

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

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

August 31, 2005 and 2004

TABLE OF CONTENTS

| | |
|--|--------|
| Independent Auditor's Report | 2 |
| Financial Statements: | |
| Consolidated Statements of Financial Position | 3 |
| Consolidated Statements of Activities..... | 4 – 5 |
| Consolidated Statements of Functional Expenses | 6 – 7 |
| Consolidated Statements of Cash Flows..... | 8 |
| Notes to Consolidated Financial Statements..... | 9 – 18 |

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, 2005 and 2004, 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, 2005 and 2004, 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 financial statements have been prepared assuming that the Organization will continue as a going concern. As discussed in Note 13 to the financial statements, the Organization has a working capital deficiency of \$6,507,460 at August 31, 2005, and has incurred a significant decrease in net assets. Additionally, the Organization is working with its senior lender with the objective of restructuring its debt. In connection therewith, required debt service payments to that lender 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 2005 could have the effect of making most of Easter Seals' 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, as more fully described in Note 13, include working with its lenders to obtain revised loan agreements to permit the realization of assets and the liquidation of liabilities in the ordinary course of business, reducing operating costs, and obtaining additional financing as necessary. However, the ultimate outcome is uncertain. The financial statements do not include any adjustments that might result from the outcome of this uncertainty.

Fraser, Dean & Howard PLLC

November 7, 2005

EASTER SEALS TENNESSEE, INC. AND AFFILIATE
CONSOLIDATED STATEMENTS OF FINANCIAL POSITION
August 31, 2005 and 2004

| | <u>2005</u> | <u>2004</u> |
|---|----------------------------|----------------------------|
| Assets | | |
| Current assets: | | |
| Cash and cash equivalents | \$ 82,556 | \$ 174,191 |
| Accounts receivable, net | 1,045,858 | 885,533 |
| Investments | - | 222,500 |
| Prepaid expenses | 42,186 | 26,969 |
| Contributions receivable, net | <u>91,714</u> | <u>286,456</u> |
| Total current assets | 1,262,314 | 1,595,649 |
| Contributions receivable, net | 84,625 | 178,228 |
| Property and equipment, net | 8,055,805 | 8,476,213 |
| Loan costs, net of accumulated amortization of \$49,627 and \$37,627, respectively | <u>169,869</u> | <u>181,869</u> |
| Total assets | <u><u>\$ 9,572,613</u></u> | <u><u>\$10,431,959</u></u> |
| Liabilities and Net Assets (Deficit) | | |
| Current liabilities: | | |
| Accounts payable | \$ 375,876 | \$ 320,164 |
| Accrued expenses | 774,307 | 548,844 |
| Accrued interest | 261,323 | 28,343 |
| Deferred revenue | 510,377 | 371,350 |
| Note payable - line of credit | 247,000 | 23,631 |
| Current portion of long-term debt | 5,275,953 | 2,913,233 |
| Accrued pension liability | <u>324,938</u> | <u>191,035</u> |
| Total current liabilities | 7,769,774 | 4,396,600 |
| Accrued expense - noncurrent | 88,000 | - |
| Accrued pension liability, net of current portion | - | 103,877 |
| Long-term debt, net of current portion | <u>3,330,983</u> | <u>6,320,999</u> |
| Total liabilities | <u>11,188,757</u> | <u>10,821,476</u> |
| Net assets (deficit): | | |
| Unrestricted | (1,792,483) | (864,151) |
| Temporarily restricted | <u>176,339</u> | <u>474,634</u> |
| Total net deficit | <u>(1,616,144)</u> | <u>(389,517)</u> |
| Total liabilities and net deficit | <u><u>\$ 9,572,613</u></u> | <u><u>\$10,431,959</u></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 | 21,451 | - | 21,451 |
| 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 return, net | 520 | - | 520 |
| Total revenue | <u>9,351,257</u> | <u>-</u> | <u>9,351,257</u> |
| Net assets released from restrictions: | | | |
| Expiration of time restrictions | 441,162 | (441,162) | - |
| 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 | 68,342 | - | 68,342 |
| 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 | 467,605 | - | 467,605 |
| Total supporting services | <u>1,172,268</u> | <u>-</u> | <u>1,172,268</u> |
| National program fee | 149,060 | - | 149,060 |
| 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 | (864,151) | 474,634 | (389,517) |
| 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 ACTIVITIES
For the Year Ended August 31, 2004

