



**OPERATION SMILE, INC.**

Consolidated Financial Statements

June 30, 2016

(With Independent Auditors' Report Thereon)

# OPERATION SMILE, INC.

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KPMG LLP  
Suite 1900  
440 Monticello Avenue  
Norfolk, VA 23510

## Independent Auditors' Report

The Board of Directors  
Operation Smile, Inc.:

We have audited the accompanying consolidated financial statements of Operation Smile, Inc., which comprise the consolidated statement of financial position as of June 30, 2016, and the related consolidated statement of activities, cash flows, and functional expenses for the year then ended, and the related notes to the consolidated 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 U.S. generally accepted accounting principles; 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.

### *Auditors' 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 auditors' 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 Operation Smile, Inc. as of June 30, 2016, and the changes in its net assets and its cash flows for the year then ended in accordance with U.S. generally accepted accounting principles.

**KPMG LLP**

Norfolk, Virginia  
October 17, 2016

**OPERATION SMILE, INC.**

Consolidated Statement of Financial Position

June 30, 2016

**Assets**

Cash	\$	2,870,657
Investments		1,095,766
Prepaid expenses and other assets		1,166,230
Mission advances and other receivables		312,018
Inventories		5,199,508
Contributions receivable, net (note 2)		12,776,537
Property and equipment, net (notes 3, 5, 9, and 10)		<u>21,108,170</u>
Total assets	\$	<u><u>44,528,886</u></u>

**Liabilities and Net Assets**

Liabilities:

Accounts payable and accrued expenses	\$	7,756,389
Deferred revenue		303,445
Line of credit (note 9)		1,025,975
Capital lease obligations (notes 3 and 5)		84,256
Long-term debt (note 10)		<u>8,275,626</u>
Total liabilities		<u>17,445,691</u>

Net assets:

Unrestricted		18,254,536
Temporarily restricted (note 6)		<u>8,828,659</u>
Total net assets		27,083,195

Commitments and contingencies (notes 5 and 9)

Total liabilities and net assets	\$	<u><u>44,528,886</u></u>
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See accompanying notes to consolidated financial statements.

**OPERATION SMILE, INC.**

Consolidated Statement of Activities

Year ended June 30, 2016

	<u>Unrestricted net assets</u>	<u>Temporarily restricted net assets</u>	<u>Total</u>
Revenues:			
Contributions (note 8)	\$ 41,852,181	14,279,490	56,131,671
Gifts-in-kind (note 4)	4,301,365	—	4,301,365
Contributed services (note 4)	31,935,728	—	31,935,728
Program service revenue	952,813	—	952,813
Foreign currency transaction losses, net	(94,299)	—	(94,299)
Other income, net	124,075	—	124,075
Net assets released from restrictions	16,659,747	(16,659,747)	—
Total revenues	<u>95,731,610</u>	<u>(2,380,257)</u>	<u>93,351,353</u>
Expenses and loss:			
Expenses:			
Program services:			
Medical missions (note 4)	50,496,059	—	50,496,059
Education and sustainability	24,651,392	—	24,651,392
Total program services	<u>75,147,451</u>	<u>—</u>	<u>75,147,451</u>
Supporting services:			
Fund-raising	15,895,536	—	15,895,536
Administration	6,909,780	—	6,909,780
Total supporting services	<u>22,805,316</u>	<u>—</u>	<u>22,805,316</u>
Total expenses	<u>97,952,767</u>	<u>—</u>	<u>97,952,767</u>
Loss on contributions receivable	<u>120,793</u>	<u>456,564</u>	<u>577,357</u>
Total expenses and loss	<u>98,073,560</u>	<u>456,564</u>	<u>98,530,124</u>
Change in net assets	(2,341,950)	(2,836,821)	(5,178,771)
Net assets at beginning of year	<u>20,596,486</u>	<u>11,665,480</u>	<u>32,261,966</u>
Net assets at end of year	<u>\$ 18,254,536</u>	<u>8,828,659</u>	<u>27,083,195</u>

See accompanying notes to consolidated financial statements.

