

**EASTER SEALS TENNESSEE, INC.
AND AFFILIATE**

**CONSOLIDATED FINANCIAL STATEMENTS AND
INDEPENDENT AUDITOR'S REPORT**

August 31, 2007 and 2006

**EASTER SEALS TENNESSEE, INC.
AND AFFILIATE**

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INDEPENDENT AUDITOR'S REPORT

To the Board of Directors of
Easter Seals Tennessee, Inc. and Affiliate
Nashville, Tennessee

We have audited the accompanying consolidated statements of financial position of Easter Seals Tennessee, Inc. and Affiliate (a nonprofit organization) as of August 31, 2007 and 2006, and the related consolidated 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. 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 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 consolidated financial statements referred to above present fairly, in all material respects, the financial position of Easter Seals Tennessee, Inc. and affiliate as of August 31, 2007 and 2006, and the changes in their net assets and their cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

The accompanying consolidated financial statements have been prepared assuming that the Organization will continue as a going concern. As discussed in Note 14 to the financial statements, the Organization has a working capital deficiency of \$11,704,898 at August 31, 2007, and has incurred a significant decrease in net assets. Additionally, required debt service payments to a lender have not been made since December 2004. Most of the Organizations' debt obligations contain cross default provisions. The failure to make required debt payments during 2007 and 2006 could have the effect of making most of the Organizations' debt obligations callable by the lenders. These conditions raise substantial doubt about the Organization's ability to continue as a going concern. Management's plans regarding those matters also are described in Note 14. The consolidated financial statements do not include any adjustments that might result from the outcome of this uncertainty.

Frasier, Dean & Howard, PLLC

January 29, 2008
(May 2, 2008 as to Note 17)

EASTER SEALS TENNESSEE, INC. AND AFFILIATE
CONSOLIDATED STATEMENTS OF FINANCIAL POSITION
August 31, 2007 and 2006

	<u>2007</u>	<u>2006</u>
Assets		
Current assets:		
Cash and cash equivalents	\$ 277,181	\$ 234,516
Accounts receivable, net	925,223	893,595
Prepaid expenses	39,698	34,853
Contributions receivable, net	<u>-</u>	<u>33,155</u>
Total current assets	1,242,102	1,196,119
Contributions receivable, net	-	16,179
Property and equipment, net	1,203,641	7,981,193
Real estate held for sale	5,500,000	-
Loan costs, net of accumulated amortization of \$72,627 and \$61,627, respectively	<u>146,869</u>	<u>157,869</u>
Total assets	<u><u>\$ 8,092,612</u></u>	<u><u>\$ 9,351,360</u></u>
Liabilities and Net Assets (Deficit)		
Current liabilities:		
Accounts payable	\$ 290,370	\$ 386,045
Accrued expenses	620,430	681,089
Accrued interest	1,095,433	655,364
Deferred revenue	1,314,963	525,024
Notes payable - line of credit	1,149,794	548,176
Current portion of notes payable	7,532,632	7,444,904
Accrued pension liability	<u>943,378</u>	<u>333,038</u>
Total current liabilities	12,947,000	10,573,640
Accrued expenses - noncurrent	82,886	95,734
Notes payable, net of current portion	<u>1,389,910</u>	<u>1,047,090</u>
Total liabilities	<u>14,419,796</u>	<u>11,716,464</u>
Net assets (deficit):		
Unrestricted	(6,327,184)	(2,414,438)
Temporarily restricted	<u>-</u>	<u>49,334</u>
Total net deficit	<u>(6,327,184)</u>	<u>(2,365,104)</u>
Total liabilities and net deficit	<u><u>\$ 8,092,612</u></u>	<u><u>\$ 9,351,360</u></u>

See accompanying notes.

