

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

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

August 31, 2006 and 2005

**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

We have audited the accompanying consolidated statements of financial position of Easter Seals Tennessee, Inc. and Affiliate (a nonprofit organization) as of August 31, 2006 and 2005, 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, 2006 and 2005, 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 12 to the financial statements, the Organization has a working capital deficiency of \$9,357,521 at August 31, 2006, 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 2006 and 2005 could have the effect of making most of the Organizations' debt obligations callable by the lenders. However, no such calls have been made as of the issuance of this report. 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 12. The consolidated financial statements do not include any adjustments that might result from the outcome of this uncertainty.

Frasier, Dean & Howard, PLLC

April 10, 2007

EASTER SEALS TENNESSEE, INC. AND AFFILIATE
CONSOLIDATED STATEMENTS OF FINANCIAL POSITION
August 31, 2006 and 2005

	<u>2006</u>	<u>2005</u>
Assets		
Current assets:		
Cash and cash equivalents	\$ 234,516	\$ 82,556
Accounts receivable, net	893,595	1,045,858
Prepaid expenses	34,853	42,186
Contributions receivable, net	<u>33,155</u>	<u>91,714</u>
Total current assets	1,196,119	1,262,314
Contributions receivable, net	16,179	84,625
Property and equipment, net	7,981,193	8,055,805
Loan costs, net of accumulated amortization of \$61,627 and \$49,627, respectively	<u>157,869</u>	<u>169,869</u>
Total assets	<u><u>\$ 9,351,360</u></u>	<u><u>\$ 9,572,613</u></u>
Liabilities and Net Assets (Deficit)		
Current liabilities:		
Accounts payable	\$ 386,045	\$ 375,876
Accrued expenses	681,089	774,307
Accrued interest	655,364	261,323
Deferred revenue	525,024	510,377
Notes payable - line of credit	548,176	247,000
Current portion of notes payable	7,444,904	5,275,953
Accrued pension liability	<u>333,038</u>	<u>324,938</u>
Total current liabilities	10,573,640	7,769,774
Accrued expenses - noncurrent	95,734	88,000
Notes payable, net of current portion	<u>1,047,090</u>	<u>3,330,983</u>
Total liabilities	<u>11,716,464</u>	<u>11,188,757</u>
Net assets (deficit):		
Unrestricted	(2,414,438)	(1,792,483)
Temporarily restricted	<u>49,334</u>	<u>176,339</u>
Total net deficit	<u>(2,365,104)</u>	<u>(1,616,144)</u>
Total liabilities and net deficit	<u><u>\$ 9,351,360</u></u>	<u><u>\$ 9,572,613</u></u>

See accompanying notes.

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

	<u>Unrestricted</u>	<u>Temporarily Restricted</u>	<u>Total</u>
Public support and revenue:			
Public support:			
Contributions	\$ 728,100	\$ -	\$ 728,100
Donated land	330,000	-	330,000
Special events	322,077	-	322,077
Less: direct benefit costs	(74,175)	-	(74,175)
Bequests	7,990	-	7,990
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	1,191	-	1,191
Total revenue	<u>9,857,519</u>	<u>-</u>	<u>9,857,519</u>
Net assets released from restrictions:			
Expiration of time restrictions	57,005	(57,005)	-
Total public support and revenue	<u>11,228,516</u>	<u>(57,005)</u>	<u>11,171,511</u>
Expenses:			
Program services:			
Direct services	10,467,867	-	10,467,867
Public health education	22,199	-	22,199
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	392,724	-	392,724
Total supporting services	<u>1,198,885</u>	<u>-</u>	<u>1,198,885</u>
Provision for loss on uncollectible pledges	-	70,000	70,000
National program fee	161,520	-	161,520
Total expenses and losses	<u>11,850,471</u>	<u>70,000</u>	<u>11,920,471</u>
Change in net assets	(621,955)	(127,005)	(748,960)
Net assets at beginning of year	(1,792,483)	176,339	(1,616,144)
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 ACTIVITIES
For the Year Ended August 31, 2005

