FIRST STEPS, INC.

FINANCIAL STATEMENTS AND INDEPENDENT AUDITOR'S REPORT

June 30, 2012 and 2011

FIRST STEPS, INC.

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INDEPENDENT AUDITOR'S REPORT

To the Board of Directors of
First Steps, Inc.
Nashville, Tennessee

We have audited the accompanying statements of financial position of First Steps, Inc. (a not-for-profit organization) as of June 30, 2012 and 2011, and the related statements of activities, functional expenses, and cash flows for the years then ended. These financial statements are the responsibility of the Organization's management. 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 and the standards applicable to financial audits contained in *Government Auditing Standards,* issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and the significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of First Steps, Inc. as of June 30, 2012 and 2011, 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.

In accordance with *Government Auditing Standards*, we have also issued our report September 26, 2012, on our consideration of First Steps, Inc.'s internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our audit.

Our audits were conducted for the purpose of forming an opinion on the basic financial statements as a whole. The accompanying schedule of expenditures of federal awards and state financial assistance is presented for purposes of additional analysis and is not a required part of the basic financial statements. Such information is the responsibility of management and was derived from and relates directly to the underlying accounting and other records used to prepare the financial statements. The information has been subjected to the auditing procedures applied in the audit of the financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the financial statements or to the financial statements themselves, and other additional procedures in accordance with auditing standards generally accepted in the United States of America. In our opinion, the schedule of expenditures of federal awards and state financial assistance is fairly stated in all material respects in relation to the financial statements as a whole.

Frasier, Dean & Howard, PLLC

Nashville, Tennessee
September 26, 2012

FIRST STEPS, INC.
STATEMENTS OF FINANCIAL POSITION
June 30, 2012 and 2011

	2012	2011
Assets		
Current assets:		
Cash and cash equivalents	$ 884,189	$ 494,348
Investments, net of permanently restricted funds	15,939	75,243
Accounts and grants receivable	203,377	245,430
Contributions receivable, current portion	58,194	109,083
Total current assets	1,161,699	924,104
Land, buildings and equipment:		
Land	200,000	200,000
Buildings and improvements	2,199,188	2,184,767
Furniture and equipment	28,322	28,322
	2,427,510	2,413,089
Less: accumulated depreciation	(134,135)	(68,964)
Land, buildings and equipment, net	2,293,375	2,344,125
Contributions receivable, net of current portion	40,467	77,267
Beneficial interest in assets at Community Foundation of Middle Tennessee	14,176	14,251
Investments, permanently restricted	481,001	500,000
Total assets	$ 3,990,718	$ 3,859,747
Liabilities and Net Assets		
Current liabilities:		
Accounts payable	$ 37,559	$ 25,382
Accrued salaries and benefits	70,870	67,094
Note payable, current portion	31,910	21,306
Total current liabilities	140,339	113,782
Note payable, net of current portion	656,747	1,007,943
Total liabilities	797,086	1,121,725
Net assets:		
Unrestricted:		
Undesigated	2,114,280	1,946,638
Board designated	14,176	14,251
Total unrestricted net assets	2,128,456	1,960,889
Temporarily restricted	565,176	277,133
Permanently restricted	500,000	500,000
Total net assets	3,193,632	2,738,022
Total liabilities and net assets	$ 3,990,718	$ 3,859,747

See accompanying notes.

FIRST STEPS, INC.
STATEMENT OF ACTIVITIES
For the Year Ended June 30, 2012

	Unrestricted	Temporarily Restricted	Permanently Restricted	Total
Public support and revenue:				
Department of Education contracts and grants	$ 974,617	$ -	$ -	$ 974,617
Contributions	185,353	603,661	-	789,014
Program service fees	463,063	-	-	463,063
United Way	127,847	-	-	127,847
Special events	60,266	-	-	60,266
Department of Human Services contracts and grants	31,939	-	-	31,939
Other	16,250	-	-	16,250
Change in beneficial interest in assets held by others	277	-	-	277
Investment loss, net	(6,957)	-	-	(6,957)
Net assets released from restrictions	315,618	(315,618)	-	-
Total public support and revenue	2,168,273	288,043	-	2,456,316
Expenses:				
Program services	1,666,078	-	-	1,666,078
Supporting services	239,414	-	-	239,414
Fundraising	95,214	-	-	95,214
Total expenses	2,000,706	-	-	2,000,706
Change in net assets	167,567	288,043	-	455,610
Net assets - beginning of year	1,960,889	277,133	500,000	2,738,022
Net assets - end of year	$ 2,128,456	$ 565,176	$ 500,000	$ 3,193,632

See accompanying notes.