**OPERATION SMILE, INC.**

Consolidated Statement of Cash Flows

Year ended June 30, 2016

Cash flows from operating activities:	
Change in net assets	\$ (5,178,771)
Adjustments to reconcile change in net assets to net cash used in operating activities:	
Depreciation and amortization expense	1,053,781
Loss on contributions receivable	577,357
Gain on disposal of assets	(112,098)
Net realized and unrealized loss on investments	12,709
Net usage of in-kind donations of supplies and inventory	178,860
Changes in operating assets and liabilities:	
Prepaid expenses	143,919
Mission advances and other receivables	81,538
Contributions receivable, net	(663,773)
Inventories	232,748
Accounts payable and accrued expenses	2,810,733
Other liabilities	(500,000)
Deferred revenue	(21,296)
Net cash used in operating activities	<u>(1,384,293)</u>
Cash flows from investing activities:	
Purchases of property and equipment	(1,304,965)
Purchases of investments	(1,613,280)
Sale of investments	1,236,250
Net cash used in investing activities	<u>(1,681,995)</u>
Cash flows from financing activities:	
Principal payments on long-term debt	(546,427)
Net borrowings on line of credit	809,568
Principal payments on capital lease obligations	(53,286)
Net cash provided by financing activities	<u>209,855</u>
Net decrease in cash	(2,856,433)
Cash at beginning of year	<u>5,727,090</u>
Cash at end of year	<u>\$ 2,870,657</u>
Supplemental cash flow information:	
Cash paid for interest	\$ 242,811
Property and equipment acquired under capital leases	\$ 65,679

See disclosure of noncash items in note 4 to the consolidated financial statements.

See accompanying notes to consolidated financial statements.

**OPERATION SMILE, INC.**

Consolidated Statement of Functional Expenses

Year ended June 30, 2016

	Program services			Supporting services			Total expenses
	Medical missions	Education and sustainability	Total	Fund-raising	Administration	Total	
Grants	\$ 1,997,168	6,663,286	8,660,454	—	—	—	8,660,454
Salaries and benefits	4,023,465	2,860,975	6,884,440	2,417,297	3,309,530	5,726,827	12,611,267
Professional services	979,224	932,102	1,911,326	958,754	1,120,789	2,079,543	3,990,869
Advertising and promotion	100,444	661,565	762,009	1,435,165	88,237	1,523,402	2,285,411
Supplies and equipment	1,579,485	297,654	1,877,139	155,762	888,287	1,044,049	2,921,188
Mission supplies	6,009,826	222,905	6,232,731	—	—	—	6,232,731
Occupancy	268,166	158,297	426,463	59,337	108,439	167,776	594,239
Travel and conferences	3,360,873	2,011,853	5,372,726	382,298	292,731	675,029	6,047,755
Interest	6,773	3,249	10,022	1,611	231,178	232,789	242,811
Depreciation and amortization	439,816	147,140	586,956	51,113	415,712	466,825	1,053,781
Insurance	28,933	14,164	43,097	3,165	101,610	104,775	147,872
Other mission expense	462,967	43,276	506,243	—	—	—	506,243
Fundraising	—	—	—	10,410,775	—	10,410,775	10,410,775
Public education and awareness	—	9,865,243	9,865,243	—	287,510	287,510	10,152,753
Contributed services	31,201,994	733,734	31,935,728	—	—	—	31,935,728
Other	36,925	35,949	72,874	20,259	65,757	86,016	158,890
Total expenses	\$ 50,496,059	24,651,392	75,147,451	15,895,536	6,909,780	22,805,316	97,952,767

See accompanying notes to consolidated financial statements.

