

**EDUCATION MANAGEMENT  
SYSTEMS, INC. &  
SUBSIDIARIES  
(An S Corporation)  
CONSOLIDATED  
FINANCIAL STATEMENTS  
AND SUPPLEMENTAL  
INFORMATION  
June 30, 2016**

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## **INDEPENDENT AUDITOR'S REPORT**

To the Board of Directors and Stockholders  
Education Management Systems, Inc.  
Pasadena, California

We have audited the accompanying consolidated financial statements of Education Management Systems, Inc. (an S Corporation) and subsidiaries, which comprise the consolidated balance sheet as of June 30, 2016, and the related consolidated statements of operation, stockholders' equity and cash flows for the year then ended, and the related notes to the financial statements.

### ***Management's Responsibility for the Financial Statements***

Management is responsible for the preparation and fair presentation of these consolidated financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of consolidated financial statements that are free from material misstatement, whether due to fraud or error.

### ***Auditor's Responsibility***

Our responsibility is to express an opinion on these consolidated financial statements based on our audit. We conducted our audit 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 consolidated financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the consolidated financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

### ***Opinion***

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Education Management Systems, Inc. and subsidiaries as of June 30, 2016, and the results of their operations and their cash flows for the year then ended in accordance with accounting principles generally accepted in the United States of America.

### ***Contingency***

As discussed in Note 6 to the consolidated financial statements, the Company was the subject of an audit for the California Department of Education. The audit identified potential disallowed funding of \$19,509,000, alleging improper accounting for teacher compensation, improper computation of teacher full time equivalency, and other matters. The Company filed a legal action challenging the allegation of improper computation of teacher full time equivalency and filed an appeal of the audit report for the potential disallowed funding. As described in the Management's Plan section, the CDE withheld \$18,207,609 from the Company's apportionment funding for full time equivalency. OFL filed an appeal in Superior Court and believes funds withheld by the CDE will be recovered through court trial. The ultimate outcome of any further action that may be taken cannot be presently determined. As such, management is not able to make a reasonable estimate of further potential effects, if any, on the financial statements. Accordingly, no provision for any additional liability that may result has been made in the financial statements. As more information becomes available, due to uncertainties with the potential disallowed funding and the action filed by management, it is at least reasonably possible that management's view of the outcome will change in the near term. Management's plans regarding this matter are also described in Note 6. Our opinion is not modified with respect to this matter.

### ***Transactions with related parties***

As discussed in Note 5 to the consolidated financial statements, the Company is engaged in transactions with various related parties for management services and other educational services for the Company's charter school operations. Our opinion is not modified with respect to this matter.

### ***Concentration***

As discussed in Note 1 to the consolidated financial statements, the Company provides services to students under the charter with the Baldwin Park Unified School District, William S. Hart Union High School District, and Capistrano Unified School District which amounted to 100% of charter school revenues reported for the year ended June 30, 2016. Loss of charter authorization could have a material adverse effect on the Company. Our opinion is not modified with respect to this matter.

### ***Report on Consolidating Information***

Our audit was conducted for the purpose of forming an opinion on the consolidated financial statements as a whole. The consolidating information in Schedules A, B and C is presented for purposes of additional analysis of the consolidated financial statements rather than to present the financial position, results of operations, and cash flows of the individual companies, and it is not a required part of the consolidated financial statements. Such information is the responsibility of management and was derived from and relates directly to the underlying accounting and other records used to prepare the consolidated financial statements. The consolidating information has been subjected to the auditing procedures applied in the audit of the consolidated financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the consolidated financial statements or to the consolidated financial statements themselves, and other additional procedures in accordance with auditing standards generally accepted in the United States of America. In our opinion, the consolidating information is fairly stated in all material respects in relation to the consolidated financial statements as a whole.