EASTER SEALS TENNESSEE, INC. AND AFFILIATE
CONSOLIDATED STATEMENT OF ACTIVITIES
For the Year Ended August 31, 2007

	<u>Unrestricted</u>	<u>Temporarily Restricted</u>	<u>Total</u>
Public support and revenue:			
Public support:			
Contributions	\$ 879,671	\$ -	\$ 879,671
Special events	323,052	-	323,052
Less: direct benefit costs	<u>(105,175)</u>	<u>-</u>	<u>(105,175)</u>
Total public support	<u>1,097,548</u>	<u>-</u>	<u>1,097,548</u>
Revenue:			
Government fees and grants	6,009,234	-	6,009,234
Program service fees	467,546	-	467,546
Child development center	267,817	-	267,817
Camp rental	146,211	-	146,211
Membership fees	133,704	-	133,704
Contract services	65,528	-	65,528
Other	32,660	-	32,660
Investment income, net	<u>1,724</u>	<u>-</u>	<u>1,724</u>
Total revenue	<u>7,124,424</u>	<u>-</u>	<u>7,124,424</u>
Net assets released from restrictions:			
Expiration of time restrictions	<u>49,334</u>	<u>(49,334)</u>	<u>-</u>
Total public support and revenue	<u>8,271,306</u>	<u>(49,334)</u>	<u>8,221,972</u>
Expenses and losses:			
Program services:			
Direct services	8,674,595	-	8,674,595
Public health education	<u>21,755</u>	<u>-</u>	<u>21,755</u>
Total program services	<u>8,696,350</u>	<u>-</u>	<u>8,696,350</u>
Supporting services:			
Management and general	1,062,791	-	1,062,791
Fundraising	<u>290,406</u>	<u>-</u>	<u>290,406</u>
Total supporting services	<u>1,353,197</u>	<u>-</u>	<u>1,353,197</u>
National program fee	<u>164,179</u>	<u>-</u>	<u>164,179</u>
Change in net assets from operating activities	(1,942,420)	(49,334)	(1,991,754)
Other expenses:			
Change in funded status of defined benefit pension plan	619,547	-	619,547
Asset impairment writedown	<u>1,350,779</u>	<u>-</u>	<u>1,350,779</u>
Total other expenses	<u>1,970,326</u>	<u>-</u>	<u>1,970,326</u>
Change in net assets	(3,912,746)	(49,334)	(3,962,080)
Net assets (deficit) at beginning of year	<u>(2,414,438)</u>	49,334	<u>(2,365,104)</u>
Net assets (deficit) at end of year	<u>\$ (6,327,184)</u>	<u>\$ -</u>	<u>\$ (6,327,184)</u>

See accompanying notes.

EASTER SEALS TENNESSEE, INC. AND AFFILIATE
CONSOLIDATED STATEMENT OF ACTIVITIES
For the Year Ended August 31, 2006

	Unrestricted	Temporarily Restricted	Total
Public support and revenue:			
Public support:			
Contributions	\$ 736,090	\$ -	\$ 736,090
Donated land	330,000	-	330,000
Special events	322,077	-	322,077
Less: direct benefit costs	(74,175)	-	(74,175)
Total public support	<u>1,313,992</u>	<u>-</u>	<u>1,313,992</u>
Revenue:			
Government fees and grants	7,706,381	-	7,706,381
Program service fees	1,267,507	-	1,267,507
Child development center	414,247	-	414,247
Camp rental	188,378	-	188,378
Membership fees	135,965	-	135,965
Contract services	118,668	-	118,668
Other	25,182	-	25,182
Investment income, net	<u>1,191</u>	<u>-</u>	<u>1,191</u>
Total revenue	<u>9,857,519</u>	<u>-</u>	<u>9,857,519</u>
Net assets released from restrictions:			
Expiration of time restrictions	<u>57,005</u>	<u>(57,005)</u>	<u>-</u>
Total public support and revenue	<u>11,228,516</u>	<u>(57,005)</u>	<u>11,171,511</u>
Expenses and losses:			
Program services:			
Direct services	10,467,867	-	10,467,867
Public health education	<u>22,199</u>	<u>-</u>	<u>22,199</u>
Total program services	<u>10,490,066</u>	<u>-</u>	<u>10,490,066</u>
Supporting services:			
Management and general	806,161	-	806,161
Fundraising	<u>392,724</u>	<u>-</u>	<u>392,724</u>
Total supporting services	<u>1,198,885</u>	<u>-</u>	<u>1,198,885</u>
National program fee	<u>161,520</u>	<u>-</u>	<u>161,520</u>
Change in net assets from operating activities	(621,955)	(57,005)	(678,960)
Other expenses:			
Provision for loss on uncollectible pledges	<u>-</u>	<u>70,000</u>	<u>70,000</u>
Change in net assets	(621,955)	(127,005)	(748,960)
Net assets at beginning of year	<u>(1,792,483)</u>	<u>176,339</u>	<u>(1,616,144)</u>
Net assets at end of year	<u>\$ (2,414,438)</u>	<u>\$ 49,334</u>	<u>\$ (2,365,104)</u>

See accompanying notes.