## OPERATION SMILE, INC.

### Notes to Consolidated Financial Statements

June 30, 2016

#### (1) Nature of Organization and Summary of Significant Accounting Policies

##### (a) *Nature of Organization*

Operation Smile, Inc. (Operation Smile or OSI) is a 501c(3) not-for-profit voluntary health and welfare organization whose principal purpose is to perform life-changing reconstructive surgery on children with facial deformities such as cleft lips and cleft palates in developing countries and the United States. Operation Smile is the largest volunteer-based charity providing free cleft surgeries for children around the world, and is a leading advocate for medical education and training to impact universal surgery practices and related public health initiatives to build long-term self-sufficiency in developing countries. The organization's activities also focus on community-based education and training, nutrition, research, as well as post-operative and comprehensive care.

In May 2010, OS HQ, LLC, a wholly owned subsidiary of Operation Smile, was formed to hold the assets and liabilities for the global center located in Virginia Beach, Virginia.

OSI has seven representative offices in international countries, and their activities have been included in the accompanying consolidated financial statements. OSI has international foundations that host mission teams, which are responsible for all in-country mission logistics. International foundations may also raise funds and awareness to support programs in international countries. The accompanying consolidated financial statements do not include the accounts of OSI affiliates in international countries.

##### (b) *Basis of Presentation*

The accompanying consolidated financial statements include the accounts of Operation Smile, including its wholly owned subsidiary, OS HQ, LLC. All significant intercompany balances and transactions have been eliminated in consolidation.

##### (c) *Recently Issued Accounting Pronouncement*

In August 2016, The Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2016-14, *Presentation of Financial Statements of Not-for-Profit Entities (Topic 958)*. The ASU incorporates part of a multi-phased project undertaken by the FASB to improve the current net asset classification requirements and the information presented in financial statements and notes about a not-for-profit entity's (NFP) liquidity, financial performance, and cash flows. The ASU is effective for annual financial statements issued for fiscal years beginning after December 15, 2017, and for interim periods within fiscal years beginning after December 15, 2018. Early application is permitted and retrospective application for all periods presented is required, with certain limited exceptions to periods presented before the period of adoption. The adoption of the ASU is expected to have a significant impact on the consolidated financial statements when it is adopted effective July 1, 2018.

##### (d) *Contributions*

Contributions of cash and other assets, including unconditional promises to give, are recognized as revenue when the gifts are received by the OSI. Contributions of other assets are recorded at their fair value at the date of the gift and classified in the statements of activities based on the existence of

## OPERATION SMILE, INC.

### Notes to Consolidated Financial Statements

June 30, 2016

donor-imposed restrictions on the contributions. Unconditional promises to give that are expected to be collected within one year are recorded on the date of gift at net realizable value which approximates fair value. OSI uses present value techniques to measure the fair value on the date of gift of unconditional promises to give that are expected to be collected in future years. The discount rates used to compute the discounts on those amounts are determined at the time the unconditional promises to give are initially recognized and are not revised subsequently. Amortization of the discounts is recorded as additional contribution revenue in accordance with the donor-imposed restrictions on the contributions. Gifts whose restrictions are met in the same fiscal year as their receipt are reported as unrestricted contribution revenue. Conditional promises to give are not recognized as revenues until such time as the conditions are substantially met.

**(e) Cash**

Cash consists primarily of cash in banks. Cash in banks exceeded federally insured limits at June 30, 2016.

**(f) Investments**

Investment securities consist of mutual funds and money market funds held in investment broker accounts. The net realized and unrealized gains and losses on investments are reflected in other income, net, in the accompanying consolidated statement of activities.

**(g) Prepaid Expenses and Other Assets**

Prepaid expenses are stated at cost less applicable amortization and include expenses prepaid for events that will occur in the next fiscal year, deferred direct response advertising costs and insurance premiums, which are expensed over their estimated useful lives using the straight-line method. Total amortization expense for the year ended June 30, 2016 was \$39,943.

**(h) Inventories**

Inventories consist primarily of supplies to be used for medical missions. Purchased inventory is valued at cost on the date of purchase. Donated inventory is valued at fair value on the date of receipt. Both are accounted for on the first-in, first-out basis, and to the extent fair value is lower on the date of the consolidated statement of financial position, the value assigned at the date of purchase or donation is reduced accordingly.

