Company's financial position and results of operations.

**3. Disposal of Assets**

On November 17, 2015, the Organization sold the two senior facilities: Village at Gleannloch Farms and Copperfield Village. The facilities and related assets held by VGF, Upbring, and LPI were sold to a third party for total cash proceeds of \$47,350,000. The assets sold consisted primarily of accounts receivable and property and equipment. The buyer also assumed certain accrued liabilities, refundable deposits, and life lease liabilities. As a part of the sale, the Organization retained its responsibility to provide charity care to VGF residents who were receiving such care as of the sale date. In FY 2016, the Organization recognized a gain on disposal of approximately \$36 million, which is reflected in the accompanying consolidated statements of activities.

Lutheran Social Services of the South, Inc.  
*d/b/a* Upbring  
Notes to Consolidated Financial Statements

**3. Disposal of Assets (continued)**

The following is a summary of the net assets sold as of the closing date of November 17, 2015:

	<b>November 17, 2015</b>
Accounts receivable	\$ 424,370
Property and equipment, net	44,718,541
Total assets	45,142,911
Accrued liabilities	146,607
Refundable deposits and life lease liabilities	32,536,552
Total liabilities	32,683,159
Net disposed assets	\$ 12,459,752

The financial results for VGF presented in the accompanying consolidated statements of activities consisted of the following:

	<b>March 31, 2016</b>
Revenues	\$ 6,998,001
Program expenses	(7,590,647)
Change in net assets	\$ (592,646)

Depreciation expense related to the assets sold in this transaction for the year ended March 31, 2016 was approximately \$1 million. Amortization expense was approximately \$506,000 for the year ended March 31, 2016.

On August 27, 2015, the Organization sold Wedgewood, a senior service facility. The facility and related assets were held by Lubbock Lutheran Retirement Corporation (“LLRC”) and Upbring and were sold to a third party for total proceeds of \$5.1 million. Proceeds consisted of \$4.1 million in cash and \$1 million in notes receivable. The note receivable has a 5 year term, accrues interest at 4.75%, with a balloon payment of \$834,801 due October 5, 2020. The note receivable is included in other long term assets on the accompanying consolidated statements of financial position. The assets sold consisted primarily of property and equipment. In FY 2016, the Organization recognized a gain on sale of approximately \$1.9 million, which is reflected in the accompanying consolidated statements of activities.

The following is a summary of the net assets sold as of the closing date of August 27, 2015:

	<b>August 27, 2015</b>
Property and equipment, net	\$ 3,248,250
Net disposed assets	\$ 3,248,250

Lutheran Social Services of the South, Inc.  
*d/b/a* Upbring  
Notes to Consolidated Financial Statements

**3. Disposal of Assets (continued)**

The financial results for Wedgewood presented in the accompanying consolidated statements of activities consisted of the following:

	<b>March 31, 2016</b>
Revenues	\$ 678,425
Program expenses	(954,762)
Change in net assets	<u>\$ (276,337)</u>

Depreciation expense related to the assets sold in this transaction for the year ended March 31, 2016 was approximately \$80,000.

On December 2, 2016, the Organization sold the senior facility Kruse Village (“KMLV”). The facilities and related assets held by the Organization were sold to a third party for total cash proceeds of \$7,996,711. The assets sold consisted primarily of accounts receivable, and property and equipment. The buyer also assumed certain accrued liabilities, non-refundable and refundable deposits, and life lease liabilities. In FY 2017, the Organization recognized a gain on sale of approximately \$7.8 million, which is reflected in the accompanying consolidated statements of activities.