EASTER SEALS TENNESSEE, INC. AND AFFILIATE
CONSOLIDATED STATEMENT OF FUNCTIONAL EXPENSES
For the Year Ended August 31, 2007

	Program Services			Supporting Services			National Program Fee	Total Expenses
	Direct Services	Public Health Education	Total	Management and General	Fundraising	Total		
Salaries and related expenses	\$ 6,641,785	\$ 6,040	\$ 6,647,825	\$ 165,765	\$ 233,515	\$ 399,280	\$ -	\$ 7,047,105
Interest	-	-	-	709,819	-	709,819	-	709,819
Professional fees	431,367	697	432,064	37,432	13,956	51,388	-	483,452
Depreciation and amortization	434,675	5,399	440,074	32,794	9,548	42,342	-	482,416
Travel and transportation	200,808	84	200,892	35,098	2,145	37,243	-	238,135
Insurance	172,307	1,386	173,693	9,043	2,795	11,838	-	185,531
Utilities	160,395	2,458	162,853	2,876	5,628	8,504	-	171,357
National program fee	-	-	-	-	-	-	164,179	164,179
Building and grounds maintenance	142,082	2,434	144,516	6,883	4,321	11,204	-	155,720
Supplies	137,118	-	137,118	4,198	3,455	7,653	-	144,771
Telephone	83,626	1,023	84,649	8,938	1,564	10,502	-	95,151
Occupancy	76,650	-	76,650	-	-	-	-	76,650
Specific assistance	69,809	-	69,809	-	-	-	-	69,809
Rental and maintenance of equipment	57,771	1,552	59,323	-	6,018	6,018	-	65,341
Miscellaneous	38,523	-	38,523	8,107	847	8,954	-	47,477
Letter of credit fees	-	-	-	34,898	-	34,898	-	34,898
Advertising	12,562	98	12,660	75	-	75	-	12,735
Postage and shipping	4,899	25	4,924	1,428	1,744	3,172	-	8,096
Printing and publications	2,532	454	2,986	1,100	3,945	5,045	-	8,031
Conferences, conventions and meetings	4,234	-	4,234	2,578	186	2,764	-	6,998
Membership and support payments	3,452	105	3,557	1,759	739	2,498	-	6,055
Total functional expenses	\$ 8,674,595	\$ 21,755	\$ 8,696,350	\$ 1,062,791	\$ 290,406	\$ 1,353,197	\$ 164,179	\$ 10,213,726

See accompanying notes

EASTER SEALS TENNESSEE, INC. AND AFFILIATE
CONSOLIDATED STATEMENT OF FUNCTIONAL EXPENSES
For the Year Ended August 31, 2006

	Program Services			Supporting Services			National Program Fee	Total Expenses
	Direct Services	Public Health Education	Total	Management and General	Fundraising	Total		
Salaries and related expenses	\$ 7,995,553	\$ 6,163	\$ 8,001,716	\$ 74,033	\$ 339,950	\$ 413,983	\$ -	\$ 8,415,699
Interest	-	-	-	597,564	-	597,564	-	597,564
Depreciation and amortization	399,019	5,509	404,528	40,971	13,511	54,482	-	459,010
Professional fees	406,435	711	407,146	22,389	1,540	23,929	-	431,075
Insurance	339,151	1,414	340,565	1,796	7,557	9,353	-	349,918
Travel and transportation	300,185	86	300,271	2,444	2,087	4,531	-	304,802
Supplies	198,432	-	198,432	3,728	2,468	6,196	-	204,628
Utilities	176,257	2,508	178,765	2,205	3,972	6,177	-	184,942
National program fee	-	-	-	-	-	-	161,520	161,520
Building and grounds maintenance	131,773	2,484	134,257	3,145	3,936	7,081	-	141,338
Occupancy	106,394	-	106,394	-	-	-	-	106,394
Bad debt expense	89,303	-	89,303	866	-	866	-	90,169
Telephone	86,090	1,044	87,134	1,082	1,791	2,873	-	90,007
Rental and maintenance of equipment	78,613	1,584	80,197	-	5,647	5,647	-	85,844
Specific assistance	75,897	-	75,897	-	-	-	-	75,897
Letter of credit fees	-	-	-	52,733	-	52,733	-	52,733
Miscellaneous	32,057	-	32,057	1,097	52	1,149	-	33,206
Printing and publications	17,853	463	18,316	844	3,895	4,739	-	23,055
Postage and shipping	13,770	26	13,796	862	3,729	4,591	-	18,387
Membership and support payments	6,269	107	6,376	195	2,402	2,597	-	8,973
Conferences, conventions and meetings	8,467	-	8,467	207	187	394	-	8,861
Advertising	6,117	100	6,217	-	-	-	-	6,217
Broadcast costs	232	-	232	-	-	-	-	232
Total functional expenses	\$10,467,867	\$ 22,199	\$10,490,066	\$806,161	\$392,724	\$1,198,885	\$161,520	\$11,850,471

See accompanying notes.