*Maginnis Knechtel & McIntyre, LLP*

Pasadena, California  
January 11, 2017

**EDUCATION MANAGEMENT SYSTEMS, INC. & SUBSIDIARIES**  
**(An S Corporation)**

**CONSOLIDATED BALANCE SHEETS**

June 30, 2016

**ASSETS**

Current assets	
Cash and cash equivalents	\$ 4,083,419
Amount due from school district/state aid	7,145,406
Receivable from PSE	1,992,104
Notes receivable from related parties	1,000,000
Prepaid expenses and other receivables	<u>2,039,805</u>
Total current assets	16,260,734
Property and equipment, net	3,581,157
Deposits and other assets	<u>237,842</u>
	<u><u>\$ 20,079,733</u></u>

**LIABILITIES AND STOCKHOLDERS' EQUITY**

Current Liabilities	
Accounts payable and accrued expenses	\$ 6,404,895
Notes payable to related parties	14,565
Deferred revenue	<u>4,588,436</u>
Total current liabilities	11,007,896
Commitments and contingencies (Notes 3 and 5)	
Stockholders' equity	
Common stock, no par value:	
Voting authorized 10,000 shares,	
issued and outstanding 3,000 shares	5
Non-voting authorized 1,000,000 shares,	
issued and outstanding 300,000 shares	495
Retained earnings	<u>9,071,337</u>
	<u>9,071,837</u>
	<u><u>\$ 20,079,733</u></u>

See accompanying notes to financial statements.

**EDUCATION MANAGEMENT SYSTEMS, INC. & SUBSIDIARIES**  
**(An S Corporation)**

**CONSOLIDATED STATEMENTS OF OPERATIONS**

For the year ended June 30, 2016

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Revenue from educational services	
LCFF principal apportionment / categorical funds	\$ 44,202,666
Local revenue	5,889,611
Lottery	755,808
Other revenue	<u>933,289</u>
	51,781,374
Education and operating expenses	
Direct site expenses	38,698,609
Administration, curriculum and development	<u>6,806,942</u>
	6,275,823
Income before other expense and taxes	
Other expenses	
Interest and other	<u>159,192</u>
Income before income tax provision	6,116,631
Income tax expense (including LLC tax fees)	<u>35,280</u>
Net income	<u><u>\$ 6,081,351</u></u>

See accompanying notes to financial statements.

**EDUCATION MANAGEMENT SYSTEMS, INC. & SUBSIDIARIES**  
**(An S Corporation)**

**CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY**

For the year ended June 30, 2016

	<b>Common stock</b>				<b>Retained earnings</b>	<b>Total</b>
	<b>Voting</b>		<b>Non - voting</b>			
	<u>Shares</u>	<u>Amount</u>	<u>Shares</u>	<u>Amount</u>		
Balance June 30, 2015 as previously reported	3,000	\$ 5	300,000	\$ 495	\$ 1,513,350	\$ 1,513,850
Prior period adjustment	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>1,501,157</u>	<u>1,501,157</u>
Balance June 30, 2015 as restated	3,000	5	300,000	495	3,014,507	3,015,007
Net income	-	-	-	-	6,081,351	6,081,351
Distributions to stockholders	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>(24,521)</u>	<u>(24,521)</u>
Balance June 30, 2016	<u>3,000</u>	<u>\$ 5</u>	<u>300,000</u>	<u>\$ 495</u>	<u>\$ 9,071,337</u>	<u>\$ 9,071,837</u>

See accompanying notes to financial statements.

**EDUCATION MANAGEMENT SYSTEMS, INC. & SUBSIDIARIES**  
**(An S Corporation)**

**CONSOLIDATED STATEMENTS OF CASH FLOWS**

For the year ended June 30, 2016

Cash flows from operating activities:	
Net income	\$ 6,081,351
Adjustments to reconcile net income to net cash provided by operating activities:	
Depreciation and amortization	1,006,218
(Increase) decrease in:	
Amount due from school districts/state aid	(1,439,492)
Receivable from PSE	(490,947)
Prepaid expenses and other receivables	453,885
Increase (decrease) in:	
Accounts payable and accrued expenses	(920,369)
Deferred revenue	<u>4,336,317</u>
Net cash provided by operating activities	9,026,963
Cash flows provided (used) by investing activities:	
Purchase of equipment	(820,337)
Proceeds from note receivable from related parties	<u>1,385,000</u>
Net cash provided by investing activities	564,663
Cash flows provided (used) by financing activities:	
Payments on note payable to related parties	(7,325,000)
Distributions to stockholders	<u>(24,521)</u>
Net cash (used) in financing activities	<u>(7,349,521)</u>
Net increase in cash	2,242,105
Cash at beginning of year	<u>1,841,314</u>
Cash at end of year	<u><u>\$ 4,083,419</u></u>