	<u>Unrestricted</u>	<u>Temporarily Restricted</u>	<u>Total</u>
Public support and revenue:			
Public support:			
Contributions	\$ 641,510	\$ 142,867	\$ 784,377
Special events (including in-kind donations of \$32,545)	562,364	-	562,364
Less: direct benefit costs (including in-kind expenses of \$32,545)	(139,797)	-	(139,797)
Bequests	<u>21,451</u>	<u>-</u>	<u>21,451</u>
Total public support	<u>1,085,528</u>	<u>142,867</u>	<u>1,228,395</u>
Revenue:			
Government fees and grants	6,954,798	-	6,954,798
Program service fees	1,486,063	-	1,486,063
Child development center	383,819	-	383,819
Camp rental	199,421	-	199,421
Membership fees	164,311	-	164,311
Contract services	143,628	-	143,628
Other	18,697	-	18,697
Investment income, net	<u>520</u>	<u>-</u>	<u>520</u>
Total revenue	<u>9,351,257</u>	<u>-</u>	<u>9,351,257</u>
Net assets released from restrictions:			
Expiration of time restrictions	<u>441,162</u>	<u>(441,162)</u>	<u>-</u>
Total public support and revenue	<u>10,877,947</u>	<u>(298,295)</u>	<u>10,579,652</u>
Expenses:			
Program services:			
Direct services	10,416,609	-	10,416,609
Public health education	<u>68,342</u>	<u>-</u>	<u>68,342</u>
Total program services	<u>10,484,951</u>	<u>-</u>	<u>10,484,951</u>
Supporting services:			
Management and general	704,663	-	704,663
Fundraising	<u>467,605</u>	<u>-</u>	<u>467,605</u>
Total supporting services	<u>1,172,268</u>	<u>-</u>	<u>1,172,268</u>
National program fee	<u>149,060</u>	<u>-</u>	<u>149,060</u>
Total expenses	<u>11,806,279</u>	<u>-</u>	<u>11,806,279</u>
Change in net assets	(928,332)	(298,295)	(1,226,627)
Net assets at beginning of year	<u>(864,151)</u>	<u>474,634</u>	<u>(389,517)</u>
Net assets at end of year	<u>\$ (1,792,483)</u>	<u>\$ 176,339</u>	<u>\$ (1,616,144)</u>

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	<u>\$10,467,867</u>	<u>\$ 22,199</u>	<u>\$10,490,066</u>	<u>\$806,161</u>	<u>\$392,724</u>	<u>\$1,198,885</u>	<u>\$161,520</u>	<u>\$11,850,471</u>

See accompanying notes.

EASTER SEALS TENNESSEE, INC. AND AFFILIATE
CONSOLIDATED STATEMENT OF FUNCTIONAL EXPENSES
For the Year Ended August 31, 2005

	Program Services			Supporting Services			National Program Fee	Total Expenses
	Direct Services	Public Health Education	Total	Management and General	Fundraising	Total		
Salaries and related expenses	\$ 7,931,658	\$ 42,873	\$ 7,974,531	\$ 148,351	\$ 359,586	\$ 507,937	\$ -	\$ 8,482,468
Depreciation and amortization	425,517	7,864	433,381	42,972	12,504	55,476	-	488,857
Interest	-	-	-	434,033	-	434,033	-	434,033
Professional fees	330,019	3,498	333,517	21,487	1,101	22,588	-	356,105
Insurance	300,393	1,136	301,529	8,650	5,057	13,707	-	315,236
Bad debt expense	214,809	-	214,809	-	56,976	56,976	-	271,785
Travel and transportation	268,073	406	268,479	720	2,277	2,997	-	271,476
Supplies	188,808	231	189,039	761	1,280	2,041	-	191,080
Specific assistance	172,983	-	172,983	-	-	-	-	172,983
Utilities	150,457	2,484	152,941	1,138	3,936	5,074	-	158,015
National program fee	-	-	-	-	-	-	149,060	149,060
Building and grounds maintenance	134,433	2,460	136,893	805	3,900	4,705	-	141,598
Occupancy	82,140	-	82,140	-	-	-	-	82,140
Telephone	67,518	1,032	68,550	298	1,946	2,244	-	70,794
Miscellaneous	53,839	-	53,839	3,150	1,824	4,974	-	58,813
Rental and maintenance of equipment	36,879	1,572	38,451	-	4,920	4,920	-	43,371
Letter of credit fees	-	-	-	40,552	-	40,552	-	40,552
Printing and publications	17,824	4,355	22,179	881	5,630	6,511	-	28,690
Conferences, conventions and meetings	17,366	84	17,450	124	583	707	-	18,157
Postage and shipping	12,563	4	12,567	621	4,833	5,454	-	18,021
Advertising	7,264	179	7,443	-	25	25	-	7,468
Membership and support payments	4,066	164	4,230	120	1,227	1,347	-	5,577
Total functional expenses	<u>\$10,416,609</u>	<u>\$ 68,342</u>	<u>\$10,484,951</u>	<u>\$ 704,663</u>	<u>\$ 467,605</u>	<u>\$1,172,268</u>	<u>\$ 149,060</u>	<u>\$11,806,279</u>