EASTER SEALS TENNESSEE, INC. AND AFFILIATE
CONSOLIDATED STATEMENTS OF CASH FLOWS
For the Years Ended August 31, 2007 and 2006

	<u>2007</u>	<u>2006</u>
Cash flows from operating activities:		
Change in net assets	\$ (3,962,080)	\$ (748,960)
Adjustments to reconcile change in net assets to net cash used in operating activities:		
Provision for uncollectible accounts and contractual allowance	-	(124,869)
Depreciation and amortization	482,416	459,010
Net gain on property disposal	(28,510)	(10,836)
Receipt of donated land	-	(330,000)
Asset impairment writedown	1,350,779	-
Changes in operating assets and liabilities:		
Accounts receivable	(31,628)	257,831
Contributions receivable	49,334	146,306
Prepaid expenses	(4,845)	7,333
Accounts payable	(95,675)	10,169
Accrued expenses	366,562	308,557
Deferred revenue	789,939	14,647
Accrued pension liability	610,340	8,100
Net cash used in operating activities	<u>(473,368)</u>	<u>(2,712)</u>
Cash flows from investing activities:		
Purchases of property and equipment	(24,805)	(42,540)
Proceeds from disposal of property and equipment	29,150	10,978
Net cash provided by (used in) investing activities	<u>4,345</u>	<u>(31,562)</u>
Cash flows from financing activities:		
Proceeds from borrowings	601,588	7,173,240
Payments on notes payable	(89,900)	(6,987,006)
Net cash provided by financing activities	<u>511,688</u>	<u>186,234</u>
Net increase in cash and cash equivalents	42,665	151,960
Cash and cash equivalents at beginning of year	234,516	82,556
Cash and cash equivalents at end of year	<u>\$ 277,181</u>	<u>\$ 234,516</u>
Supplemental disclosure of cash flow information:		
Interest paid	<u>\$ 259,905</u>	<u>\$ 203,523</u>
Non-cash investing and financing activity:		
Receipt of donated land	<u>\$ -</u>	<u>\$ 330,000</u>
Property and equipment purchases financed with borrowings	<u>\$ 520,478</u>	<u>\$ -</u>

See accompanying notes.

EASTER SEALS TENNESSEE, INC. AND AFFILIATE
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
August 31, 2007 and 2006

NOTE 1 – NATURE OF ACTIVITIES AND SIGNIFICANT ACCOUNTING POLICIES

Easter Seals Tennessee, Inc. and Affiliate (“Easter Seals”) is a not-for-profit organization organized in Nashville, Tennessee in 1923. Easter Seals provides programs and services to children and adults with disabilities throughout Tennessee. Easter Seals owns a membership interest in Easter Seals West Tennessee, LLC (“West”). West was formed in 2004 in connection with obtaining a credit facility secured by certain assets (primarily accounts receivable and equipment) related to Easter Seals West Tennessee operations. West operates as a single member limited liability company wholly owned by Easter Seals.

Principles of Consolidation

The financial statements include the accounts of Easter Seals and West. All significant inter-entity transactions and balances have been eliminated in consolidation.

Basis of Presentation

Easter Seals has adopted Statement of Financial Accounting Standards (“SFAS”) No. 117, *Financial Statements of Not-for-Profit Organizations*. Under SFAS No. 117, Easter Seals is required to report information regarding its financial position and activities according to three classes of net assets: unrestricted net assets, temporarily restricted net assets and permanently restricted net assets. In addition, Easter Seals is required to present a statement of cash flows. Net assets of Easter Seals are presented 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 Easter Seals 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 Easter Seals. Generally, donors of these assets may permit Easter Seals to use all or part of the income earned for general or specific purposes. Easter Seals currently has no permanently restricted net assets.

Cash and Cash Equivalents

For purposes of the consolidated statements of cash flows, Easter Seals considers all cash funds, cash bank accounts and highly liquid debt instruments with an original maturity when purchased of three months or less to be cash and cash equivalents.

EASTER SEALS TENNESSEE, INC. AND AFFILIATE
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
August 31, 2007 and 2006

NOTE 1 – NATURE OF ACTIVITIES AND SIGNIFICANT ACCOUNTING POLICIES (Continued)

Accounts Receivable

Accounts receivable are carried net of allowance for uncollectible accounts and contractual allowances. The allowance for uncollectible accounts is based on historical experience coupled with a review of the current status of existing receivables. The contractual allowance is computed based upon Easter Seals' historical percentage of insurance adjustments and collections from patients.

Property and Equipment

Easter Seals generally capitalizes an asset if its life is estimated to be one year or greater and the cost is \$500 or greater. Property and equipment are recorded at cost when purchased or at fair value as of the date contributed. Depreciation is provided on the straight-line method over the estimated useful lives of the respective assets.