Supplemental disclosure for cash flow information:

Cash paid for taxes: \$35,280  
Cash paid for interest: \$327,434

See accompanying notes to financial statements.



**EDUCATION MANAGEMENT SYSTEMS, INC. & SUBSIDIARIES**  
**(An S Corporation)**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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**1 Organization and summary of significant accounting policies**

Organization

Education Management Systems, Inc. (Company) is incorporated under the laws of Delaware and manages elementary and secondary charter schools under contracts with OFL – BP, LLC (BP) OFL-C, LLC (OFL-C), and OFL – WSH, LLC (WSH) (the Charters) all incorporated under the California Limited Liability Corporation laws. The Charters do business as OFL Baldwin Park, OFL San Juan Capistrano, and OFL William S. Hart. Charters are for periods of three to five years. BP, OFL-C and, WSH hold charters granted by school districts in Southern California. The school districts may unilaterally terminate the charter under certain restrictive conditions (such as a material violation of the charter, etc.) during the term of the charter. At the end of the charter term, unless the school district finds the charter school fails to meet the standards required for the initial grant of the charter, the charter will likely be renewed by the school district.

BP was formed to hold the charter with the Baldwin Park Unified School District and its sole member is the Company. OFL-C was formed to hold the charter with the Capistrano Unified School District and its sole member is the Company. WSH was formed to hold the charter with the William S. Hart Union High School District and its sole member is the Company. The current charter term is through June 30, 2021 for BP, and June 30, 2017, for OFL-C and WSH.

The Company, under an administrative management agreement, provides, among other services, the education program in facilities for independent study based instruction, recruits and manages personnel, and maintains and operates each school it manages. For June 30, 2016, for an agreed upon fee for each year, the Company operated three charter schools at multiple sites in Southern California, under the trade name "Opportunities for Learning".

Principles of consolidation

The consolidated financial statements include the accounts of the Company and Charters. The Charters are limited liability companies whose sole member is the Company and are accounted for as subsidiaries. All material inter-company balances and transactions have been eliminated from the consolidated financial statements.

Property and equipment

Property and equipment are stated at cost. Routine maintenance and repairs are expensed as incurred. The cost of major additions, replacements and improvements are capitalized. Depreciation is computed on a straight-line basis over the estimated useful lives of the respective assets which is generally 5 years. Depreciation and amortization expense for the year ended June 30, 2016 was \$1,006,218.

**EDUCATION MANAGEMENT SYSTEMS, INC. & SUBSIDIARIES**  
**(An S Corporation)**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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**1 Organization and summary of significant accounting policies, continued**

Revenue recognition

The majority of revenue the Company recognizes from each charter school is based upon 100% for 2016 of the average daily attendance (ADA) multiplied by the Local Control Funding Formula for grades K–12 (as published annually by the California Department of Education). Revenues are collected monthly, except during deferral periods as determined by the State of California, initially based on the ADA of the previous year. Revenues for the year are adjusted twice at specific dates, known as P-1 (December) and P-2 (April) when new current year ADA is ascertained.

Additional revenue recognized comes from lottery funds that are received quarterly, and is based upon the annual ADA known as P–Annual (June). Since lottery revenues are dependent upon lottery sales, actual results could differ from previous estimates.

All revenues discussed above are paid to the Charter holders through the county in which the Charter resides. California State Senate Bill 740 has placed restrictions on the amount of future LCFF funding revenue to be received.