| | <u>Unrestricted</u> | <u>Temporarily Restricted</u> | <u>Total</u> |
|--|---------------------|-----------------------------------|---------------------|
| Public support and revenue: | | | |
| Public support: | | | |
| Contributions | \$ 1,142,924 | \$ 244,448 | \$ 1,387,372 |
| Special events (including in-kind donations of \$54,425) | 336,966 | - | 336,966 |
| Less: direct benefit costs (including in-kind expenses of \$54,425) | (86,359) | - | (86,359) |
| Donated goods and services, at fair value | 4,529 | - | 4,529 |
| Bequests | 4,481 | - | 4,481 |
| Total public support | <u>1,402,541</u> | <u>244,448</u> | <u>1,646,989</u> |
| Revenue: | | | |
| Government fees and grants | 4,904,389 | - | 4,904,389 |
| Program service fees | 1,571,681 | - | 1,571,681 |
| Child development center | 320,935 | - | 320,935 |
| Camp rental | 270,810 | - | 270,810 |
| Membership fees | 141,352 | - | 141,352 |
| Contract services | 123,799 | - | 123,799 |
| Other | 22,155 | - | 22,155 |
| Investment income, net | 1,594 | - | 1,594 |
| Total revenue | <u>7,356,715</u> | <u>-</u> | <u>7,356,715</u> |
| Net assets released from restrictions: | | | |
| Expiration of time restrictions | 369,460 | (369,460) | - |
| Total public support and revenue | <u>9,128,716</u> | <u>(125,012)</u> | <u>9,003,704</u> |
| Expenses: | | | |
| Program services: | | | |
| Direct services | 8,509,486 | - | 8,509,486 |
| Public health education | 49,934 | - | 49,934 |
| Total program services | <u>8,559,420</u> | <u>-</u> | <u>8,559,420</u> |
| Supporting services: | | | |
| Management and general | 491,980 | - | 491,980 |
| Fundraising | 461,089 | - | 461,089 |
| Total supporting services | <u>953,069</u> | <u>-</u> | <u>953,069</u> |
| National program fee | <u>143,931</u> | <u>-</u> | <u>143,931</u> |
| Total expenses | <u>9,656,420</u> | <u>-</u> | <u>9,656,420</u> |
| Change in net assets | (527,704) | (125,012) | (652,716) |
| Net assets at beginning of year | <u>(336,447)</u> | <u>599,646</u> | <u>263,199</u> |
| Net assets at end of year | <u>\$ (864,151)</u> | <u>\$ 474,634</u> | <u>\$ (389,517)</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 |
| 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 | \$ 10,416,609 | \$ 68,342 | \$ 10,484,951 | \$ 704,663 | \$ 467,605 | \$ 1,172,268 | \$ 11,806,279 |