See accompanying notes

EASTER SEALS TENNESSEE, INC. AND AFFILIATE
CONSOLIDATED STATEMENTS OF CASH FLOWS
For the Years Ended August 31, 2006 and 2005

	<u>2006</u>	<u>2005</u>
Cash flows from operating activities:		
Change in net assets	\$ (748,960)	\$ (1,226,627)
Adjustments to reconcile change in net assets to net cash (used in) provided by operating activities:		
Provision for uncollectible accounts and contractual allowance	(124,869)	61,247
Depreciation and amortization	459,010	488,857
Net gain on property disposal	(10,836)	(8,600)
Receipt of donated land	(330,000)	-
Changes in operating assets and liabilities:		
Accounts receivable	257,831	(174,803)
Contributions receivable	146,306	241,576
Prepaid expenses	7,333	(15,217)
Accounts payable	10,169	55,712
Accrued expenses	308,557	546,443
Deferred revenue	14,647	139,027
Accrued pension liability	8,100	30,026
Net cash (used in) provided by operating activities	<u>(2,712)</u>	<u>137,641</u>
Cash flows from investing activities:		
Proceeds from sale of investments	-	222,500
Purchases of property and equipment	(42,540)	(56,449)
Proceeds from disposal of property and equipment	10,978	8,600
Net cash (used in) provided by investing activities	<u>(31,562)</u>	<u>174,651</u>
Cash flows from financing activities:		
Proceeds from borrowings	7,173,240	3,446,650
Payments on notes payable	(6,987,006)	(3,850,577)
Net cash provided by (used in) financing activities	<u>186,234</u>	<u>(403,927)</u>
Net increase (decrease) in cash and cash equivalents	151,960	(91,635)
Cash and cash equivalents at beginning of year	<u>82,556</u>	<u>174,191</u>
Cash and cash equivalents at end of year	<u>\$ 234,516</u>	<u>\$ 82,556</u>
Supplemental disclosure of cash flow information:		
Interest paid	<u>\$ 203,523</u>	<u>\$ 201,053</u>
Non-cash investing and financing activity:		
Receipt of donated land	<u>\$ 330,000</u>	<u>\$ -</u>

See accompanying notes.

EASTER SEALS TENNESSEE, INC. AND AFFILIATE
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
August 31, 2006 and 2005

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.

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.

EASTER SEALS TENNESSEE, INC. AND AFFILIATE
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
August 31, 2006 and 2005

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

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 \$12,000 in 2006 and 2005.

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.

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.

EASTER SEALS TENNESSEE, INC. AND AFFILIATE
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
August 31, 2006 and 2005

NOTE 2 – ACCOUNTS RECEIVABLE

Accounts receivable consist of the following at August 31:

	<u>2006</u>	<u>2005</u>
Accounts receivable	\$ 97,447	\$ 166,329
Grants and fees receivable from state agencies	639,189	777,994
Rehabilitation fees	<u>330,102</u>	<u>380,246</u>
Subtotal	1,066,738	1,324,569
Less: allowance for uncollectible accounts	(125,939)	(216,491)
Less: contractual allowance	<u>(47,204)</u>	<u>(62,220)</u>
Net accounts receivable	<u>\$ 893,595</u>	<u>\$ 1,045,858</u>

NOTE 3 – CONTRIBUTIONS RECEIVABLE

Contributions receivable are as follows at August 31:

	<u>2006</u>	<u>2005</u>
McWhorter Family Children's Center	\$ 20,000	\$ 30,000
Gross capital campaign receivables	78,647	88,647
Annual gift receivables	<u>14,709</u>	<u>141,015</u>
Subtotal	113,356	259,662
Less: allowance for uncollectible contributions	(48,451)	(49,301)
Less: discount to net present value	<u>(15,571)</u>	<u>(34,022)</u>
Net contributions receivable	<u>\$ 49,334</u>	<u>\$ 176,339</u>
Receivable in less than one year, net	\$ 33,155	\$ 91,714
Receivable in one to five years, net	<u>16,179</u>	<u>84,625</u>
	<u>\$ 49,334</u>	<u>\$ 176,339</u>

NOTE 4 – PROPERTY AND EQUIPMENT

Property and equipment consists of the following at August 31:

	<u>2006</u>	<u>2005</u>
Land	\$ 1,862,557	\$ 1,532,557
Buildings and improvements	7,862,460	7,862,460
Vehicles	659,974	706,153
Equipment	<u>1,306,287</u>	<u>1,263,747</u>
	11,691,278	11,364,917
Less accumulated depreciation	<u>(3,710,085)</u>	<u>(3,309,112)</u>
Net property and equipment	<u>\$ 7,981,193</u>	<u>\$ 8,055,805</u>

EASTER SEALS TENNESSEE, INC. AND AFFILIATE
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
August 31, 2006 and 2005

NOTE 4 – PROPERTY AND EQUIPMENT (Continued)

Depreciation expense totaled \$447,010 and \$476,857 in 2006 and 2005, respectively. At August 31, 2006 and 2005, respectively, vehicles with a depreciated value of \$68,089 and \$109,442 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 – NOTES PAYABLE

	<u>2006</u>	<u>2005</u>
Notes payable is comprised of the following at August 31:		
Line of credit payable to bank, interest at one-half percent per annum over the bank's prime rate (8.75% at August 31, 2006), 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 12, required debt service payments have not been made since December 2004. The line of credit has not been renewed at August 31, 2006 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 (3.9% at August 31, 2006), 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 12).	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 12, 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, 2006 and 2005

NOTE 5 – NOTES PAYABLE (Continued)

	<u>2006</u>	<u>2005</u>
Promissory note payable to bank, interest at 1.0% per annum over the bank's prime rate (9.25% at August 31, 2006), 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 12, 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, 2006); 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.	1,071,494	1,097,689
Line of credit payable to bank, interest at 7.5% per annum, interest only payable through maturity (December 28, 2006), 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. Maximum borrowings available under the note amounted to \$680,728 at August 31, 2006.	301,176	88,747
Note payable, interest at prime rate (8.25% at August 31, 2006), 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.	<u>278,239</u>	<u>278,239</u>
	<u>\$ 9,040,170</u>	<u>\$ 8,853,936</u>

EASTER SEALS TENNESSEE, INC. AND AFFILIATE
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
August 31, 2006 and 2005

NOTE 5 – NOTES PAYABLE (Continued)

Included in the accompanying consolidated statements of financial position as:

Notes payable – line of credit	\$ 548,176	\$ 247,000
Current portion of notes payable	7,444,904	5,275,953
Notes payable – net of current portion	<u>1,047,090</u>	<u>3,330,983</u>
	<u>\$ 9,040,170</u>	<u>\$ 8,853,936</u>

The following represents principal maturities of notes payable as of August 31, 2006:

Year ending	
<u>August 31,</u>	
2007	\$ 7,993,080
2008	26,496
2009	28,767
2010	31,232
2011	33,908
Thereafter	<u>926,687</u>
	<u>\$ 9,040,170</u>

NOTE 6 – 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, 2006 or 2005.

NOTE 7 – TEMPORARILY RESTRICTED NET ASSETS

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

	<u>2006</u>	<u>2005</u>
Unconditional promises to give due in future periods	<u>\$ 49,334</u>	<u>\$ 176,339</u>

NOTE 8 – 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.

EASTER SEALS TENNESSEE, INC. AND AFFILIATE
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
August 31, 2006 and 2005

NOTE 9 – 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, 2006 and 2005, Easter Seals had \$639,189 and \$777,994, respectively, due in grants and fees receivable from government entities.

NOTE 10 – 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 2006 or 2005.

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.