Income taxes

The Company has elected to be taxed under the provisions of Subchapter S of the Internal Revenue Code. Under those provisions, the Company will not pay federal income taxes on its corporate taxable income. Instead, the stockholders will be liable for individual federal income taxes on the Company's consolidated taxable income. As a result, the effects of the differences between income for tax and financial reporting will accrue to the stockholders. The Company has also elected to be taxed under the provisions of Subchapter S for California and under such regulations, the corporate tax rate is 1-1/2%. The Company's subsidiaries, which are LLCs, must pay a fee based on total annual revenue to a maximum of \$12,590.

The U.S. federal and California state tax returns have statutes of limitations that generally range from three to four years. No open tax returns are currently under examination.

Use of estimates

The preparation of consolidated financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts and disclosures. Actual results could differ from those estimates.

**EDUCATION MANAGEMENT SYSTEMS, INC. & SUBSIDIARIES**  
**(An S Corporation)**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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**1 Organization and summary of significant accounting policies, continued**

Concentration of credit risk

The Company provides services to three school districts which amounted to 100% of total revenue from educational services for the year ended June 30, 2016. The Company performs periodic credit evaluations and generally does not require collateral.

The Company maintains its cash in bank deposit accounts which, at times, may exceed federally insured limits. At June 30, 2016, the Company had \$3,662,659 deposits in excess of FDIC insured limits.

**2 Property and equipment**

Property and equipment at June 30, 2016, consists of the following:

Furniture, fixtures, computers and other equipment	\$ 4,078,368
School equipment	135,777
Leasehold improvements	4,979,932
Construction in Progress	<u>636,227</u>
	9,830,304
Less: accumulated depreciation and amortization	<u>(6,249,147)</u>
	<u>\$ 3,581,157</u>

**3 Deferred revenue**

Deferred revenue at June 30, 2016 consist of the following:

One-time funds for outstanding mandate claims	\$ 3,067,991
Educator effectiveness funds	483,693
Special education	<u>1,036,752</u>
Total deferred revenue	<u>\$ 4,588,436</u>

**EDUCATION MANAGEMENT SYSTEMS, INC. & SUBSIDIARIES**  
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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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**4 Lease commitments**

The Company has entered into operating leases for the school sites. The agreements expire at various times through October 2022. Most of the lease agreements allow the Company to terminate the lease with notice ranging from three days to six months. Upon termination of the lease, the Company is liable for lease payments during the termination notice period as well as the property owner's unamortized tenant improvements and brokerage commissions.

The minimum annual rental payments under these leases are as follows:

For the year ended June 30:

2017	\$ 2,566,431
2018	2,123,255
2019	1,556,222
2020	1,182,192
2021	571,190
Thereafter	<u>507,391</u>
	<u>\$ 8,506,681</u>

Total rent expense for the year ended June 30, 2016 was \$3,211,083.

**5 Transactions with related parties**

The Company uses certain purchasing and development services related to curriculum/instructional materials and events materials, supplies and services from Education Management Systems III (EMS III), an affiliate of the Company. Total payments to EMS III for the year ended June 30, 2016 was \$5,614,198. Amount due to EMS III was \$1,108,157 at June 30, 2016.

The Company purchases maintenance, property management, and construction oversight services from Lupine Properties, LLC (Lupine), a subsidiary of EMS III. Total payments to Lupine for the year ended June 30, 2016 was \$514,579. Amounts due to Lupine were \$129,572 at June 30, 2016.

The Company purchases employee recruiting services from 9Dot Education Solutions, LLC (9Dot), a subsidiary of EMS III. Total payments to 9Dot for the year ended June 30, 2016 was \$816,630.

**EDUCATION MANAGEMENT SYSTEMS, INC. & SUBSIDIARIES**  
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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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**5 Transactions with related parties, continued**

The Company purchases services from Education Dynamics, Inc. (EDI) and its subsidiary, AllTech Enterprises, LLC, for computer consulting, student information system usage/maintenance, and software development services. EDI is owned by the stockholders of EMS. For the year ended June 30, 2016, the total consolidated purchases from EDI was \$3,275,042, of which \$511,642 was owed. Included in these expenses was \$1,623,500 for software development.