See accompanying notes

EASTER SEALS TENNESSEE, INC. AND AFFILIATE
CONSOLIDATED STATEMENT OF FUNCTIONAL EXPENSES

For the Year Ended August 31, 2004

| | Program Services | | | Supporting Services | | | National Program Fee | Total Expenses |
|---------------------------------------|------------------|-------------------------|--------------|------------------------|-------------|------------|----------------------|----------------|
| | Direct Services | Public Health Education | Total | Management and General | Fundraising | Total | | |
| Salaries and related expenses | \$ 6,370,187 | \$ 29,295 | \$ 6,399,482 | \$ 34,648 | \$ 365,654 | \$ 400,302 | \$ - | \$ 6,799,784 |
| Depreciation and amortization | 428,494 | 8,190 | 436,684 | 44,250 | 13,180 | 57,430 | - | 494,114 |
| Professional fees | 327,990 | 3,230 | 331,220 | 22,624 | 9,358 | 31,982 | - | 363,202 |
| Interest | - | - | - | 335,431 | - | 335,431 | - | 335,431 |
| Insurance | 219,475 | 900 | 220,375 | - | 3,440 | 3,440 | - | 223,815 |
| Supplies | 190,528 | 11 | 190,539 | 820 | 8,382 | 9,202 | - | 199,741 |
| Travel and transportation | 169,626 | 284 | 169,910 | 1,432 | 4,336 | 5,768 | - | 175,678 |
| Building and grounds maintenance | 157,540 | 2,460 | 160,000 | 3,755 | 3,913 | 7,668 | - | 167,668 |
| Utilities | 138,908 | 2,484 | 141,392 | 837 | 3,936 | 4,773 | - | 146,165 |
| National program fee | - | - | - | - | - | - | 143,931 | 143,931 |
| Specific assistance | 137,056 | - | 137,056 | - | - | - | - | 137,056 |
| Rental and maintenance of equipment | 74,105 | 1,572 | 75,677 | 2,698 | 4,937 | 7,635 | - | 83,312 |
| Occupancy | 81,090 | - | 81,090 | - | - | - | - | 81,090 |
| Telephone | 57,617 | 1,032 | 58,649 | 144 | 1,985 | 2,129 | - | 60,778 |
| Bad debts | 49,692 | - | 49,692 | 3 | 756 | 759 | - | 50,451 |
| Printing and publications | 29,082 | 138 | 29,220 | 935 | 15,449 | 16,384 | - | 45,604 |
| Letter of credit fees | - | - | - | 40,518 | - | 40,518 | - | 40,518 |
| Miscellaneous | 28,863 | - | 28,863 | 2,660 | 642 | 3,302 | - | 32,165 |
| Advertising | 21,214 | - | 21,214 | 42 | 2,010 | 2,052 | - | 23,266 |
| Postage and shipping | 15,054 | 11 | 15,065 | 939 | 6,129 | 7,068 | - | 22,133 |
| Planned Giving Program | - | - | - | - | 12,895 | 12,895 | - | 12,895 |
| Conferences, conventions and meetings | 8,797 | 249 | 9,046 | 162 | 2,722 | 2,884 | - | 11,930 |
| Membership and support payments | 4,168 | 78 | 4,246 | 82 | 1,365 | 1,447 | - | 5,693 |
| Total functional expenses | \$ 8,509,486 | \$ 49,934 | \$ 8,559,420 | \$ 491,980 | \$ 461,089 | \$ 953,069 | \$ 143,931 | \$ 9,656,420 |

See accompanying notes.

EASTER SEALS TENNESSEE, INC. AND AFFILIATE
CONSOLIDATED STATEMENTS OF CASH FLOWS
For the Years Ended August 31, 2005 and 2004

| | <u>2005</u> | <u>2004</u> |
|---|-------------------|-------------------|
| Cash flows from operating activities: | | |
| Change in net assets | \$ (1,226,627) | \$ (652,716) |
| Adjustments to reconcile change in net assets to net cash provided by (used in) operating activities: | | |
| Depreciation and amortization | 488,857 | 494,114 |
| Net gain on property disposal | (8,600) | 350 |
| Receipts of donated investments | - | (222,500) |
| Changes in operating assets and liabilities: | | |
| Accounts receivable, net | (160,325) | (157,784) |
| Contributions receivable, net | 288,345 | 124,808 |
| Prepaid expenses | (15,217) | (8,911) |
| Accounts payable | 55,712 | (220,583) |
| Accrued expenses | 546,443 | 175,525 |
| Estimated fair value of interest rate swap agreement | - | (243,000) |
| Deferred revenue | 139,027 | (14,087) |
| Accrued pension liability | 30,026 | (89,502) |
| Net cash provided by (used in) operating activities | <u>137,641</u> | <u>(814,286)</u> |
| Cash flows from investing activities: | | |
| Proceeds from sale of investments | 222,500 | - |
| Purchases of property and equipment | (56,449) | (109,657) |
| Proceeds from disposal of property and equipment | 8,600 | - |
| Net cash provided by (used in) investing activities | <u>174,651</u> | <u>(109,657)</u> |
| Cash flows from financing activities: | | |
| Proceeds from borrowings | 3,446,650 | 3,170,394 |
| Payments on notes payable | (3,850,577) | (2,108,120) |
| Payment of loan costs | - | (10,893) |
| Net cash (used in) provided by financing activities | <u>(403,927)</u> | <u>1,051,381</u> |
| Net (decrease) increase in cash and cash equivalents | (91,635) | 127,438 |
| Cash and cash equivalents at beginning of year | 174,191 | 46,753 |
| Cash and cash equivalents at end of year | <u>\$ 82,556</u> | <u>\$ 174,191</u> |
| Supplemental disclosure of cash flow information: | | |
| Interest paid | <u>\$ 201,053</u> | <u>\$ 403,094</u> |
| Non-cash investing and financing activity: | | |
| Receipts of donated investments | <u>\$ -</u> | <u>\$ 222,500</u> |