FIRST STEPS, INC.
STATEMENT OF ACTIVITIES
For the Year Ended June 30, 2011

	Unrestricted	Temporarily Restricted	Permanently Restricted	Total
Public support and revenue:				
Department of Education contracts and grants	$ 891,395	$ -	$ -	$ 891,395
Contributions	300,878	248,034	-	548,912
Program service fees	430,976	-	-	430,976
United Way	134,146	-	-	134,146
Investment gain, net	88,373	29,099	-	117,472
Special events	37,629	-	-	37,629
Department of Human Services contracts and grants	24,007	-	-	24,007
In-kind contributions	18,700	-	-	18,700
Change in beneficial interest in assets held by others	14,251	-	-	14,251
Other	709	-	-	709
Loss on disposal of asset	(40,745)	-	-	(40,745)
Net assets released from restrictions	250,000	(250,000)	-	-
Total public support and revenue	2,150,319	27,133	-	2,177,452
Expenses:				
Program services	1,544,269	-	-	1,544,269
Supporting services	276,527	-	-	276,527
Fundraising	114,368	-	-	114,368
Total expenses	1,935,164	-	-	1,935,164
Change in net assets	215,155	27,133	-	242,288
Net assets - beginning of year	1,745,734	250,000	500,000	2,495,734
Net assets - end of year	$ 1,960,889	$ 277,133	$ 500,000	$ 2,738,022

See accompanying notes.

FIRST STEPS, INC.
STATEMENT OF FUNCTIONAL EXPENSES
For the Year Ended June 30, 2012

	Program Services	Supporting Services	Fundraising	Total
Salaries	$1,047,159	$ 98,134	$ 73,926	$1,219,219
Employee benefits	200,351	9,833	9,197	219,381
Total salaries and employee benefits	1,247,510	107,967	83,123	1,438,600
Professional services	88,850	1,243	-	90,093
Travel	65,464	-	-	65,464
Occupancy	39,932	19,174	-	59,106
Interest	-	55,234	-	55,234
Supplies	43,913	2,046	-	45,959
Utilities	36,975	4,908	-	41,883
Conferences	23,199	2,128	-	25,327
Communications	20,123	5,019	-	25,142
Maintenance	19,555	2,721	-	22,276
Insurance	18,307	1,605	-	19,912
Miscellaneous	54	14,724	-	14,778
Special events expenses (rental, postage)	-	-	12,091	12,091
Advertising	485	7,735	-	8,220
Food	5,983	-	-	5,983
Bad debts	2,121	-	-	2,121
Dues	484	1,350	-	1,834
Licenses	1,200	312	-	1,512
Total expenses before depreciation	1,614,155	226,166	95,214	1,935,535
Depreciation	51,923	13,248	-	65,171
Total expenses	$1,666,078	$ 239,414	$ 95,214	$ 2,000,706

See accompanying notes.

FIRST STEPS, INC.
STATEMENT OF FUNCTIONAL EXPENSES
For the Year Ended June 30, 2011

	Program Services	Supporting Services	Fundraising	Total
Salaries	$ 976,770	$ 102,106	$ 91,470	$1,170,346
Employee benefits	203,864	11,391	12,564	227,819
Total salaries and employee benefits	1,180,634	113,497	104,034	1,398,165
Professional services	47,639	6,279	-	53,918
Travel	58,482	8	-	58,490
Occupancy (includes in-kind of $18,700)	57,272	24,237	-	81,509
Interest	-	49,898	-	49,898
Supplies	52,297	5,049	-	57,346
Utilities	32,927	10,951	-	43,878
Conferences	6,013	3,565	-	9,578
Communications	19,231	6,350	-	25,581
Maintenance	12,029	1,233	-	13,262
Insurance	19,744	7,413	-	27,157
Miscellaneous	1,780	10,555	-	12,335
Special events				-
expenses (rental, postage)	-	-	10,334	10,334
Advertising	641	10,445	-	11,086
Food	10,170	-	-	10,170
Bad debts	1,247	-	-	1,247
Dues	536	2,264	-	2,800
Licenses	860	1,124	-	1,984
Total expenses before depreciation	1,501,502	252,868	114,368	1,868,738
Depreciation	42,767	23,659	-	66,426
Total expenses	$1,544,269	$ 276,527	$ 114,368	$ 1,935,164

See accompanying notes.