The following is a summary of the net assets sold as of the closing date of December 2, 2016 and as of March 31, 2016:

	<b>December 2, 2016</b>	<b>March 31, 2016</b>
Accounts receivable	\$ 261,049	\$ 665,959
Property and equipment, net	10,669,796	11,202,761
Total assets	<u>10,930,845</u>	<u>11,868,720</u>
Accrued vacation	73,255	168,732
Deposits and life lease liabilities	10,577,822	9,966,457
Total liabilities	<u>10,651,077</u>	<u>10,135,189</u>
Net sold assets	<u>\$ 279,768</u>	<u>\$ 1,733,531</u>

The financial results for KMLV presented in the accompanying consolidated statements of activities consist of the following:

	<b>March 31, 2017</b>	<b>March 31, 2016</b>
Revenues	\$ 4,260,305	\$ 7,014,914
Program expenses	7,684,717	10,574,564
Change in net assets	<u>\$ (3,424,412)</u>	<u>\$ (3,559,650)</u>

Depreciation expense related to the assets sold in this transaction for the years ended March 31, 2017 and 2016 was approximately \$619,401 and \$924,371, respectively.

Lutheran Social Services of the South, Inc.  
*d/b/a* Upbring  
Notes to Consolidated Financial Statements

**4. Long - Term Debt**

In August 2015, the Organization redeemed outstanding bonds and mortgage with an aggregate principal balance of approximately \$7.5 million. The Organization repaid the outstanding balances with proceeds from the sale of Wedgewood, and the proceeds from the sale of securities that collateralized the mortgage. The Organization recognized a loss on debt retirement of approximately \$318,000, which principally represents the unamortized bond discount and unamortized deferred financing costs.

In November 2015, the Organization redeemed outstanding debt, consisting of Series 2004, Series 2006A, and Series 2012 bonds with an outstanding principal balance of approximately \$48.8 million. The Organization repaid the outstanding balance with proceeds from the sale of the Village at Gleannloch Farms and Copperfield Village, and proceeds from the sale of securities that collateralized the bonds. The Organization recognized a loss on debt retirement of approximately \$3.9 million, which principally represents unamortized deferred financing costs, unamortized bond premium, and interest costs through the bonds initial redemption date of February 2017.

A summary of long-term debt of the Organization is as follows:

	<b>March 31,</b>	
	<b>2017</b>	<b>2016</b>
Demand note payable, accruing interest at 3.2%	\$ 86,661	\$ 121,499
Less current portion of long-term debt	(10,407)	(9,258)
Long-term debt, less current portion	\$ 76,254	\$ 112,241

Maturities of outstanding debt as of March 31, 2017 are as follows:

<u>Years ending March 31,</u>		
2018	\$	10,407
2019		10,751
2020		11,105
2021		11,472
2022 and thereafter		42,926
Total maturities	\$	86,661

**Lubbock Lutheran Retirement Corporation Debt**

*Lubbock Lutheran Retirement Corporation - Mortgage Loan*

LLRC owned a building (the Project) whose primary purpose was for housing the elderly, nursing homes, and/or immediate care facilities located in Lubbock, Texas. LLRC acquired the Project through a mortgage loan payable of \$4,500,000. Interest accrued at 6.29% with fixed monthly payments of principal and interest totaling \$26,541. The mortgage loan commenced April 1, 2002 and matures March 1, 2037. The mortgage loan was insured by the Federal Housing Administration (“FHA”), an organizational unit within HUD, under Section 232 of the National Housing Act of 1934. The mortgage loan was secured on a non-recourse basis pursuant to FHA loan documents. The mortgage loan was fully repaid during the year ended March 31, 2016.

Lutheran Social Services of the South, Inc.  
*d/b/a Upbring*  
Notes to Consolidated Financial Statements

**4. Long Term Debt (continued)**

**The Village at Gleannloch Farms Debt**

*Series 2006A Optional and Mandatory Redemption*

The Series 2006A bonds maturing on and after February 15, 2027 were subject to optional redemption prior to maturity in whole or in part on February 15, 2017 or on any date thereafter, at a redemption price equal to the principal amount of such bonds to be redeemed, together with accrued interest to the date of redemption. As of March 31, 2016, VGF exercised the optional redemption on the Series 2006A bonds.

The Series 2006A bonds were subject to mandatory redemption in whole or in part following the Project completion date at a redemption price equal to the aggregate principal, together with accrued interest to the date of redemption to the extent that surplus construction funds are transferred to the Principal Account of the Bond Fund established pursuant to the bond indenture. For the year ended March 31, 2016, VGF repaid the entire \$31,820,000 balance of the Series 2006A bonds.