Loan Costs

Costs relating to the issuance of bond indebtedness and debt refinancing are amortized over the term of the debt agreements using the straight-line method. Amortization expense totaled \$11,000 and \$12,000 in 2007 and 2006, respectively.

Income Taxes

Easter Seals is exempt from federal and state income taxes under section 501(c)(3) of the Internal Revenue Code and is not a private foundation. Accordingly, no provision for income taxes has been made.

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 certain reported amounts and disclosures. Accordingly, actual results could differ from those estimates.

Unconditional Promises to Give

Contributions are recognized when the donor makes a promise to give to Easter Seals 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. Easter Seals uses the allowance method to determine uncollectible unconditional promises to give.

EASTER SEALS TENNESSEE, INC. AND AFFILIATE
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
August 31, 2007 and 2006

NOTE 1 – NATURE OF ACTIVITIES AND SIGNIFICANT ACCOUNTING POLICIES (Continued)

Donated Assets

Donations of property and equipment are recorded as support at their estimated fair value. Such donations are reported as unrestricted support unless the donor has restricted the donated asset to a specific purpose. Assets donated with explicit restrictions regarding their use and contributions of cash that must be used to acquire property and equipment are reported as restricted support. Absent donor stipulations regarding how long those donated assets must be maintained, Easter Seals reports expirations of donor restrictions when the donated or acquired assets are placed in service as instructed by the donor. Easter Seals reclassifies temporarily restricted net assets to unrestricted net assets at that time.

NOTE 2 – ACCOUNTS RECEIVABLE

Accounts receivable consist of the following at August 31:

	<u>2007</u>	<u>2006</u>
Accounts receivable	\$ 63,111	\$ 97,447
Grants and fees receivable from state agencies	862,112	639,189
Rehabilitation fees	-	<u>330,102</u>
Subtotal	925,223	1,066,738
Less: allowance for uncollectible accounts	-	(125,939)
Less: contractual allowance	-	<u>(47,204)</u>
Net accounts receivable	<u>\$ 925,223</u>	<u>\$ 893,595</u>

NOTE 3 – CONTRIBUTIONS RECEIVABLE

Contributions receivable are as follows at August 31:

	<u>2007</u>	<u>2006</u>
McWhorter Family Children's Center	\$ -	\$ 20,000
Gross capital campaign receivables	-	78,647
Annual gift receivables	-	<u>14,709</u>
Subtotal		113,356
Less: allowance for uncollectible contributions	-	(48,451)
Less: discount to net present value	-	<u>(15,571)</u>
Net contributions receivable	<u>\$ -</u>	<u>\$ 49,334</u>
Receivable in less than one year, net	\$ -	\$ 33,155
Receivable in one to five years, net	-	<u>16,179</u>
	<u>\$ -</u>	<u>\$ 49,334</u>

EASTER SEALS TENNESSEE, INC. AND AFFILIATE
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
August 31, 2007 and 2006

NOTE 4 – PROPERTY AND EQUIPMENT

Property and equipment consists of the following at August 31:

	<u>2007</u>	<u>2006</u>
Land	\$ 1,862,557	\$ 1,862,557
Buildings and improvements	1,011,680	7,862,460
Vehicles	818,671	659,974
Equipment	<u>1,333,103</u>	<u>1,306,287</u>
	5,026,011	11,691,278
Less accumulated depreciation	<u>(3,822,370)</u>	<u>(3,710,085)</u>
Net property and equipment	<u>\$ 1,203,641</u>	<u>\$ 7,981,193</u>

Depreciation expense totaled \$471,416 and \$447,010 in 2007 and 2006, respectively. At August 31, 2007 and 2006, respectively, vehicles with a depreciated value of \$35,332 and \$68,089 are held by Easter Seals. These vehicles were purchased primarily with government grant funds. As a result, the vehicles are restricted under the terms of the grant agreement.

NOTE 5 – REAL ESTATE HELD FOR SALE

Easter Seal's headquarters campus is classified as real estate held for sale in the statement of financial position at August 31, 2007. The campus has depreciated value of \$6,850,779 at August 31, 2007. In fiscal 2007, the decision was made to sell its headquarters campus and it is currently listed for sale. It is estimated by management that net sales proceeds will be approximately \$5.5 million. As a result, the depreciated value of the campus has been written down \$1,350,779 to reflect management's estimate of fair value at August 31, 2007.

NOTE 6 – DEFERRED REVENUE

Deferred revenue consists of amounts advanced from the State of Tennessee related to West's programs. Amounts totaled \$1,314,963 and \$525,024 at August 31, 2007 and 2006, respectively, and are payable on demand.