FIRST STEPS, INC.
STATEMENTS OF CASH FLOWS
For the Years Ended June 30, 2012 and 2011

	2012	2011
Cash flows from operating activities:		
Change in net assets	$ 455,610	$ 242,288
Adjustments to reconcile change in net assets to net cash provided by operating activities:		
Depreciation	65,171	66,426
Loss on disposal of asset	-	40,745
Contribution of stock	(5,170)	(10,110)
Realized and unrealized loss (gain) on investments, net	6,601	(114,731)
Changes in operating assets and liabilities:		
Accounts and grants receivable	42,053	(105,011)
Contributions receivable	87,689	63,650
Beneficial interest in assets held by others	75	(14,251)
Accounts payable	12,177	(3,655)
Accrued salaries and benefits	3,776	(15,226)
Net cash provided by operating activities	667,982	150,125
Cash flows from investing activities:		
Proceeds from sale of investments	117,072	222,189
Purchase of investments	(40,200)	-
Purchase of property and equipment	(14,421)	(1,291,673)
Net cash provided by (used in) investing activities	62,451	(1,069,484)
Cash flows from financing activities:		
Payments on long-term debt	(340,592)	(20,751)
Draws on line of credit	30,000	-
Repayments on line of credit	(30,000)	-
Net cash used in financing activities	(340,592)	(20,751)
Net increase (decrease) in cash and cash equivalents	389,841	(940,110)
Cash and cash equivalents - beginning of year	494,348	1,434,458
Cash and cash equivalents - end of year	$ 884,189	$ 494,348
Supplemental cash flow information:		
Cash paid during the year for interest	$ 55,234	$ 49,898
Supplemental schedule of noncash investing and financing activities:		
Contribution of stock	$ 5,170	$ 10,110
Land and building acquired with escrow deposit	$ -	$ 50,000
Land and building acquired by issuance of note payable	$ -	$ 1,050,000

See accompanying notes.

FIRST STEPS, INC.
NOTES TO FINANCIAL STATEMENTS
June 30, 2012 and 2011

NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Nature of Operations

First Steps, Inc. (the "Organization") is a not-for-profit corporation located in Nashville, Tennessee, that provides education and care for children with special needs and medical conditions alongside their typically developing peers in an inclusive environment, and supports their families.

Financial Statement Presentation

The accompanying financial statements have been prepared on the accrual basis of accounting in accordance with accounting principles generally accepted in the United States of America. Net assets and revenues, expenses and gains and losses are classified based on the existence or absence of donor-imposed restrictions. Accordingly, net assets of the Organization and changes therein are classified and reported as follows:

> Unrestricted net assets – Net assets that are not subject to donor-imposed stipulations.
>
> Temporarily restricted net assets – Net assets subject to donor-imposed stipulations that may or will be met, either by actions of the Organization and/or the passage of time. When a restriction expires, temporarily restricted net assets are reclassified to unrestricted net assets and reported in the statements of activities as net assets released from restrictions.
>
> Permanently restricted net assets – Net assets subject to donor-imposed stipulations that they be maintained permanently by the Organization. Generally the donors of these assets permit the Organization to use all or part of the income on related investments for general or specific purposes.

Cash Equivalents

The Organization considers all highly liquid investments purchased with an original maturity of three months or less to be cash equivalents.

Investments

In accordance with accounting principles generally accepted in the United States of America, investments in marketable securities and all investments in debt securities are reported at their fair values in the statements of financial position. Unrealized gains and losses are included in the statements of activities.

NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Fair Value Measurements

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

> *Level 1* – inputs to the valuation methodology are quoted prices (unadjusted) for identical assets or liabilities in active markets.
>
> *Level 2* – inputs to the valuation methodology include quoted prices for similar assets and liabilities in active markets, and inputs that are observable for the asset and liability, either directly or indirectly, for substantially the full term of the financial instrument.
>
> *Level 3* – inputs to the valuation methodology are unobservable and significant to the fair value measurement.

An asset's or liability's fair value measurement level within the fair value hierarchy is based on the lowest level of any input that is significant to the fair value measurement. Valuation techniques should maximize the use of observable inputs and minimize the use of unobservable inputs.

Following is a description of the valuation methodologies used for assets measured at fair value on a recurring basis:

> *Investments* - Where quoted prices are available in an active market, securities are classified within Level 1 of the valuation hierarchy. Level 1 securities include highly liquid government securities and certain other products, such as mutual funds. If quoted market prices are not available, then fair values are estimated by using pricing models, quoted prices of securities with similar characteristics, or discounted cash flows and are classified within Level 2 of the valuation hierarchy. In certain cases where there is limited activity, or less transparency around inputs to the valuation, securities are classified within Level 3 of the valuation hierarchy.

No changes in the valuation methodologies have been made during the period from July 1, 2010 through June 30, 2012.

NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Fair Value Measurements (Continued)

The methods described above may produce a fair value calculation that may not be indicative of net realizable value or reflective of future fair values. Furthermore, while the Organization believes its valuation methods are appropriate and consistent with that of other market participants, the use of different methodologies or assumptions to determine the fair value of certain financial instruments could result in different fair value measurements at the reporting date. (See Note 2.)

Receivables

Accounts, grants and contributions receivable are reviewed periodically as to their collectability. Management provides for losses on receivables using the allowance method. Based on collection experience and management's review, no allowance for doubtful accounts is considered necessary at June 30, 2012 and 2011.

Land, Buildings and Equipment

Land, buildings and equipment are recorded at cost or, if donated, at the estimated fair market value as of the date of donation. The Organization generally capitalizes an asset if its life is estimated to be one year or greater and the cost is $1,000 or greater. Depreciation is provided using the straight-line basis over the estimated useful lives of the respective assets, which range from 5 - 39 years. Expenditures for repairs and maintenance are charged to expense as incurred.

Income Tax Status

The Organization is a tax-exempt organization under Section 501(c)(3) of the Internal Revenue Code, and the Organization is classified as an organization that is not a private foundation as defined in Section 509(a) of the Internal Revenue Code. Therefore, no provision for federal income taxes is included in the accompanying financial statements.

The Organization follows Financial Accounting Standards Board Accounting Standards Codification ("FASB ASC") guidance concerning the accounting for income taxes recognized in an entity's financial statements. This guidance prescribes a minimum probability threshold that a tax position must meet before a financial statement benefit is recognized. The minimum threshold is defined as a tax position that is more likely than not to be sustained upon examination by the applicable taxing authority, including resolution of any related appeals or litigation processes, based on the technical merits of the position. The tax benefit to be recognized is measured as the largest amount of benefit that is greater than fifty percent likely of being realized upon ultimate settlement. The Organization does not believe there are any uncertain tax positions at June 30, 2012. Additionally, the Organization has not recognized any tax related interest and penalties in the accompanying financial statements. Federal tax years that remain open for examination include the years ended June 30, 2009 through June 30, 2012.

NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Unconditional Promises to Give

Contributions are recognized when the donor makes a promise to give to the Organization that is, in substance, unconditional. Contributions that are restricted by the donor are reported as increases in unrestricted net assets if the restrictions expire in the fiscal year in which the contributions are recognized. All other donor restrictions are reported as increases in temporarily or permanently restricted net assets depending on the nature of the restrictions. When a restriction expires, temporarily restricted net assets are reclassified to unrestricted net assets.

In-Kind Contributions

The Organization records various types of in-kind support including contributed facilities and equipment. Contributions of tangible assets are recognized at fair market value when received. The amounts reflected in the accompanying financial statements as in-kind contributed facilities are offset by like amounts included in expenses.