See accompanying notes.

EASTER SEALS TENNESSEE, INC. AND AFFILIATE
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
August 31, 2005 and 2004

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 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.

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 or at fair value as of the date purchased or contributed. Depreciation is provided on the straight-line method over the estimated useful lives of the respective assets.

EASTER SEALS TENNESSEE, INC. AND AFFILIATE
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
August 31, 2005 and 2004

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

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 2005 and 2004.

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, 2005 and 2004

NOTE 2 – ACCOUNTS RECEIVABLE

Accounts receivable consist of the following at August 31:

| | <u>2005</u> | <u>2004</u> |
|--|---------------------|-------------------|
| Accounts receivable | \$ 166,329 | \$ 128,443 |
| Grants and fees receivable from state agencies | 777,994 | 460,692 |
| Rehabilitation fees | <u>380,246</u> | <u>560,631</u> |
| Subtotal | 1,324,569 | 1,149,766 |
| Less: allowance for uncollectible accounts | (216,491) | (95,120) |
| Less: contractual allowance | <u>(62,220)</u> | <u>(169,113)</u> |
| Net accounts receivable | <u>\$ 1,045,858</u> | <u>\$ 885,533</u> |

NOTE 3 – INVESTMENTS

During 2004, Easter Seals received 2,500 Class B shares of a privately held corporation. The shares were recorded at their appraisal value which totaled \$222,500 as of August 31, 2004. The investment was liquidated in fiscal 2005 at appraised value.

NOTE 4 – CONTRIBUTIONS RECEIVABLE

Contributions receivable are as follows at August 31:

| | <u>2005</u> | <u>2004</u> |
|---|-------------------|-------------------|
| McWhorter Family Children's Center | \$ 30,000 | \$ 90,000 |
| Gross capital campaign receivables | 88,647 | 138,657 |
| United Way allocations | - | 69,237 |
| Annual gift receivables | <u>141,015</u> | <u>203,345</u> |
| Subtotal | 259,662 | 501,239 |
| Less: allowance for uncollectible contributions | (49,301) | (7,533) |
| Less: discount to net present value | <u>(34,022)</u> | <u>(29,022)</u> |
| Net contributions receivable | <u>\$ 176,339</u> | <u>\$ 464,684</u> |
| Receivable in less than one year, net | \$ 91,714 | \$ 286,456 |
| Receivable in one to five years, net | <u>84,625</u> | <u>178,228</u> |
| | <u>\$ 176,339</u> | <u>\$ 464,684</u> |

EASTER SEALS TENNESSEE, INC. AND AFFILIATE
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
August 31, 2005 and 2004

NOTE 5 – PROPERTY AND EQUIPMENT

Property and equipment consists of the following at August 31:

| | <u>2005</u> | <u>2004</u> |
|-------------------------------|---------------------|---------------------|
| Land | \$ 1,532,557 | \$ 1,532,557 |
| Buildings and improvements | 7,862,460 | 7,862,460 |
| Vehicles | 706,153 | 723,703 |
| Equipment | <u>1,263,747</u> | <u>1,244,050</u> |
| | 11,364,917 | 11,362,770 |
| Less accumulated depreciation | <u>(3,309,112)</u> | <u>(2,886,557)</u> |
| Net property and equipment | <u>\$ 8,055,805</u> | <u>\$ 8,476,213</u> |