The Company's charters contract with Partners in Special Education (PSE), owned by some stockholders of the Company, to obtain special education program services for the charters' students. For the year ended June 30, 2016, the program expense was \$1,550,161 of which \$277,999 and \$6,717 is included in accounts payable and accrued expenses for BP and OFL-C. Additionally, included in the Receivable from PSE at June 30, 2016 is a \$490,947 credit from 2016 billing corrections for WSH and a \$1,501,157 credit to the charters from prior years' billing corrections, as discussed in Note 9.

Pathways in Education and Rocky Mountain Pathways, and Pathways in Education – Mendocino, non-profit organizations and related parties founded by the Company's founders, provide after school programs, other instructional programs, and outdoor educational camp programs to the Company's students. Total payments to Pathways for year ended June 30, 2016 was \$1,593,855. At June 30, 2016, \$21,915 was due to Pathways. In addition, the Company rented office space from Hawkeye Properties, Inc. (Hawkeye) and its subsidiary, Eagle Eye Title Holding Company, a non-profit organization founded by the Company's founders. Total payments to Hawkeye for the year ended June 30, 2016 was \$344,359.

For the year ended June 30, 2016, a note receivable of \$1,000,000, at interest of 3.64% was due from EMS III. This note receivable matures on June 30, 2017.

Included in the prepaid expenses and other receivables are \$804,768 of receivables for payments made by EMS, on behalf of EMS III to its shareholders in prior year. In addition, included in the accounts payable balance at June 30, 2016 is a \$994,921 of payable to EMS II for payments made by EMS II, on behalf of EMS, to its stockholders in prior year. These receivables and payables are expected to be collected or repaid in FY2016-2017.

**EDUCATION MANAGEMENT SYSTEMS, INC. & SUBSIDIARIES**  
**(An S Corporation)**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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**6 Contingencies**

The Company was the subject of an audit for the California Department of Education. The audit identified potential disallowed funding of \$19,509,000, alleging improper accounting for teacher compensation, improper computation of teacher full time equivalency, and other matters. The Company filed a legal action challenging the allegation of improper computation of teacher full time equivalency and filed an appeal of the audit report for the potential disallowed funding. As described in the Management's Plan section, the CDE withheld \$18,207,609 from the Company's apportionment funding for full time equivalency. OFL filed an appeal in Superior Court and believes funds withheld by the CDE will be recovered through court trial. The ultimate outcome of any further action that may be taken cannot be presently determined. As such, management is not able to make a reasonable estimate of further potential effects, if any, on the financial statements. Accordingly, no provision for any additional liability that may result has been made in the financial statements. As more information becomes available, due to uncertainties with the potential disallowed funding and the action filed by management, it is at least reasonably possible that management's view of the outcome will change in the near term.

Management's plans regarding this matter also are described below.

Background and Analysis of Issues

On March 8, 2005, the California Department of Education ("CDE") announced that a collaborative effort to investigate the operations of the Options for Youth ("OFY") and Opportunities for Learning ("OFL") charter schools had been initiated by the CDE and the county offices of education in Los Angeles, Orange, Sacramento, San Bernardino and Siskiyou Counties.

The audit was conducted pursuant to Section 1241.5 of the California Education Code. The audit was conducted by the Fiscal Crisis and Management Assistance Team ("FCMAT") and its sub-contractor MGT of America, Inc. ("MGT"). FCMAT/MGT was initially directed to audit the fiscal year ended June 30, 2004. However, in December 2005, the scope of the audit was expanded to also include the fiscal years ended June 30, 2003 and June 30, 2005.

**EDUCATION MANAGEMENT SYSTEMS, INC. & SUBSIDIARIES**  
**(An S Corporation)**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**6 Contingencies, continued**

Background and Analysis of Issues, continued

FCMAT/MGT commenced their audit in May 2005 and released the audit report on August 9, 2006. Additionally, FCMAT/MGT performed a follow-up audit, commencing January 2007, which expanded the scope of the audit to include the fiscal year ended June 30, 2002. FCMAT/MGT released the follow-up audit report on April 11, 2007.