EASTER SEALS TENNESSEE, INC. AND AFFILIATE
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
August 31, 2007 and 2006

NOTE 7 – NOTES PAYABLE

Notes payable is comprised of the following at August 31:

	<u>2007</u>	<u>2006</u>
Line of credit payable to bank, interest at one-half percent per annum over the bank's prime rate (8.75% at August 31, 2007), with a stated maturity of January 3, 2005. The line of credit is secured by a first lien security interest in Easter Seals' accounts receivable, furniture, equipment, capital campaign receipts, machinery, and fixtures, a first priority deed of trust on camp property, and the Woodmont Boulevard facility. As described in Note 14, required debt service payments have not been made since December 2004. The line of credit has not been renewed at August 31, 2007 and is therefore presented in the accompanying financial statements as currently due.	\$ 247,000	\$ 247,000
Note payable related to Series 1999 Variable Rate Revenue Bonds, interest payable monthly (3.95% at August 31, 2007), principal payments due in varying amounts from August 2005 to August 2019. The note is collateralized by a lien and security interest in premises and equipment, a first priority security interest in cash payments on donor pledges, and a letter of credit in the amount of \$2,570,899. This note contains cross default provisions and, as a result, the entire principal balance is presented as currently due in the accompanying financial statements (see Note 14).	2,425,000	2,425,000
Term loan payable to bank, interest at 6.0% per annum, secured by all of Easter Seals' accounts receivable, pledges, security interest in premises and equipment and all proceeds from policies of insurance of any of the foregoing; monthly payments of principal and interest payable over a three year period with a final maturity of January 3, 2006. As described in Note 14, required debt service payments have not been made since December 2004. As a result, the entire principal balance is presented as currently due in the accompanying financial statements.	1,967,261	1,967,261

EASTER SEALS TENNESSEE, INC. AND AFFILIATE
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
August 31, 2007 and 2006

NOTE 7 – NOTES PAYABLE (Continued)

	<u>2007</u>	<u>2006</u>
Promissory note payable to bank, interest at 1.0% per annum over the bank's prime rate (9.25% at August 31, 2007), secured by land, buildings and improvements, pledge agreement, and cross collateralization of all other assets, interest only payable through original maturity (July 17, 2005). The note provided for maximum borrowings of \$2,750,000. The proceeds of the note were used for the purchase of real property and construction of building and improvements presently utilized as a child development center. As described in Note 14, required debt service payments have not been made since December 2004. As a result, the entire principal balance is presented as currently due in the accompanying financial statements.	2,750,000	2,750,000
Note payable, interest at the prime rate (8.25% at August 31, 2007); secured by real property. Principal and interest shall be paid based upon a 20 year amortization schedule. The note matures on August 1, 2025, at which time all remaining principal and interest will be due.	1,047,031	1,071,494
Line of credit payable to bank, interest at 7.5% per annum, interest only payable through maturity (September 28, 2007), at which time remaining principal and interest will be due. The line of credit is secured by all assets and rights of Easter Seals West Tennessee, LLC. The line of credit provides for maximum borrowings of \$1,200,000, limited to 85 percent of qualified accounts receivable plus a percentage of equipment. No significant additional borrowings were available at August 31, 2007.	904,082	301,176
Note payable, interest at 3% over prime rate (11.25% at August 31, 2007), interest only payable through the earlier of a) maturity (September 15, 2005), b) the sale, transfer or other disposition of the collateral, or c) the date the indebtedness is accelerated, at which time remaining principal and interest will be due. The note is secured by a second priority lien, security interest and mortgage on the camp property. The note payable has not been renewed and is therefore presented in the accompanying financial statements as currently due.	278,239	278,239

EASTER SEALS TENNESSEE, INC. AND AFFILIATE
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
August 31, 2007 and 2006

NOTE 7 – NOTES PAYABLE (Continued)

	<u>2007</u>	<u>2006</u>
Note payable, interest at 8.99% per annum, secured by a vehicle. Principal and interest of \$418 shall be paid monthly through December 2011.	17,954	-
Note payable, interest at 7.99% per annum, secured by vehicles. Principal and interest of \$10,142 shall be paid monthly through December 2011.	<u>435,769</u>	<u>-</u>
	<u>\$10,072,336</u>	<u>\$ 9,040,170</u>

Included in the accompanying consolidated statements of financial position as:

Notes payable – line of credit	\$ 1,149,794	\$ 548,176
Current portion of notes payable	7,532,632	7,444,904
Notes payable – net of current portion	<u>1,389,910</u>	<u>1,047,090</u>
	<u>\$10,072,336</u>	<u>\$ 9,040,170</u>

The following represents principal maturities of notes payable as of August 31, 2007:

Year ending <u>August 31,</u>	
2007	\$ 8,682,426
2008	129,648
2009	140,509
2010	152,279
2011	78,547
Thereafter	<u>888,927</u>
	<u>\$10,072,336</u>

NOTE 8 – LETTER OF CREDIT

In connection with Easter Seals' obligations under its agreement with a bank, a letter of credit in the amount of \$2,570,899 was established for securing the Industrial Development Board of the Metropolitan Government of Nashville and Davidson County Variable Rate Revenue Bonds Series 1999 issued in the original principal amount of \$2,500,000. Easter Seals had no outstanding borrowings associated with this letter of credit at August 31, 2007 or 2006.