Depreciation expense totaled \$476,857 and \$482,114 in 2005 and 2004, respectively. At August 31, 2005 and 2004, respectively, vehicles with a depreciated value of \$72,761 and \$60,494 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 6 – NOTES PAYABLE

| | <u>2005</u> | <u>2004</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 (7.0% at August 31, 2005), interest only payable through original maturity (January 3, 2005). The line of credit is secured by a first lien security interest in Easter Seals' accounts receivable, furniture, equipment, capital campaign receipt, machinery, and fixtures, a first priority deed of trust on camp property, and the Woodmont Boulevard facility. The line of credit provided for maximum borrowings of \$300,000. As described in Note 13, required debt service payments have not been made since December 2004. The line of credit has not been renewed at August 31, 2005 and is therefore presented in the accompanying financial statements as currently due. | \$ 247,000 | \$ 23,631 |

EASTER SEALS TENNESSEE, INC. AND AFFILIATE
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
August 31, 2005 and 2004

NOTE 6 – NOTES PAYABLE (Continued)

| | <u>2005</u> | <u>2004</u> |
|---|-------------|-------------|
| Note payable related to Series 1999 Variable Rate Revenue Bonds, interest payable monthly (2.75% at August 31, 2005), 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. | 2,425,000 | 2,425,000 |
| Term loan payable to bank, interest at 6.0% per annum, secured by all of Easter Seals' accounts, 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 13, 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 balance sheet. | 1,967,261 | 1,981,992 |
| Promissory note payable to bank, interest at 1.0% per annum over the bank's prime rate (7.5% at August 31, 2005), 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 13, 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 balance sheet. | 2,750,000 | 2,750,000 |
| Note payable, interest at the prime rate beginning August 2005 (6.5% at August 31, 2005); secured by real property. Beginning August 2005, 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. | 1,097,689 | 1,100,000 |

EASTER SEALS TENNESSEE, INC. AND AFFILIATE
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
August 31, 2005 and 2004

NOTE 6 – NOTES PAYABLE (Continued)

| | <u>2005</u> | <u>2004</u> |
|---|---------------------|---------------------|
| Line of credit payable to bank, interest at 7.5% per annum, interest only payable through maturity (September 11, 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 total borrowings of \$800,000. The credit facility contains various covenants including the requirement to maintain a coverage ratio of not less than 1.10 to be calculated quarterly. (West was not in compliance with certain of these covenants at August 31, 2005. However, a waiver of compliance was obtained for the year ended August 31, 2005.) | 88,747 | 699,001 |
| Note payable, interest at prime rate (6.50% at August 31, 2005), 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. | 278,239 | 278,239 |
| | <u>\$ 8,853,936</u> | <u>\$ 9,257,863</u> |
| Included in the accompanying balance sheet as: | | |
| Notes payable – line of credit | \$ 247,000 | \$ 23,631 |
| Long term debt, net of current portion | 3,330,983 | 6,320,999 |
| Current portion of long term debt | <u>5,275,953</u> | <u>2,913,233</u> |
| | <u>\$ 8,853,936</u> | <u>\$ 9,257,863</u> |

The following represents scheduled principal maturities of long-term debt as of August 31, 2005:

| | |
|-------------------|---------------------|
| Year ending | |
| <u>August 31,</u> | |
| 2006 | \$ 5,522,953 |
| 2007 | 252,917 |
| 2008 | 171,020 |
| 2009 | 182,965 |
| 2010 | 190,010 |
| Thereafter | <u>2,534,071</u> |
| | <u>\$ 8,853,936</u> |

EASTER SEALS TENNESSEE, INC. AND AFFILIATE
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
August 31, 2005 and 2004

NOTE 7 – LETTER OF CREDIT

In connection with securing 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, 2005 or 2004.

NOTE 8 – TEMPORARILY RESTRICTED NET ASSETS

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

| | <u>2005</u> | <u>2004</u> |
|---|-------------------|-------------------|
| Unconditional promises to give due in future periods | \$ 176,339 | \$ 464,684 |
| Contributions designated for Nashville Child Development Center | <u>-</u> | <u>9,950</u> |
| | <u>\$ 176,339</u> | <u>\$ 474,634</u> |

NOTE 9 – ALLOCATION OF FUNCTIONAL EXPENSES

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

NOTE 10 – 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, 2005 and 2004, Easter Seals had \$777,994 and \$460,692, respectively, due in grants and fees receivable from government entities.