**5. Restricted Net Assets**

Temporarily restricted net assets are available for the following purposes:

	<b>March 31,</b>	
	<b>2017</b>	<b>2016</b>
Adoption services	\$ 275,964	\$ 186,470
Elderly care services	51,819	96,978
Children services	8,652,433	8,813,890
Disaster relief services	222,740	277,932
Services for the poor	117,658	56,742
Perpetual trusts held by Lutheran Foundations	502,832	485,845
	<b>\$ 9,823,446</b>	<b>\$ 9,917,857</b>

Permanently restricted net assets are to be held in investment in perpetuity, the income from which is expendable to support as follows:

	<b>March 31,</b>	
	<b>2017</b>	<b>2016</b>
Adoption services	\$ 229,932	\$ 55,027
Elderly care services	152,134	151,916
Children services	3,625,237	3,410,795
Clergy care services	-	240,423
Perpetual trusts held by Lutheran Foundations	2,965,229	2,906,251
	<b>\$ 6,972,532</b>	<b>\$ 6,764,412</b>

Lutheran Social Services of the South, Inc.  
*d/b/a* Upbring  
Notes to Consolidated Financial Statements

**5. Restricted Net Assets (continued)**

Net assets were released from donor restrictions by incurring expenses satisfying the restricted purposes as follows:

	March 31,	
	2017	2016
Program restrictions accomplished:		
Adoption services	\$ 209,257	\$ 208,578
Elderly care services	47,122	7,323
Children services	1,583,990	1,740,561
Services to the poor	62,256	70,018
Administrative	38,219	15,669
Disaster relief	124,521	717,223
Total restrictions released	\$ 2,065,365	\$ 2,759,372

**6. Property, Buildings, and Equipment, Net**

A summary of property, buildings, and equipment is as follows:

	March 31,	
	2017	2016
Land and improvements	\$ 1,195,894	\$ 1,392,205
Buildings and improvements	19,748,625	43,939,546
Equipment	9,416,644	11,219,847
Construction in progress	21,095	19,000
Total	30,382,258	56,570,598
Less accumulated depreciation	(18,728,020)	(33,433,390)
Property, buildings, and equipment, net	\$ 11,654,238	\$ 23,137,208

Depreciation for the years ended March 31, 2017 and 2016 was \$1,618,443 and \$2,997,096, respectively, and is included in “Depreciation and amortization” in the consolidated statements of activities. See Note 3 for further description of property, buildings, and equipment transactions for the years ended March 31, 2017 and 2016.

**7. Related Party Transactions**

Residents at residential treatment centers receive education services provided by Trinity Charter Schools (“TCS”), an unconsolidated related party non-profit organization. For the years ended March 31, 2017 and 2016, TCS leased office and classroom space from the Organization for approximately \$167,000 and \$171,000, respectively.

Lutheran Social Services of the South, Inc.  
*d/b/a* Upbring  
Notes to Consolidated Financial Statements

**7. Related Party Transactions (continued)**

Trinity Place Apartments (“TPA”), a related party under common control, is a Section 202 Program of Housing for the Elderly or Handicapped in conjunction with the Section 8 Housing Assistance Payments Program. The Organization provides certain administrative support for a management fee, but does not have an economic interest in TPA and TPA is, therefore, not a consolidated entity with the Organization. For the years ended March 31, 2017 and 2016, TPA owed LSSS approximately \$9,000 and \$11,000, respectively.