In the two combined audit reports, FCMAT/MGT stated that, based on their field work, there existed "*Potential Disallowed Funding*" totaling \$19,509,000 with respect to OFL:

	<u>Charter</u>			
	<u>OFL- Baldwin Park</u>	<u>OFL- San Juan Capistrano</u>	<u>OFL- William S. Hart</u>	<u>Total</u>
Summary of Potential Disallowed Funding	\$11,800,000	\$528,000	\$7,181,000	\$19,509,000

A summary of the more significant issues included in the audit report are as follows:

FCMAT/MGT concluded that certain teacher educational and other costs are not a component of teachers' compensation and benefits but should be classified as instructional costs rather than compensation and benefit costs. By reclassifying these costs from compensation to instructional costs FCMAT/MGT concluded that OFL had not spent adequate funds on teachers compensation and benefits in order to meet specified California funding thresholds.

Management asserts that OFL teachers work more hours per day and work more days per year than traditional school teachers. As such OFL calculates that its teachers have an FTE ratio of more than 1.0 and are in compliance with California Education Code and applicable regulations. The CDE asserted the FTE ratio can not be more than 1.0 and be in compliance with the California Education Code and applicable regulations. Additionally FCMAT/MGT contends certain instructional staff should not have been included as full time certificated teachers. FCMAT/MGT recommended OFL resolve the FTE issue with the CDE.

FCMAT/MGT also concluded that OFL William S. Hart exceeded the verified pupil-to-teacher ratio numbers of the largest unified school district, during the fiscal year ended June 30, 2002 and, as a result, OFL William S. Hart was ineligible to collect revenues in connection with average daily attendance in excess of the verified pupil-to-teacher ratio.

**EDUCATION MANAGEMENT SYSTEMS, INC. & SUBSIDIARIES**  
**(An S Corporation)**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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**6 Contingencies, continued**

Management's Plan

Management's intent is to exercise all administrative and legal remedies available to resolve these issues in OFL's favor including:

OFL has filed an appeal with Education Audit Appeals Panel (EAAP) to challenge certain matters in the FCMAT/MGT audit report. The EAAP granted OFL a hearing which was held in February 2008. In March 2008, the Administrative Law Judge issued a ruling that the FCMAT/MGT had no legal basis upon which to find that the Company was over-funded in any amount as a result of "FTE" or "PTR" calculations. The Company intends to defend any challenges to the March 2008 ruling that may be filed by the Department of Education.

Additionally, the Judge concluded that OFL did not establish that they are entitled to claim more than one FTE for each full-time certified teacher who teaches at their independent study charter schools.

OFL filed an action in Los Angeles County Superior Court seeking a judicial declaration regarding the CDE's interpretation of laws and regulations governing the calculation of full time teacher equivalency. To date no action has been taken by the court.

The CDE filed a motion asking the administrative law judge to reconsider his ruling and he agreed. The judge ruled on the reconsidered matter on March 3, 2011. In this ruling, the administrative law judge finds that an Education Code requirement that FTE not exceed 1.0 continued to apply even after the SB 740 requirements (which separately include PTR requirements based, in part, on FTE) were adopted and that, therefore, the OFL Schools may have been over-funded. On February 21, 2014, the administrative law judge concluded that OFL was over-funded. Subsequent to the ruling, the CDE requested \$10,306,547 from OFL-BP, \$7,611,513 from OFL-WSH, and \$289,549 from OFL-C. OFL filed a Petition for Writ of Administrative Mandamus in the Los Angeles Superior Court seeking judicial review and reversal of the decision adopted by the EAAP. OFL also received a temporary restraining order preventing the CDE from withholding those funds. The restraining order expired in December 2014. OFL did not continue to pursue the preliminary injunction. In 2015, CDE withheld \$10,306,547 from OFL-BP, \$7,611,513 from OFL-WSH, and \$289,549 from OFL-C apportionment funding. A court date is scheduled for June 13, 2017. Management believes funds withheld by the CDE will be recovered through the court trial.

Management and its legal counsel are of the opinion that they have appropriately followed the law. In the Superior Court action, management intends to prove the FCMAT/MGT audit report lacks legal and factual merit.