EASTER SEALS TENNESSEE, INC. AND AFFILIATE
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
August 31, 2007 and 2006

NOTE 9 – TEMPORARILY RESTRICTED NET ASSETS

Temporarily restricted net assets are available for the following purposes or periods at August 31:

	<u>2007</u>	<u>2006</u>
Unconditional promises to give due in future periods	\$ <u>-</u>	\$ <u>49,334</u>

NOTE 10 – ALLOCATION OF FUNCTIONAL EXPENSES

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

NOTE 11 – CONCENTRATIONS

Easter Seals receives a substantial amount of its support from governmental grants, contracts, and individual contributions. A significant reduction in the level of this support, if this were to occur, could have an adverse impact on Easter Seals' programs and services. At August 31, 2007 and 2006, Easter Seals had \$742,100 and \$639,189, respectively, due in grants and fees receivable from government entities.

NOTE 12 – EMPLOYEE BENEFIT PLANS

During 2003, Easter Seals implemented a defined contribution retirement plan for the benefit of all employees. Employees are allowed to make contributions on a pre-tax basis. The plan provides for Easter Seals to make a discretionary contribution to the plan. No employer contributions were made to the plan during 2007 or 2006.

Easter Seals also has a noncontributory, defined benefit pension plan covering substantially all employees, which was amended and frozen effective August 31, 2003, so that no new employees can enter the plan, and no additional benefits will accrue. Reduced benefits are available for early retirement. The amount funded each year is determined by the plan's actuary based upon required funding levels. The plan's assets are primarily invested in equities, fixed income vehicles and cash.

During 2007, Easter Seals adopted the provisions of SFAS No. 158 *Employers' Accounting for Defined Benefit Pension and Other Retirement Plans* and accounts for its pension plan accordingly. The following table sets forth the funded status of the pension plan and amounts recognized in Easter Seals' consolidated financial statements at August 31:

	<u>2007</u>	<u>2006</u>
Benefit obligation	\$ 2,209,703	\$ 2,152,015
Fair value of plan assets	<u>1,266,325</u>	<u>1,225,160</u>
Funded status	<u>\$ (943,378)</u>	<u>\$ (926,855)</u>

EASTER SEALS TENNESSEE, INC. AND AFFILIATE
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
August 31, 2007 and 2006

NOTE 12 – EMPLOYEE BENEFIT PLANS (Continued)

	<u>2007</u>	<u>2006</u>
Accrued pension liability recognized in balance sheet	\$ (943,378)	\$ (333,038)
Benefit cost	\$ 66,835	\$ 74,186
Employer contributions	\$ 68,595	\$ 66,086
Plan participants' contributions	\$ -	\$ -
Benefits paid	\$ 59,969	\$ 46,055
Assumptions used in the accounting at August 31 were:		
Discount rate	6.25%	6.25%
Rate of increase in compensation levels	0.00%	0.00%
Expected long-term rate of return on assets	7.50%	7.50%

The overall expected return on assets assumption was based on an asset mix of 35% equity and 65% fixed income. Equity returns were based on capitalization weighted CRSP 1 – 10 Index from 1926 – 1971 and the Wilshire 5000 Index from 1971 – 2004. Fixed Income returns were based on the 5-Year Treasury Note from 1926 – 1972 and Lehman Brothers Intermediate Bond Index from 1973 – 2004. The expected nominal return on this basis is 7.8%.

During fiscal year 2007, the Plan received a waiver from the Internal Revenue Service related to the minimum required contribution for the Plan years ending August 31, 2005 and 2006. The waiver contained several conditions, including Easter Seals making sufficient contributions to meet the minimum funding standard for the Plan for the Plan year ending August 31, 2007 by May 15, 2008. Such contribution is estimated to be \$535,000.

