

**FIRST STEPS, INC.
FINANCIAL STATEMENTS AND
INDEPENDENT AUDITOR'S REPORT**

June 30, 2005 and 2004

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FRASIER, DEAN & HOWARD, PLLC

CERTIFIED PUBLIC ACCOUNTANTS

3310 WEST END AVENUE, SUITE 550
NASHVILLE, TENNESSEE 37203
PHONE 615-383-8502, FAX 615-383-7094

INDEPENDENT AUDITOR'S REPORT

To the Board of Directors
First Steps, Inc.

We have audited the accompanying statements of financial position of First Steps, Inc. (a nonprofit organization) as of June 30, 2005 and 2004, 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. 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 financial statements referred to above present fairly, in all material respects, the financial position of First Steps, Inc. as of June 30, 2005 and 2004, 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.

Frasier, Dean & Howard, PLLC

September 16, 2005

FIRST STEPS, INC.
STATEMENTS OF FINANCIAL POSITION
June 30, 2005 and 2004

ASSETS

	<u>2005</u>	<u>2004</u>
Current assets:		
Cash and cash equivalents	\$ 98,070	\$ 92,948
Investments	108,315	54,223
Accounts and grants receivable	<u>83,783</u>	<u>67,436</u>
Total current assets	<u>290,168</u>	<u>214,607</u>
Property and equipment:		
Vehicles	19,855	19,855
Building improvements and playground	110,439	107,939
Furniture and equipment	<u>82,562</u>	<u>82,512</u>
	212,856	210,306
Less: accumulated depreciation	<u>(128,567)</u>	<u>(117,491)</u>
Property and equipment, net	<u>84,289</u>	<u>92,815</u>
Total assets	<u>\$ 374,457</u>	<u>\$ 307,422</u>

LIABILITIES AND NET ASSETS

Current liabilities:		
Accounts payable	\$ 8,418	\$ 14,984
Accrued expenses	8,400	8,000
Accrued salaries and benefits	<u>55,495</u>	<u>47,732</u>
Total current liabilities	<u>72,313</u>	<u>70,716</u>
Net assets:		
Unrestricted	273,144	216,706
Temporarily restricted	<u>29,000</u>	<u>20,000</u>
Total net assets	<u>302,144</u>	<u>236,706</u>
Total liabilities and net assets	<u>\$ 374,457</u>	<u>\$ 307,422</u>

See accompanying notes.

FIRST STEPS, INC.
STATEMENT OF ACTIVITIES
For the year ended June 30, 2005

	<u>Unrestricted</u>	<u>Temporarily Restricted</u>	<u>Total</u>
Public support and revenues:			
Department of Mental Health and Developmental Disabilities grant	\$ 435,500	\$ -	\$ 435,500
Department of Human Services contracts and grants	295,089	-	295,089
Contributions	221,645	29,000	250,645
Program service fees	168,921	-	168,921
United Way	206,991	-	206,991
Special events	22,598	-	22,598
In-kind contributions	64,000	-	64,000
Tennessee Early Intervention Services	31,823	-	31,823
Investment income	6,487	-	6,487
Loss on disposal of property and equipment	(471)	-	(471)
Total public support and revenues	1,452,583	29,000	1,481,583
Net assets released from restrictions	20,000	(20,000)	-
	1,472,583	9,000	1,481,583
Expenses:			
Program services	1,207,425	-	1,207,425
Supporting services	117,141	-	117,141
Fundraising	91,579	-	91,579
Total expenses	1,416,145	-	1,416,145
Change in net assets	56,438	9,000	65,438
Net assets - beginning of year	216,706	20,000	236,706
Net assets - end of year	<u>\$ 273,144</u>	<u>\$ 29,000</u>	<u>\$ 302,144</u>

See accompanying notes.

FIRST STEPS, INC.
STATEMENT OF ACTIVITIES
For the year ended June 30, 2004

	<u>Unrestricted</u>	<u>Temporarily Restricted</u>	<u>Total</u>
Public support and revenues:			
Department of Mental Health and Developmental Disabilities grant	\$ 401,082	\$ -	\$ 401,082
Contributions	330,712	20,000	350,712
Department of Human Services contracts and grants	327,883	-	327,883
Program service fees	143,107	-	143,107
In-kind contributions	121,841	-	121,841
United Way	109,678	-	109,678
Special events	49,708	-	49,708
Tennessee Early Intervention Services	20,585	-	20,585
Other	8,870	-	8,870
Gain on disposal of property and equipment	5,730	-	5,730
Investment income	1,801	-	1,801
	<hr/>	<hr/>	<hr/>
Total public support and revenues	1,520,997	20,000	1,540,997
Net assets released from restrictions	25,000	(25,000)	-
	<hr/>	<hr/>	<hr/>
	1,545,997	(5,000)	1,540,997
	<hr/>	<hr/>	<hr/>
Expenses:			
Program services	1,248,410	-	1,248,410
Supporting services	115,855	-	115,855
Fundraising	81,077	-	81,077
	<hr/>	<hr/>	<hr/>
Total expenses	1,445,342	-	1,445,342
	<hr/>	<hr/>	<hr/>
Change in net assets	100,655	(5,000)	95,655
Net assets - beginning of year	116,051	25,000	141,051
	<hr/>	<hr/>	<hr/>
Net assets - end of year	\$ 216,706	\$ 20,000	\$ 236,706
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See accompanying notes.