Contributed professional services are recognized if the services received (a) create or enhance long-lived assets or (b) require specialized skills, are provided by individuals possessing those skills, and would typically need to be purchased if not provided by donation. The Organization receives contributed time from volunteers which does not meet this recognition criteria. Accordingly, the value of this contributed time has not been determined and is not reflected in the accompanying financial statements.

Permanently Restricted Endowment Funds

The Uniform Prudent Management Institutional Funds Act ("UPMIFA") was enacted in Tennessee effective July 1, 2007. The FASB ASC provides guidance on the net asset classification of donor-restricted endowment funds for a not-for-profit organization that is subject to an enacted version of UPMIFA. It also requires disclosure of a description of the governing board's interpretation of the law that underlies the organization's net asset classification of donor-restricted endowment funds, a description of the organization's policies for the appropriation of endowment assets for expenditures (its endowment spending policies), a description of the organization's endowment investment policies, and additional disclosures not previously required. (See Note 7.)

Functional Allocation of Expenses

The costs of providing program services and supporting services have been summarized on a functional basis in the statements of activities. Accordingly, certain costs have been allocated among the programs and supporting services benefited based upon estimates by management.

NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America 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 the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Subsequent Events

The Organization evaluated subsequent events through September 26, 2012 when these financial statements were available to be issued. The Organization is not aware of any significant events that occurred subsequent to the statement of financial position date but prior to the filing of this report that would have a material impact on the financial statements.

NOTE 2 – INVESTMENTS

The following table sets forth the Organization's major categories of assets measured at fair value on a recurring basis, by level within the fair value hierarchy, as of June 30, 2012:

	Fair Value	Level 1 Inputs	Level 2 Inputs	Level 3 Inputs
Investments in securities:				
Money market funds	$ 5,132	$ 5,132	$ -	$ -
Fixed income investments-domestic	210,944	15,939	195,005	-
Equity investments:				
Small/Mid Cap U.S. Equity fund	56,754	-	56,754	-
Large Cap U.S. Equity fund	114,587	-	114,587	-
International Equity fund	109,523	-	109,523	-
Total investment in securities	$ 496,940	$ 21,071	$ 475,869	$ -

NOTE 2 – INVESTMENTS (Continued)

The following table sets forth the Organization's major categories of assets measured at fair value on a recurring basis, by level within the fair value hierarchy, as of June 30, 2011:

	Fair Value	Level 1 Inputs	Level 2 Inputs	Level 3 Inputs
Investments in securities:				
Certificate of deposit	$ 15,000	$ 15,000	$ -	$ -
Fixed income investments-domestic	229,859	31,943	197,916	-
Equity investments:				
Small/Mid Cap U.S. Equity fund	70,508	-	70,508	-
Large Cap U.S. Equity fund	129,784	-	129,784	-
International Equity fund	130,092	-	130,092	-
Total investment in securities	$ 575,243	$ 46,943	$ 528,300	$ -

The following schedule summarizes the investment returns for the years ended June 30:

	2012	**2011**
Interest and dividends, net of investment fees	$ (356)	$ 2,741
Realized and unrealized gains (losses), net	(6,601)	114,731
Investment (loss) gain	$ (6,957)	$ 117,472

NOTE 3 – CONTRIBUTIONS RECEIVABLE

Contributions receivable consist of the following at June 30:

	2012	**2011**
Capital campaign pledges	$ 98,661	$ 186,350
Less allowance for doubtful accounts	-	-
	$ 98,661	$ 186,350
Receivable in less than one year	$ 58,194	$ 109,083
Receivable in one to five years	40,467	77,267
	$ 98,661	$ 186,350

NOTE 4 – ENDOWMENT FUND AT COMMUNITY FOUNDATION OF MIDDLE TENNESSEE

The Community Foundation of Middle Tennessee (the “Foundation”) maintains investments on behalf of the Organization. The Foundation has ultimate authority and control over the investments. However, the Organization is the beneficiary of these funds and receives distributions of income, subject to the Community Foundation’s spending policy. The investments result from unrestricted amounts transferred by the Organization to the Foundation in prior years. The Organization has recorded the related asset “Beneficial interest in assets at Community Foundation of Middle Tennessee” in the accompanying statements of financial position.