**EDUCATION MANAGEMENT SYSTEMS, INC. & SUBSIDIARIES**  
**(An S Corporation)**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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**6 Contingencies, continued**

Other contingency

The Company operates resource centers outside of its authorizing district boundaries. There is a current California Court of Appeal ruling that could impact charter schools with resource centers that are located outside of their authorizing districts but inside of the counties. There is a petition to appeal this ruling to the California Supreme Court. The ultimate outcome of any action that may be taken cannot presently be determined. As such, management is not able to make a reasonable estimate of potential effects, if any, on the financial statements. Accordingly, no provision for any liability that may result has been made in the financial statements.

**7 Defined contribution plan**

The Company maintains a 401(k) plan. Matching employer contributions are made to a maximum of 50% of an employee's contribution to a maximum of 2.5% of salary. For the year ended June 30, 2016, employer matching contribution expense was \$465,846. Included in this expense was a discretionary contribution bonus of \$114,100.

**8 Line of Credit**

The Company has a \$500,000 revolving loan from Union Bank with interest at LIBOR plus 2% at June 30, 2016. The line-of-credit is secured by the Company's business assets and expires on June 30, 2017. At June 30, 2016, no outstanding amount was under this revolving loan.

**9 Prior period adjustment**

Retained earnings at July 1, 2015 have been adjusted for charges that had been incorrectly billed by a related party, PSE, and recorded as expenses by the Company in prior years. It was discovered that PSE applied an incorrect method for billing services that were provided to the Company since year ended June 30, 2013. The related party corrected the billing and issued a credit to the Company, which is reflected in the Receivable from PSE balance at June 30, 2016. The cumulative effect resulting from years ended June 30, 2015, 2014, and 2013 increases beginning retained earnings at July 1, 2015 by \$1,501,157. Had the error not occurred, net income for the year ended June 30, 2015 would have been increased by \$5,316.

**10 Subsequent events**

Management has evaluated subsequent events through January 11, 2017, the date the consolidated financial statements were available to be issued.

## **SUPPLEMENTARY INFORMATION**

**EDUCATION MANAGEMENT SYSTEMS, INC. & SUBSIDIARIES**  
**(An S Corporation)**  
**CONSOLIDATING BALANCE SHEET**

**SCHEDULE A**

June 30, 2016

**ASSETS**

	EMS	OFL - BP	OFL - WSH	OFL - C	EJE	Total
Current assets						
Cash and cash equivalents	\$ 1,312,983	\$ 1,567,411	\$ 1,127,154	\$ 75,871	\$ -	\$ 4,083,419
Amount due from school district/state aid	-	2,920,735	4,070,422	154,249	-	7,145,406
Receivable from PSE	-	658,397	1,304,320	29,387	-	1,992,104
Notes receivable from related parties	1,650,000	-	-	-	(650,000)	1,000,000
Prepaid expenses and other receivables	<u>2,981,668</u>	<u>205,996</u>	<u>115,268</u>	<u>7,135</u>	<u>(1,270,262)</u>	<u>2,039,805</u>
Total current assets	5,944,651	5,352,539	6,617,164	266,642	(1,920,262)	16,260,734
Property and equipment, net	432,657	1,762,698	1,348,915	36,887	-	3,581,157
Deposits and other assets	<u>16,396</u>	<u>129,464</u>	<u>87,929</u>	<u>4,053</u>	<u>-</u>	<u>237,842</u>
	<u>\$ 6,393,704</u>	<u>\$ 7,244,701</u>	<u>\$ 8,054,008</u>	<u>\$ 307,582</u>	<u>\$ (1,920,262)</u>	<u>\$ 20,079,733</u>