FIRST STEPS, INC.
STATEMENT OF FUNCTIONAL EXPENSES
For the year ended June 30, 2005

	<u>Program Services</u>	<u>Supporting Services</u>	<u>Fundraising</u>	<u>Total</u>
Salaries	\$ 791,393	\$ 76,080	\$ 74,945	\$ 942,418
Employee benefits	172,329	8,581	11,518	192,428
Total salaries and employee benefits	963,722	84,661	86,463	1,134,846
Professional services	33,891	11,008	-	44,899
Rent (includes in-kind of \$56,100)	53,143	5,635	-	58,778
Food	38,038	-	-	38,038
Supplies	26,809	2,412	-	29,221
Insurance	11,331	604	-	11,935
Maintenance	16,504	2,013	-	18,517
Communications	8,417	1,864	-	10,281
Travel	13,596	4	-	13,600
Special events expenses	-	-	5,116	5,116
Utilities	8,553	954	-	9,507
Miscellaneous	305	2,531	-	2,836
Conferences	3,098	2,574	-	5,672
Transportation	2,276	-	-	2,276
Licenses	2,540	95	-	2,635
Bad debts	2,677	-	-	2,677
Advertising	1,822	-	-	1,822
Dues	293	1,220	-	1,513
Total expenses before depreciation	1,187,015	115,575	91,579	1,394,169
Depreciation	20,410	1,566	-	21,976
Total expenses	<u>\$ 1,207,425</u>	<u>\$ 117,141</u>	<u>\$ 91,579</u>	<u>\$ 1,416,145</u>

See accompanying notes.

FIRST STEPS, INC.
STATEMENT OF FUNCTIONAL EXPENSES
For the year ended June 30, 2004

	<u>Program Services</u>	<u>Supporting Services</u>	<u>Fundraising</u>	<u>Total</u>
Salaries	\$ 821,407	\$ 74,815	\$ 58,776	\$ 954,998
Employee benefits	195,410	11,435	10,472	217,317
Total salaries and employee benefits	1,016,817	86,250	69,248	1,172,315
Rent (includes in-kind of \$56,100)	52,644	5,852	-	58,496
Food	40,750	-	-	40,750
Professional services	30,590	10,082	-	40,672
Supplies	21,772	1,936	-	23,708
Communications	11,018	2,793	-	13,811
Insurance	10,998	1,152	-	12,150
Special events expenses	-	-	11,829	11,829
Maintenance	10,488	1,138	-	11,626
Travel	10,900	170	-	11,070
Utilities	8,787	977	-	9,764
Conferences	1,825	1,923	-	3,748
Transportation	3,192	-	-	3,192
Bad debts	2,931	-	-	2,931
Licenses	2,290	125	-	2,415
Miscellaneous	1,683	419	-	2,102
Advertising	626	969	-	1,595
Dues	84	503	-	587
Total expenses before depreciation	1,227,395	114,289	81,077	1,422,761
Depreciation	21,015	1,566	-	22,581
Total expenses	<u>\$ 1,248,410</u>	<u>\$ 115,855</u>	<u>\$ 81,077</u>	<u>\$ 1,445,342</u>

See accompanying notes.

FIRST STEPS, INC.
STATEMENTS OF CASH FLOWS
For the years ended June 30, 2005 and 2004

	<u>2005</u>	<u>2004</u>
Cash flows from operating activities:		
Change in net assets	\$ 65,438	\$ 95,655
Adjustments to reconcile changes in net assets to net cash provided by operating activities:		
Depreciation	21,976	22,581
Contribution of common stock	(49,141)	-
In-kind contribution of property and equipment	(7,900)	(64,936)
Realized and unrealized (gains) on investments, net	(1,875)	(682)
(Gain) loss on disposal of property and equipment	471	(5,730)
Changes in operating assets and liabilities:		
Accounts and grants receivable	(16,347)	(43,192)
Accounts payable	(6,566)	(4,153)
Accrued expenses	400	300
Accrued salaries and benefits	7,763	13,165
Net cash provided by operating activities	<u>14,219</u>	<u>13,008</u>
Cash flows from investing activities:		
Proceeds from sale of investments, net	49,141	-
Proceeds from sale of property and equipment	75	6,200
Purchase of investments	(52,217)	(21,005)
Purchase of property and equipment	(6,096)	(9,332)
Net cash used in investing activities	<u>(9,097)</u>	<u>(24,137)</u>
Cash flows from financing activities:		
Proceeds from line of credit borrowings	-	55,000
Payments on line of credit	-	(55,000)
Net cash provided by financing activities	<u>-</u>	<u>-</u>
Net increase (decrease) in cash and cash equivalents	5,122	(11,129)
Cash and cash equivalents - beginning of year	<u>92,948</u>	<u>104,077</u>
Cash and cash equivalents - end of year	<u>\$ 98,070</u>	<u>\$ 92,948</u>
Supplemental disclosure:		
Non-cash property and equipment additions	<u>\$ 7,900</u>	<u>\$ 64,936</u>
Contribution of common stock	<u>\$ 49,141</u>	<u>\$ -</u>
Interest paid	<u>\$ -</u>	<u>\$ 754</u>

See accompanying notes.