NOTE 5 – NOTE PAYABLE

On July 13, 2010, the Organization acquired a building to serve as its principal facility for programs and administration at a cost of $2,225,000. The purchase was financed through the issuance of a $1,050,000 promissory note payable to a financial institution that required interest at 5.38%, with monthly principal and interest payments of $6,423 through July 2015, at which time all remaining principal and interest was due. During 2012, the Organization executed a change in terms agreement effective May 16, 2012, which extended the maturity date to May 13, 2027 and reduced the interest rate to 4.90%. Amounts outstanding under this debt arrangement were $688,657 and $1,029,249 at June 30, 2012 and 2011, respectively. The note is collateralized by land and building.

Interest expense for the years ended June 30, 2012 and 2011 was $55,234 and $49,898, respectively.

Following is a summary of future principal maturities under the note payable agreement:

Years ending June 30,	
2013	$ 31,910
2014	33,532
2015	35,236
2016	36,950
2017	38,905
Thereafter	512,124
Total principal maturities	688,657
Less current portion	(31,910)
Long-term obligations	$ 656,747

NOTE 6 – LINE OF CREDIT

At June 30, 2012 and 2011, the Organization had available a $100,000 revolving line-of-credit with a bank. Initially, payments of interest only at the prime rate plus 0.75%, with a minimum rate of 4.00%, will be due monthly. During 2012, the arrangement was extended through November 1, 2012 and the minimum interest rate was revised to 5.50%. No borrowings were outstanding at June 30, 2012 and 2011.

NOTE 7 – NET ASSETS

Temporarily restricted net assets are available for the following purposes at June 30:

	2012	2011
Capital campaign	$ 98,661	$ 96,034
Therapy program	466,515	-
Other specified projects	-	2,000
Building purchase and debt retirement	-	150,000
Investment earnings on endowment	-	29,099
	$ 565,176	$ 277,133

Permanently restricted net assets consist of the following endowment funds at June 30:

	2012	2011
Investments to be held for production of income:		
General endowment	$ 500,000	$ 500,000

The interest earned on permanently restricted net assets is available to the Organization on an unrestricted basis.

The Organization's endowment consists of a gift from Massey Foundation of $500,000 which was received in 1991. The donor stipulated that only the income from this endowment gift should be available directly or indirectly for operations of the Organization. The initial gift and earnings thereon are maintained in the Organization's brokerage account. As required by accounting principles generally accepted in the United States, net assets associated with endowment funds are classified and reported based upon the existence or absence of donor-imposed restrictions. Additional endowment funds consist of assets designated by the Board of Directors which are held in investment accounts. As required by generally accepted accounting principles, net assets associated with endowment funds are classified and reported based upon the existence or absence of donor-imposed restrictions.

The Board of Directors has interpreted UPMIFA as requiring that the Organization classify as permanently restricted net assets a) the original value of donor-restricted gifts to the permanent endowment, b) the original value of subsequent donor-restricted gifts to the permanent endowment, and c) accumulations (interest, dividends, capital gain/loss) to the permanent endowment made in accordance with the direction of the applicable donor gift instrument at the time the accumulation is 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 approved for expenditure by the Organization in a manner consistent with the standard of prudence prescribed by UPMIFA.

FIRST STEPS, INC.
NOTES TO FINANCIAL STATEMENTS (Continued)
June 30, 2012 and 2011

NOTE 7 – NET ASSETS (Continued)

Endowment Net Asset Composition by Type of Fund as of June 30, 2012:

	Unrestricted	Temporarily Restricted	Permanently Restricted	Total
Board designated endowment fund	$ 14,176	$ -	$ -	$ 14,176
Donor restricted endowment funds	(18,999)	-	500,000	481,001
Total endowment	$ (4,823)	$ -	$ 500,000	$ 495,177

Changes in Endowment Net Assets for the fiscal year ended June 30, 2012:

	Unrestricted	Temporarily Restricted	Permanently Restricted	Total
Endowment net assets, beginning of year	$ 14,251	$ 29,099	$ 500,000	$ 543,350
Withdrawals and other	-	(29,099)	-	(29,099)
Investment return:				
Net depreciation (realized and unrealized)	(19,074)	-	-	(19,074)
Endowment net assets, end of year	$ (4,823)	$ -	$ 500,000	$ 495,177