Easter Seals accounts for its pension plan in accordance with SFAS No. 87 *Employers' Accounting for Pensions* and SFAS No. 132 *Employers Disclosures about Pensions and Other Postretirement Benefits*. 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>2006</u>	<u>2005</u>
Benefit obligation	\$ 2,152,015	\$ 2,366,057
Fair value of plan assets	<u>1,225,160</u>	<u>1,199,135</u>
Funded status	<u>\$ (926,855)</u>	<u>\$ (1,166,922)</u>
Accrued pension liability recognized in balance sheet	\$ (333,038)	\$ (324,938)
Benefit cost	\$ 74,186	\$ 65,026
Employer contributions	\$ 66,086	\$ 35,000
Plan participants' contributions	\$ -	\$ -
Benefits paid	\$ 46,055	\$ 42,609
Assumptions used in the accounting at August 31 were:		
Discount rate	6.25%	5.50%
Rate of increase in compensation levels	0.00%	3.50%
Expected long-term rate of return on assets	7.50%	7.50%

EASTER SEALS TENNESSEE, INC. AND AFFILIATE
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
August 31, 2006 and 2005

NOTE 10 – EMPLOYEE BENEFIT PLANS (Continued)

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%.

The plan had a minimum required contribution requirement of \$352,457 for the plan year ending August 31, 2005. The plan made a contribution in the amount of \$66,086 on May 11, 2006, and requested a waiver of the remaining contribution (which includes the \$156,035 funding deficiency for the plan year ending August 31, 2004). The plan filed the waiver request on October 28, 2005. The minimum required funding requirement for the plan year ending August 31, 2006 is dependent upon the resolution of the pending waiver request. It is currently estimated that the minimum required contribution will be \$250,119 in the event the waiver is granted. In the event the waiver is not granted, the minimum required contribution is estimated to be \$535,096.

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

2007	\$ 63,807
2008	74,556
2009	126,583
2010	125,910
2011	127,333
2012 – 2016	<u>692,715</u>
	<u>\$ 1,210,904</u>

Plan Assets:

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

Asset Category	<u>August 31, 2006</u>	<u>August 31, 2005</u>
Equity Mutual Funds	39.78%	37.21%
Fixed Income Mutual Funds	<u>60.22%</u>	<u>62.79%</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%

EASTER SEALS TENNESSEE, INC. AND AFFILIATE
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
August 31, 2006 and 2005

NOTE 11 – 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, 2006, are as follows:

Year ending <u>August 31,</u>	
2007	\$ 39,668
2008	36,138
2009	21,383
2010	16,856
2011	<u>1,242</u>
	<u><u>\$ 115,287</u></u>

Rent expense amounted to \$147,557 and \$86,897 in 2006 and 2005, respectively.

NOTE 12 – GOING CONCERN

The accompanying financial statements have been prepared assuming that Easter Seals will continue as a going concern. At August 31, 2006, Easter Seals has a working capital deficiency of \$9,357,521 (including \$7,993,080 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 2006 and 2005 could have the effect of making those debt obligations callable by the lenders. However, no such calls have been made as of the issuance of this report. 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 its headquarters campus for sale in an effort to satisfy obligations with its two largest creditors. It should be noted that the existing campus and the camp property have an appraised value of approximately \$11,225,000 and a net book value of \$7,339,614. 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 13 – 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.

EASTER SEALS TENNESSEE, INC. AND AFFILIATE
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
August 31, 2006 and 2005

NOTE 14 – 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.

Easter Seals has requested a waiver from the Internal Revenue Service ("IRS") of the minimum required contribution of \$352,457 for the plan year ending August 31, 2005. This amount includes \$156,035 funding deficiency for the plan year ending August 31, 2004. The waiver request is still pending. For the plan year ended August 31, 2006, another funding shortfall occurred and management plans to file another waiver. The plan is subject to statutory funding requirements and an excise tax equal to the entire funding deficiency if the waivers are not approved by the IRS.

During 2005, Easter Seals was placed on Mandatory Technical Assistance by the Department of Mental Retardation Services ("DMRS") related to West's operations. Easter Seals is working with DMRS to address the issues noted. DMRS has placed a moratorium on Easter Seals adding new patients in its West operations while under the Mandatory Technical Assistance program.