**(i) Property and Equipment**

Property and equipment are stated at cost except for donated equipment, artwork, and land, which are stated at fair value at the date of receipt. Medical equipment and furniture, fixtures, and office equipment are depreciated using the straight-line method over estimated useful lives ranging from 3 to 10 years. No provision for depreciation is made on land or artwork. Additionally, no provision for depreciation is made on work in process until such time as the relevant assets are completed and placed into service. Buildings and building improvements are depreciated using the straight-line method over their estimated useful lives of 40 years. Property and equipment held under capital leases are amortized using the straight-line method over the shorter of the lease term or the estimated useful life of the asset. Total depreciation expense for the year ended June 30, 2016 was \$1,013,838.

## OPERATION SMILE, INC.

### Notes to Consolidated Financial Statements

June 30, 2016

**(j) *Deferred Revenue***

Deferred revenue consists of cash collected for program events that will occur and be recognized as revenue in future periods.

**(k) *Classification of Net Assets***

OSI's net assets are grouped into the following three net asset classes:

*Unrestricted Net Assets* – Unrestricted net assets generally result from contributions and other revenues not subject to donor-imposed purpose or time restrictions.

*Temporarily Restricted Net Assets* – Temporarily restricted net assets generally result from contributions and other revenues whose use by the organization is limited by donor-imposed stipulations that either expire by passage of time or can be fulfilled and removed by actions of OSI pursuant to those stipulations.

*Permanently Restricted Net Assets* – Permanently restricted net assets result from contributions whose use by the organization is limited by donor stipulation that neither expire by passage of time nor can be fulfilled or otherwise removed by OSI. There were no permanently restricted net assets at June 30, 2016.

**(l) *Functional Expenses***

OSI allocates its expenses on a functional basis among its various programs and supporting services. Expenses that can be identified with a specific program or supporting service are allocated directly. Other expenses that are common to several functions are allocated based on various statistical bases, such as content, time, and purpose.

**(m) *Joint Cost Allocation***

OSI incurred expenses that were identifiable with a particular function but served joint purposes. Expenses related to certain events, donor communication, and program materials jointly support medical missions, education and sustainability, fundraising, and administration and were allocated by their function classification as follows for the year ended June 30, 2016:

Medical missions	\$	47,728
Education and sustainability		11,688,955
Fund-raising		12,408,465
Administration		<u>1,677,232</u>
Total joint costs	\$	<u><u>25,822,380</u></u>

## OPERATION SMILE, INC.

### Notes to Consolidated Financial Statements

June 30, 2016

**(n) Use of Estimates**

The preparation of the consolidated financial statements in conformity with U.S. generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from these estimates.

**(o) Fair Value Measurements**

OSI utilizes valuation techniques that maximize the use of observable inputs and minimize the use of unobservable inputs to the extent possible and determines fair value based on assumptions that market participants would use in pricing an asset or liability in the principal or most advantageous market. When considering market participant assumptions in fair value measurements, the following fair value hierarchy distinguishes between observable and unobservable inputs, which are categorized in one of the following levels:

- Level 1 Inputs: Unadjusted quoted prices in active markets for identical assets or liabilities accessible to OSI at the measurement date.
- Level 2 Inputs: Other than quoted prices included in Level 1 inputs that are observable for the asset or liability, either directly or indirectly.
- Level 3 Inputs: Unobservable inputs for the asset or liability used to measure fair value to the extent that observable inputs are not available, thereby allowing for situations in which there is little, if any, market activity for the asset or liability at measurement date.

OSI's investments represent the financial assets that are accounted for at fair value on a recurring basis. At June 30, 2016, the carrying value of all the investments was considered to be the fair value determined using Level 1 inputs in the fair value hierarchy. There were no transfers in and out of Levels 1, 2 or 3 for the year ended June 30, 2016.