FIRST STEPS, INC.
NOTES TO FINANCIAL STATEMENTS
June 30, 2005 and 2004

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 quality early intervention services for children with and without disabilities, as well as support and guidance for their families. The Organization operates two separate facilities in the Nashville area.

Basis of Presentation

The accompanying financial statements have been prepared on the accrual basis of accounting in accordance with U.S. generally accepted accounting principles. 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 statement of activities as net assets released from restrictions.

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 Statement of Financial Accounting Standards ("SFAS") No. 124, "*Accounting for Certain Investments Held by Not-for-Profit Organizations*," investments in marketable securities with readily determinable fair values and all investments in debt securities are reported at their fair values in the statement of financial position. Fair value is determined by using quoted market prices, when available. Unrealized gains and losses are included in the statement of activities.

Receivables

Accounts and grants receivable are reviewed periodically as to their collectibility. Based on collection experience and management's review, no allowance for doubtful accounts is considered necessary at June 30, 2005 and 2004.

FIRST STEPS, INC.
NOTES TO FINANCIAL STATEMENTS
June 30, 2005 and 2004

NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

Property and Equipment

Property and equipment are recorded at cost or, if donated, at the estimated fair market value as of the date of donation. Depreciation is provided using the straight-line basis over the estimated useful lives of the respective assets, which range from five to ten 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.

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.

FIRST STEPS, INC.
NOTES TO FINANCIAL STATEMENTS
June 30, 2005 and 2004

NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

Functional Allocation of Expenses

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

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 amounts and disclosures. Actual results could differ from those estimates.

NOTE 2 – INVESTMENTS

Investments at fair value, as of June 30, 2005 and 2004, are summarized as follows:

	<u>2005</u>	<u>2004</u>
Mutual funds	<u>\$ 108,315</u>	<u>\$ 54,223</u>

The following schedule summarizes the investment returns for the years ended June 30, 2005 and 2004:

	<u>2005</u>	<u>2004</u>
Interest and dividends	\$ 4,612	\$ 1,119
Realized and unrealized gains, net	<u>1,875</u>	<u>682</u>
	<u>\$ 6,487</u>	<u>\$ 1,801</u>

NOTE 3 – RESTRICTIONS ON NET ASSETS

Temporarily restricted net assets are available for the following purposes at June 30, 2005 and 2004:

	<u>2005</u>	<u>2004</u>
Next fiscal year operations	\$ 25,000	\$ 20,000
Other	<u>4,000</u>	<u>-</u>
	<u>\$ 29,000</u>	<u>\$ 20,000</u>

FIRST STEPS, INC.
NOTES TO FINANCIAL STATEMENTS
June 30, 2005 and 2004

NOTE 4 – IN-KIND CONTRIBUTIONS

The Organization received in-kind contributions of \$64,000 and \$121,841 during the years ended June 30, 2005 and 2004, respectively. In 2005, \$7,900 consisted of donated office equipment and office supplies. In 2004, \$65,741 consisted of donated playground equipment, office equipment and office supplies. The remaining 2005 activity and 2004 activity of \$56,100 represents rent for use of one of the facility locations. The Organization operates its other location in a former school building with no fair market rental value assigned.

NOTE 5 – PENSION PLAN

The Organization has 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 years ended June 30, 2005 and 2004 was \$13,156 and \$26,233, respectively. The contribution to the plan is equal to 2% and 4% of eligible employees' compensation in 2005 and 2004, respectively.

NOTE 6 – CONCENTRATIONS

The Organization receives a significant amount of its support through grants from the Tennessee Department of Mental Health and Developmental Disabilities ("DMR") and the Tennessee Department of Human Services ("DHS"). In 2005 and 2004, the DMR accounted for 29% and 26%, respectively, of the Organization's total public support and revenues. In 2005 and 2004, the DHS accounted for 20% and 21%, 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 DMR of \$51,103 and \$33,435 at June 30, 2005 and 2004, respectively. Contracts and grants receivable from DHS amounted to \$28,798 and \$21,516 at June 30, 2005 and 2004, respectively.

Cash and investments include funds deposited in FDIC insured bank accounts. Balances on deposit may at times exceed amounts covered by FDIC insurance. Management believes that risk of loss is mitigated by maintaining deposits in high quality financial institutions.

NOTE 7 – LINE OF CREDIT

The Organization has a line of credit allowing for maximum borrowings of \$100,000, with interest at the bank's index rate due monthly. The line of credit is secured by the assets of the Organization and matures on January 31, 2006. There were no borrowings outstanding at June 30, 2005 and 2004.