Endowment Net Asset Composition by Type of Fund as of June 30, 2011:

	Unrestricted	Temporarily Restricted	Permanently Restricted	Total
Board designated endowment fund	$ 14,251	$ -	$ -	$ 14,251
Donor restricted endowment funds	-	29,099	500,000	529,099
Total endowment	$ 14,251	$ 29,099	$ 500,000	$ 543,350

NOTE 7 – NET ASSETS (Continued)

Changes in Endowment Net Assets for the fiscal year ended June 30, 2011:

	Unrestricted	Temporarily Restricted	Permanently Restricted	Total
Endowment net assets, beginning of year	$ -	$ -	$ 500,000	$ 500,000
Contributions and other	14,251	-	-	14,251
Investment return:				
Net appreciation (realized and unrealized)	-	29,099	-	29,099
Endowment net assets, end of year	$ 14,251	$ 29,099	$ 500,000	$ 543,350

From time to time, the fair value of assets associated with individual donor-restricted endowment funds may fall below the level that the donor or UPMIFA requires the Organization to retain as a fund of perpetual duration.

The Organization has adopted investment and spending policies for endowment assets that attempt to provide a predictable stream of funding to programs supported by its endowment while seeking to maintain the purchasing power of the endowment assets. Under this policy, as approved by the Board of Directors, the endowment assets are to be invested in cash and cash equivalents, fixed income, equities and publicly traded real estate. In order to ensure proper levels of diversification of investments, equity and fixed income investments are each capped at 50% of total investments. To satisfy its long-term rate-of-return objectives, the Organization 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).

The Organization has a policy of distributing annually 0%-5% of a three-year moving average from the endowment fund. This distribution is made with the understanding that the spending rate plus inflation will not normally exceed the total return from the investment. Any spending will be approved by the Finance Committee and the Board of Directors. Specific agreements with donors for income taken relative to their specific endowment gifts are exempted.

NOTE 8 – IN-KIND CONTRIBUTIONS

The Organization received total in-kind contributions of $0 and $18,700, respectively, during the years ended June 30, 2012 and 2011, which was comprised of in-kind rent.

NOTE 9 – PENSION PLAN

The Organization had a simplified employee pension plan covering all personnel who are at least 21 years old and performed services for the Organization for at least one year. Pension expense for the year ended June 30, 2011 was $12,104. The contribution to the plan was equal to 2% of eligible employees' compensation in 2011. As of June 30, 2011, the Organization ceased making contributions into this pension plan.

Effective July 1, 2011, the Organization instituted a 401(k) profit sharing plan covering all personnel who are at least 21 years old and performed services for the Organization for at least three months. The Organization makes matching contributions equal to 100% of the salary reduction contributions made by employees up to 2% of employees' compensation. Retirement expense for the year ended June 30, 2012 was $12,448.

NOTE 10 – CONCENTRATIONS

The Organization receives a significant amount of its support through grants from the Tennessee Department of Education ("DOE"). In 2012 and 2011, the DOE accounted for approximately 40% and 41%, respectively, of the Organization's total public support and revenues. A significant reduction in the level of this support, if this were to occur, could have an adverse effect on the Organization's programs and services. The Organization had grants receivable due from DOE of $195,494 and $224,562 at June 30, 2012 and 2011, respectively.

Financial instruments that potentially subject the Organization to credit risk consist principally of cash and cash equivalents, unconditional promises to give, and investments. The Organization had cash deposits in excess of federally insured limits as of June 30, 2012.

NOTE 11 – OPERATING LEASE COMMITMENTS

During fiscal years 2012 and 2011, the Organization maintained lease agreements accounted for as operating leases. Rent expense for the years ended June 30, 2012 and 2011 was $20,527 and $13,262, respectively. Future minimum lease payments required under operating leases that have initial or remaining noncancelable lease terms in excess of one year as of June 30, 2012 are as follows:

Year ended June 30,	
2013	$ 18,820
2014	13,564
2015	13,564
2016	12,913
	$ 58,861

SUPPLEMENTAL INFORMATION

FIRST STEPS, INC.
SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS AND STATE FINANCIAL ASSISTANCE
For the Year Ended June 30, 2012