Benefits expected to be paid are as follows for the years ending August 31,

2008	\$ 117,738
2009	120,030
2010	121,412
2011	120,875
2012	126,992
2013 – 2016	<u>673,619</u>
	<u>\$ 1,280,666</u>

EASTER SEALS TENNESSEE, INC. AND AFFILIATE
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
August 31, 2007 and 2006

NOTE 12 – EMPLOYEE BENEFIT PLANS (Continued)

Plan Assets:

The Pension Plan for Employees of Easter Seals, Inc. asset allocation by asset category is as follows:

	<u>August 31, 2007</u>	<u>August 31, 2006</u>
Asset Category		
Equity Mutual Funds	39.12%	39.78%
Fixed Income Mutual Funds	<u>60.88%</u>	<u>60.22%</u>
Total	100.00%	100.00%
Target Asset Allocation		
Equity Mutual Funds	35.00%	35.00%
Fixed Income Mutual Funds	<u>65.00%</u>	<u>65.00%</u>
Total	100.00%	100.00%

NOTE 13 – LEASE COMMITMENTS

Easter Seals leases certain buildings and office equipment under noncancelable lease agreements, all of which are considered operating leases. Minimum payments for these lease commitments as of August 31, 2007, are as follows:

<u>Year ending</u> <u>August 31,</u>	
2008	\$ 103,471
2009	92,502
2010	88,977
2011	75,033
2012	<u>59,177</u>
	<u>\$ 419,160</u>

Rent expense amounted to \$94,307 and \$147,557 in 2007 and 2006, respectively.

EASTER SEALS TENNESSEE, INC. AND AFFILIATE
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
August 31, 2007 and 2006

NOTE 14 – GOING CONCERN

The accompanying financial statements have been prepared assuming that Easter Seals will continue as a going concern. At August 31, 2007, Easter Seals has a working capital deficiency of \$11,704,898 (including \$8,682,426 of notes payable classified as currently due) and has incurred a significant decrease in net assets. Required debt service payments on certain of its loan agreements have not been made since December 2004. Most of Easter Seals' debt obligations contain cross default provisions. The failure to make required debt payments during 2007 and 2006 could have the effect of making those debt obligations callable by the lenders. Additionally, the creditor for the \$1.2 million line of credit has requested payment in full upon the loan maturity date. These conditions raise substantial doubt about Easter Seals' ability to continue as a going concern. However, Management believes that its residential services program, which accounts for the majority of Easter Seal's revenues and historically is its most profitable service line, would not be adversely affected in the event the debt obligations are called. Management's plans include downsizing duplicative programs to focus on its core business, expanding core services to Middle Tennessee, and substantially reducing its debts. To that end, Easter Seals has listed all of its real estate including its headquarters campus and camp property for sale with all proceeds to be used in an effort to satisfy debt obligations. In a related matter, in November 2007 the Water Resources Act passed by the United States Congress lifted waterfront restrictions on Easter Seals' camp property. It should be noted that camp property has been listed for sale for approximately \$6.5 million. The camp property has a net book value of \$215,420 at August 31, 2007. The ultimate outcome of these efforts is uncertain. The financial statements do not include any adjustments that might result from the outcome of this uncertainty.

NOTE 15 – CONCENTRATION OF CREDIT RISK

Easter Seals may at times have cash amounts at financial institutions in excess of the amount insured by the Federal Deposit Insurance Corporation. Easter Seals has not experienced any losses in such amounts and does not believe it is exposed to any significant concentration of credit risk.

NOTE 16 – CONTINGENCIES

Easter Seals is subject to various claims and legal actions which arise in the ordinary course of business. Easter Seals has professional liability insurance to protect against such claims or legal actions on a claims-made basis. In the opinion of management, the ultimate resolution of such matters will be adequately covered by the insurance and will not have a material adverse effect on the Organization's financial position or results of operations.

During fiscal year 2007, the Plan received a waiver from the Internal Revenue Service related to the minimum required contribution for the Plan years ending August 31, 2005 and 2006. The waiver contained several conditions, including Easter Seals making sufficient contributions to meet the minimum funding standard for the Plan for the Plan year ending August 31, 2007 by May 15, 2008. Such contribution is estimated to be \$535,000.

EASTER SEALS TENNESSEE, INC. AND AFFILIATE
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
August 31, 2007 and 2006

NOTE 17 - SUBSEQUENT EVENT

On May 2, 2008, Easter Seals entered into a sale and purchase agreement to sell approximately 2.2 acres including a building known as the McWhorter Family Children's Center. The sales price is approximately \$2.2 million, payable at closing. The land and building was included in real estate held for sale at August 31, 2007.

**Easter Seals Tennessee**

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Larry King
Jeffrey Lewis

June 17, 2008

This letter is to affirm that Easter Seals Tennessee does not discriminate on the basis of age, race, creed, socioeconomic status, gender, or disability. All who seek Easter Seals' services will be eligible for benefits applicable to a grant provided by The Memorial Foundation.

Sincerely,

Susan Armiger
President & CEO