**(p) Impairment of Long-Lived Assets**

Long-lived assets, such as property and equipment, are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to estimated undiscounted future cash flows expected to be generated by the asset. If the carrying amount of an asset exceeds its estimated future cash flows, an impairment charge is recognized by the amount by which the carrying amount of the asset exceeds the fair value of the asset. As of June 30, 2016, there was no indication of impairment. Any assets to be disposed of within the next fiscal year would be separately presented in the consolidated statement of financial position and reported at the lower of the carrying amount or fair value less costs to sell, and are no longer depreciated. The assets and liabilities of a disposal group classified as held-for-sale would be presented separately in the appropriate asset and liability sections of the consolidated statement of financial position.

## OPERATION SMILE, INC.

### Notes to Consolidated Financial Statements

June 30, 2016

#### (2) Contributions Receivable

Contributions receivable at June 30, 2016 are expected to be received as follows:

Within one year	\$	8,131,154
From one to five years		<u>4,933,552</u>
		13,064,706
Less discount to present value at rates, which range from 0.8% to 2.5%		<u>288,169</u>
	\$	<u><u>12,776,537</u></u>

#### (3) Property and Equipment

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

Work in process	\$	65,353
Medical equipment		4,474,539
Furniture, fixtures, and office equipment		3,146,330
Buildings		14,952,301
Building improvements		940,313
Land		3,094,293
Artwork		<u>221,697</u>
		26,894,826
Less accumulated depreciation		<u>5,786,656</u>
Property and equipment, net	\$	<u><u>21,108,170</u></u>

As of June 30, 2016, furniture, fixtures, and office equipment recorded under capital leases have a cost basis of \$198,996 and related accumulated amortization of \$95,939 for a net book value of \$103,058.

#### (4) Contributed Services and Gifts-in-Kind

OSI's medical missions are staffed by volunteer surgical teams. In addition, when patients require treatment in the United States under the World Care Program, the hospital stay and related services are fully or partially donated by the hospitals and physicians. The donated medical services are recorded at their estimated fair values and are classified as contributed services revenues and medical missions expenses in the accompanying consolidated statement of activities. Such services amounted to \$31,935,728 in 2016. OSI's medical missions are staffed by volunteer administrative support staff. These administrative personnel services are not recorded in the accompanying consolidated financial statements.

**OPERATION SMILE, INC.**

Notes to Consolidated Financial Statements

June 30, 2016

Donated mission supplies are received throughout the years for use in the overall Operation Smile mission, are recorded at their estimated fair values, and are classified as gifts-in-kind revenues in the accompanying consolidated statement of activities. Such donations amounted to \$3,935,148 in 2016. These supplies are expensed as they are used on missions and are classified as medical missions expenses in the accompanying consolidated statement of activities. Use of donated mission supplies amounted to \$4,355,117 in 2016.

Other donated nonmission supplies amounted to \$366,217 in 2016.

**(5) Leases**

OSI is obligated under capital and operating leases for certain equipment.

Future minimum lease payments under the operating leases and the present value of future minimum capital lease payments as of June 30, 2016 are as follows:

	<u>Capital leases</u>	<u>Operating leases</u>
Year ending June 30:		
2017	\$ 37,811	21,547
2018	22,027	10,431
2019	16,146	11,474
2020	16,146	12,622
2021	7,201	—
Total minimum lease payments	<u>99,331</u>	<u>56,074</u>
Less amount representing interest	<u>15,075</u>	
Present value of net minimum lease payments	84,256	
Less current maturities of capital lease obligations	<u>32,839</u>	
Capital lease obligations, excluding current maturities	<u>\$ 51,417</u>	

Total rent expense was \$55,996 in 2016.