**8. Investments**

Marketable securities, including restricted investments, stated at fair value, include:

	<b>March 31,</b>	
	<b>2017</b>	<b>2016</b>
Cash, short-term investments, and mutual funds	<b>\$ 14,115,004</b>	\$ 11,473,288
Domestic and international equity funds	<b>17,714,800</b>	12,123,555
Municipal bonds	<b>50,739</b>	234,263
Corporate bonds	<b>5,015,581</b>	460,622
International bonds	<b>554,612</b>	–
Mortgage and asset backed bonds	<b>130,672</b>	–
Other	<b>50,265</b>	–
Corporate stocks	–	1,338,914
	<b>\$ 37,631,673</b>	<b>\$ 25,630,642</b>

The following table reflects the fair value measurements for assets whose use is limited and marketable securities, which consist primarily of investments in debt and equity securities. Interest in donor established trust investments, which also consist primarily of debt and equity securities, are held by the Lutheran Foundations.

<b>Description</b>	<b>March 31, 2017</b>	<b>Fair Value Measurements at Reporting Date Using</b>		
		<b>Quoted Prices in Active Markets for Identical Assets (Level 1)</b>	<b>Significant Other Observable Inputs (Level 2)</b>	<b>Significant Unobservable Inputs (Level 3)</b>
Marketable Securities	<b>\$ 37,631,673</b>	<b>\$ 37,631,673</b>	<b>\$ –</b>	<b>\$ –</b>
Interest in Donor Established Trusts	<b>\$ 3,468,061</b>	<b>\$ –</b>	<b>\$ 3,468,061</b>	<b>\$ –</b>

Lutheran Social Services of the South, Inc.  
*d/b/a* Upbring  
Notes to Consolidated Financial Statements

**8. Investments (continued)**

Description	March 31, 2016	Fair Value Measurements at Reporting Date Using		
		Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Marketable Securities	\$ 25,630,642	\$ 25,630,642	\$ —	\$ —
Interest in Donor Established Trusts	\$ 3,423,158	\$ —	\$ 3,423,158	\$ —

Investment income (loss) for assets limited as to use, marketable securities, and interest in donor established trusts consist of the following:

	Years ended March 31,	
	2017	2016
Investment income (loss):		
Interest and dividend income	\$ 964,286	\$ 736,492
Net realized and unrealized gain (loss)	1,956,198	(1,365,299)
Total investment income (loss)	\$ 2,920,484	\$ (628,807)

To obtain the maximum benefit from its investments, the Organization pools certain available funds and allocates investment income based on the ratio of each pool category's ownership interest in the investment portfolio. Investment income is reported net of related expenses such as custodial fees and advisory costs. The related investment expense for the years ended March 31, 2017 and 2016 was \$16,737 and \$56,562, respectively.

**9. Commitments & Contingencies**

The Organization is subject to claims which arise in the ordinary course of its service. In the opinion of management, the amount of ultimate liability with respect to claims will not materially affect the consolidated financial position of LSSS.

The Organization, as an integral part of its operation, has entered into short-term, cancelable lease agreements for equipment and office space in various cities. Additionally, the Organization has entered into non-cancelable lease agreements for equipment and office space in various cities. Lease and maintenance contract expense for all leases, cancelable and non-cancelable, for the years ended March 31, 2017 and 2016 was \$1,559,514 and \$1,558,410, respectively.

Lutheran Social Services of the South, Inc.  
*d/b/a* Upbring  
Notes to Consolidated Financial Statements

**9. Commitments & Contingencies (continued)**

Future minimum lease payments on non-cancelable operating leases are as follows:

<u>Years ending March 31,</u>	
2018	\$ 843,039
2019	318,046
2020	141,632
2021	122,936
2022 and thereafter	936,380
	<u>\$ 2,362,033</u>

**10. Expenses**

A summary of expenses by functional classification is as follows:

	<u>Years ended March 31,</u>	
	<u>2017</u>	<u>2016</u>
Program services:		
Resident services	\$ 6,039,795	\$ 18,142,395
Children services	43,239,341	40,697,248
Services for the poor	1,901,047	1,220,965
Disaster relief	1,307,616	848,227
Total program services	<u>52,487,799</u>	<u>60,908,835</u>
Supporting activities:		
Agency Advancement	3,028,891	1,778,939
Management and general	7,098,718	6,719,494
Transaction related costs	1,007,296	1,316,639
Total expenses	<u>\$ 63,622,704</u>	<u>\$ 70,723,907</u>