**LIABILITIES AND STOCKHOLDERS' EQUITY**

Current Liabilities						
Accounts payable and accrued expenses	\$ 1,742,041	\$ 4,222,038	\$ 1,583,360	\$ 127,718	\$ (1,270,262)	\$ 6,404,895
Notes payable to related parties	14,565	650,000	-	-	(650,000)	14,565
Deferred revenue	<u>-</u>	<u>2,722,545</u>	<u>1,740,701</u>	<u>125,190</u>	<u>-</u>	<u>4,588,436</u>
	1,756,606	7,594,583	3,324,061	252,908	(1,920,262)	11,007,896
Commitments and contingencies						
Stockholders' equity						
Common stock, no par value; authorized						
Voting authorized 10,000 shares,						
issued and outstanding 3,000 shares	5	-	-	-	-	5
Non-voting authorized 1,000,000 shares,						
issued and outstanding 300,000 shares	495	-	-	-	-	495
Retained earnings	<u>4,636,598</u>	<u>(349,882)</u>	<u>4,729,947</u>	<u>54,674</u>	<u>-</u>	<u>9,071,337</u>
	<u>4,637,098</u>	<u>(349,882)</u>	<u>4,729,947</u>	<u>54,674</u>	<u>-</u>	<u>9,071,837</u>
	<u>\$ 6,393,704</u>	<u>\$ 7,244,701</u>	<u>\$ 8,054,008</u>	<u>\$ 307,582</u>	<u>\$ (1,920,262)</u>	<u>\$ 20,079,733</u>

**EDUCATION MANAGEMENT SYSTEMS, INC. & SUBSIDIARIES**  
**(An S Corporation)**  
**CONSOLIDATING STATEMENT OF OPERATIONS**

**SCHEDULE B**

For the year ended June 30, 2016

	EMS	OFL - BP	OFL - WSH	OFL - C	EJE	Total
Revenue from educational services						
LCFF principal apportionment / categorical funds	\$ -	\$ 20,750,344	\$ 23,070,693	\$ 381,629	\$ -	\$ 44,202,666
Local revenue	-	1,195,237	3,953,969	740,405	-	5,889,611
Lottery	-	323,858	412,016	19,934	-	755,808
Other revenue	8,900,821	706,976	1,533	11,192	(8,687,233)	933,289
	8,900,821	22,976,415	27,438,211	1,153,160	(8,687,233)	51,781,374
Education and operating expenses						
Direct site expenses	-	17,666,006	19,750,270	1,282,333	-	38,698,609
Administration, curriculum and development	5,207,124	760,669	804,204	34,945	-	6,806,942
Management fee	-	3,905,989	4,664,496	-	(8,570,485)	-
	3,693,697	643,751	2,219,241	(164,118)	(116,748)	6,275,823
Other expenses						
Interest and other	158,884	110,257	6,491	308	(116,748)	159,192
Income (loss) before income tax provision	3,534,813	533,494	2,212,750	(164,426)	-	6,116,631
Income tax expense (including LLC tax fees)	6,800	12,590	12,590	3,300	-	35,280
Net income (loss)	\$ 3,528,013	\$ 520,904	\$ 2,200,160	\$ (167,726)	\$ -	\$ 6,081,351

**EDUCATION MANAGEMENT SYSTEMS, INC. & SUBSIDIARIES**  
**(An S Corporation)**  
**CONSOLIDATING STATEMENT OF STOCKHOLDERS' EQUITY**

**SCHEDULE C**

For the year ended June 30, 2016

	EMS	OFL - BP	OFL - WSH	OFL - C	Total
Balance June 30, 2015					
As previously reported	\$ 1,133,606	\$ (1,529,183)	\$ 1,716,414	\$ 193,013	\$ 1,513,850
Prior period adjustment	<u>-</u>	<u>658,397</u>	<u>813,373</u>	<u>29,387</u>	<u>1,501,157</u>
Balance June 30, 2015, as restated	1,133,606	(870,786)	2,529,787	222,400	3,015,007
Net income	3,528,013	520,904	2,200,160	(167,726)	6,081,351
Distributions to stockholders	<u>(24,521)</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>(24,521)</u>
Balance June 30, 2016	<u><u>\$ 4,637,098</u></u>	<u><u>\$ (349,882)</u></u>	<u><u>\$ 4,729,947</u></u>	<u><u>\$ 54,674</u></u>	<u><u>\$ 9,071,837</u></u>