## OPERATION SMILE, INC.

### Notes to Consolidated Financial Statements

June 30, 2016

#### (6) Temporarily Restricted Net Assets

Temporarily restricted net assets consist of the following at June 30, 2016:

Care centers	\$	111,491
Domestic programs		45,527
Global education and sustainability		293,396
International programs		1,324,530
Research		588,216
Other programs		43,917
		<hr/>
Total purpose restricted		2,407,077
		<hr/>
Total time restricted		6,421,582
		<hr/>
Total temporarily restricted net assets	\$	<u>8,828,659</u>

#### (7) Retirement Savings Plan

OSI has a 401(k) retirement savings plan. Employees are eligible to participate beginning as of the first of the quarter following four months of employment. OSI matches a portion of the employee contributions and makes a safe harbor contribution on behalf of each employee. OSI's contributions to the retirement savings plans for the year ended June 30, 2016 were \$657,635.

#### (8) Related-Party Transactions

OSI recognized contributions from its Board of Directors, respective committee members, officers and relatives of those charged with governance of \$14,376 for the year ended June 30, 2016. Some board members may also contribute directly to independent, affiliated Operation Smile international foundations.

#### (9) Revolving Line of Credit

In June 2016, OSI renewed a line of credit agreement with a financial institution to provide for borrowings up to \$5,000,000. The line of credit bears interest payable monthly at the rate of LIBOR + 2.5% and expires in December 2017. OSI had \$1,025,975 outstanding on the line of credit at June 30, 2016, which was secured by the OSI global center property.

#### (10) Long-Term Debt

Long-term debt at June 30, 2016 consists of the following:

Promissory note in the amount of \$8,500,000, interest at LIBOR + 2.25%, payable in 83 monthly installments of \$37,932 (principal and interest) beginning January 2014 through November 2020 and a balloon payment of remaining principal due in December 2020	\$	7,875,626
Noninterest bearing promissory note		400,000
		<hr/>
Total long-term debt	\$	<u>8,275,626</u>

## **OPERATION SMILE, INC.**

### Notes to Consolidated Financial Statements

June 30, 2016

In December 2013, OSI issued a promissory note to a financial institution which provided proceeds of \$8,500,000 used primarily to refinance the nonrevolving construction loan entered into in July 2011. The note is secured by the OSI global center property. The promissory note requires OSI to maintain a minimum debt service coverage ratio, as defined, while the loan is outstanding. The note is callable at the lender's option any time beginning December 30, 2018. At the end of the five-year term, one two-year extension will be available subject to certain conditions, as defined. Principal reductions over the next year are estimated to be approximately \$250,000.

In September 2011, OSI obtained \$1,000,000 cash and entered into an interest-free promissory note for the same amount for expansion of its global direct response program. Repayment of the note began in November 2013. The final payment was made in August 2016.

#### **(11) Unconsolidated Interests with Foreign Entities (Unaudited)**

OSI has entered into an agreement with China Charities Aid Foundation for Children (CCAFC), a nationwide public-raising foundation in mainland China. CCAFC's purpose is to raise funds from the public to provide aid to a variety of children including those who confront special difficulties. The agreement between Operation Smile and CCAFC established the Operation Smile Special Fund of China Charities Aid Foundation for Children (Special Fund).

With the creation of this Special Fund, Operation Smile is able to conduct fundraising and aid activities within China related to the OSI mission including: raising social funds, arranging and merging social voluntary resources, providing free surgery and relevant treatment for children who are suffering from cleft lip and palate and other maxillofacial deformities, education, and research while spreading the concept of charity and promoting the development of volunteerism. However, the accompanying consolidated financial statements do not include the activities of the Special Fund.

The Special Fund raised approximately \$522,000 for the year ended June 30, 2016. Of this amount \$295,000 was sent from OSI directly to the Special Fund and is included as grant expense in the accompanying consolidated statement of functional expenses. The remaining \$227,000 was contributed by independent donors within China. Additionally, approximately \$344,000 was spent within China from the Special Fund during fiscal year 2016, of which \$342,000 represented surgical mission and other programmatic expenses.

#### **(12) Subsequent Events**

OSI has evaluated subsequent events from the consolidated statement of financial position date through October 17, 2016, the date these consolidated financial statements were available to be issued, and determined there are no other items to disclose.