NOTE 11 – 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 2005 or 2004.

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 TENNESSEE, INC. AND AFFILIATE
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
August 31, 2005 and 2004

NOTE 11 – EMPLOYEE BENEFIT PLANS (Continued)

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' statements at August 31:

| | <u>2005</u> | <u>2004</u> |
|---|-----------------------|---------------------|
| Benefit obligation | \$ 2,366,057 | \$ 2,082,968 |
| Fair value of plan assets | <u>1,199,135</u> | <u>1,153,124</u> |
| Funded status | <u>\$ (1,166,922)</u> | <u>\$ (929,844)</u> |
| Accrued pension liability recognized in balance sheet | \$ (324,938) | \$ (294,912) |
| Benefit cost | \$ 65,026 | \$ 69,205 |
| Employer contributions | \$ 35,000 | \$ 158,707 |
| Plan participants' contributions | \$ - | \$ - |
| Benefits paid | \$ 42,609 | \$ 41,623 |
| Assumptions used in the accounting at August 31 were: | | |
| Discount rate | 5.50% | 6.25% |
| Rate of increase in compensation levels | 3.50% | 3.50% |
| 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%. Easter Seals has requested a waiver from the Internal Revenue Service 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.

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

| | |
|-------------|---------------------|
| 2006 | \$ 55,323 |
| 2007 | 56,522 |
| 2008 | 67,255 |
| 2009 | 119,117 |
| 2010 | 120,536 |
| 2011 – 2015 | <u>691,612</u> |
| | <u>\$ 1,110,365</u> |

EASTER SEALS TENNESSEE, INC. AND AFFILIATE
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
August 31, 2005 and 2004

NOTE 11 – 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, 2005</u> | <u>August 31, 2004</u> |
|---------------------------|------------------------|------------------------|
| Asset Category | | |
| Equity Mutual Funds | 37.21% | 60.52% |
| Fixed Income Mutual Funds | 62.79% | 39.67% |
| Cash | <u>0.00%</u> | <u>-0.19%</u> |
| Total | 100.00% | 100.00% |
| Target Asset Allocation | | |
| Equity Mutual Funds | 35.00% | |
| Fixed Income Mutual Funds | <u>65.00%</u> | |
| Total | 100.00% | |

NOTE 12 – 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, 2005, are as follows:

| | |
|--------------------------|-------------------|
| Year ending | |
| <u>August 31,</u> | |
| 2006 | \$ 41,698 |
| 2007 | 35,591 |
| 2008 | 32,061 |
| 2009 | 20,017 |
| 2010 | <u>16,850</u> |
| | <u>\$ 146,217</u> |

Rent expense amounted to \$86,897 and \$104,123 in 2005 and 2004, respectively.

EASTER SEALS TENNESSEE, INC. AND AFFILIATE
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
August 31, 2005 and 2004

NOTE 13 – GOING CONCERN

The accompanying financial statements have been prepared assuming that Easter Seals will continue as a going concern. At August 31, 2005, Easter Seals has a working capital deficiency of \$6,507,460 (including \$5,522,953 of notes payable classified as currently due) and has incurred a significant decrease in net assets. Easter Seals is working with its senior lender with the objective of restructuring its debt. In connection therewith, required debt service payments to that lender 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 2005 could have the effect of making those Easter Seals 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. Management's plans include working with its lenders to obtain revised loan agreements to permit the realization of assets and the liquidation of liabilities in the ordinary course of business, reducing operating costs, and obtaining additional financing as necessary. It should be noted that Easter Seals' assets include a camp property that was purchased for \$26,283 and has an appraised value of \$3,225,000. Management believes that Easter Seals will be able to achieve positive cash flow in future periods through further maturity of its programs combined with strategies to reduce debt. However, the ultimate outcome is uncertain. The financial statements do not include any adjustments that might result from the outcome of this uncertainty.

NOTE 14 – 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.