Federal Grantor / Pass-Through Grantor	CFDA Number	State Contract Number	Receivable at June 30, 2011	Cash Receipts	Expenditures/ Revenue Recognized	Receivable at June 30, 2012
Federal Awards						
State of Tennessee, Department of Human Services						
USDA Child and Adult Care Food Program	10.558	03-47-60382-004	$ 326	$ 3,951	$ 3,985	$ 360
State of Tennessee, Department of Education						
Special Education - Grants for Infants and Families - Recovery Act	84.393A	DGA-C000008	130,324	130,324	-	-
Special Education - Grants for Infants and Families - Recovery Act	84.181A	DP1234551	-	54,267	55,997	1,730
Special Education - Grants for Infants and Families - Recovery Act	84.181A	DG12-C000008	-	87,212	87,212	-
Total CFDA 84.181A			-	141,479	143,209	1,730
Total Federal Awards			130,650	275,754	147,194	2,090
State Financial Assistance						
State of Tennessee, Department of Education						
TN Early Intervention Services	n/a	DGA-C000008	94,238	94,238	-	-
TN Early Intervention Services	n/a	DG12-C000008	-	637,644	831,408	193,764
Total Department of Education			94,238	731,882	831,408	193,764
State of Tennessee, Department of Human Services						
Families First Certificate Program	n/a	n/a	1,666	26,412	27,954	3,208
Total State Financial Assistance			95,904	758,294	859,362	196,972
Total Federal Awards and State Financial Assistance			$ 226,554	$ 1,034,048	$ 1,006,556	$ 199,062

Basis of Presentation:

Note: The accompanying Schedule of Expenditures of Federal Awards and State Financial Assistance summarizes the expenditures of First Steps, Inc. under programs of the federal and state governments for the year ended June 30, 2012. The schedule is presented using the accrual basis of accounting. Grant revenues are recognized when the related program expenditures are incurred.

REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING AND ON COMPLIANCE AND OTHER MATTERS BASED ON AN AUDIT OF FINANCIAL STATEMENTS PERFORMED IN ACCORDANCE WITH *GOVERNMENT AUDITING STANDARDS*

To the Board of Directors of
First Steps, Inc.

We have audited the financial statements of First Steps, Inc. (a not-for-profit organization) as of and for the year ended June 30, 2012, and have issued our report thereon dated September 26, 2012. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

Internal Control Over Financial Reporting

Management of the Organization is responsible for establishing and maintaining effective internal control over financial reporting. In planning and performing our audit, we considered the Organization's internal control over financial reporting as a basis for designing our auditing procedures for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Organization's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of the Organization's internal control over financial reporting.

A *deficiency in internal control* exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct misstatements on a timely basis. A *material weakness* is a deficiency, or a combination of deficiencies, in internal control such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis.

Our consideration of internal control over financial reporting was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control over financial reporting that might be deficiencies, significant deficiencies, or material weaknesses. We did not identify any deficiencies in internal control over financial reporting that we consider to be material weaknesses, as defined above. However, we identified the following deficiency in internal control over financial reporting, that we consider to be a significant deficiency in internal control over financial reporting:

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Financial Reporting

The Organization currently relies on its independent auditor to assist in making final adjustments to its internal accounting records and prepare its audited financial statements with full disclosures in accordance with generally accepted accounting principles. It should be noted that adjustments for 2012 primarily related to the capital campaign contributions receivable.

Management response: Management has historically relied on the auditors to assemble the financial statements using data supplied by the Director of Finance. However, we believe that our knowledge and experience enables us to review the report and understand it fully. The Director of Finance will work closely with the auditors to develop a year end process that reduces the likelihood of audit adjustments.

A *significant deficiency* is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the Organization's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit and, accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards.*

We noted certain matters that we reported to management of the Organization in a separate letter dated September 26, 2012.

The Organization's response to the finding identified in our audit is described above. We did not audit the Organization's response and, accordingly, we express no opinion on it.

This report is intended solely for the information and use of the Board of Directors, management, others within the Organization, and the State of Tennessee and is not intended to be and should not be used by anyone other than these specified parties.

Frasier, Dean + Howard, PLLC

Nashville, Tennessee
September 26, 2012