



OPERATION SMILE, INC.

Consolidated Financial Statements

June 30, 2015

(With Independent Auditors' Report Thereon)

OPERATION SMILE, INC.

Table of Contents

	Page(s)
Independent Auditors' Report	1
Consolidated Statement of Financial Position	2
Consolidated Statement of Activities	3
Consolidated Statement of Cash Flows	4
Consolidated Statement of Functional Expenses	5
Notes to Consolidated Financial Statements	6-13



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, 2015, and the related consolidated statements 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, 2015, 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 28, 2015

OPERATION SMILE, INC.
Consolidated Statement of Financial Position
June 30, 2015

Assets

Cash	\$	5,727,090
Investments		731,445
Prepaid expenses		750,942
Mission advances and other receivables		393,556
Inventories		6,207,777
Contributions receivable, net (note 2)		12,690,121
Property and equipment, net (notes 3, 5, 9, and 11)		<u>21,129,825</u>
Total assets	\$	<u><u>47,630,756</u></u>

Liabilities and Net Assets

Liabilities:

Accounts payable and accrued expenses	\$	4,945,656
Other liabilities (note 10)		988,070
Deferred revenue		324,741
Line of credit (note 9)		216,407
Capital lease obligations (notes 3 and 5)		71,863
Long-term debt (note 11)		<u>8,822,053</u>
Total liabilities		<u>15,368,790</u>

Net assets:

Unrestricted		20,596,486
Temporarily restricted (note 6)		<u>11,665,480</u>
Total net assets		32,261,966

Commitments and contingencies (notes 5, 9, and 11)

Total liabilities and net assets	\$	<u><u>47,630,756</u></u>
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See accompanying notes to consolidated financial statements.

OPERATION SMILE, INC.
Consolidated Statement of Activities
Year ended June 30, 2015

	Unrestricted net assets	Temporarily restricted net assets	Total
Revenues:			
Contributions (note 8)	\$ 38,814,102	19,775,037	58,589,139
Gifts-in-kind (note 4)	6,838,822	—	6,838,822
Contributed services (note 4)	28,962,016	—	28,962,016
Program service revenue	848,070	—	848,070
Foreign currency transaction losses, net	(21,282)	—	(21,282)
Other income, net	7,543	—	7,543
Net assets released from restrictions	15,505,155	(15,505,155)	—
Total revenues	<u>90,954,426</u>	<u>4,269,882</u>	<u>95,224,308</u>
Expenses and loss:			
Expenses:			
Program services:			
Medical missions (note 4)	45,170,784	—	45,170,784
Education and sustainability	17,148,396	—	17,148,396
Total program services	<u>62,319,180</u>	<u>—</u>	<u>62,319,180</u>
Supporting services:			
Fund-raising	16,463,933	—	16,463,933
Administration	6,165,444	—	6,165,444
Total supporting services	<u>22,629,377</u>	<u>—</u>	<u>22,629,377</u>
Total expenses	84,948,557	—	84,948,557
Loss on contributions receivable	2,803	800,485	803,288
Total expenses and loss	<u>84,951,360</u>	<u>800,485</u>	<u>85,751,845</u>
Change in net assets	6,003,066	3,469,397	9,472,463
Net assets at beginning of year	<u>14,593,420</u>	<u>8,196,083</u>	<u>22,789,503</u>
Net assets at end of year	<u>\$ 20,596,486</u>	<u>11,665,480</u>	<u>32,261,966</u>

See accompanying notes to consolidated financial statements.

OPERATION SMILE, INC.

Consolidated Statement of Cash Flows

Year ended June 30, 2015

Cash flows from operating activities:	
Change in net assets	\$ 9,472,463
Adjustments to reconcile change in net assets to net cash provided by operating activities:	
Depreciation expense	842,747
Loss on contributions receivable	803,288
Net realized and unrealized loss on investments	16,800
Net receipt of in-kind donations of supplies and inventory	(2,926,736)
Changes in operating assets and liabilities:	
Prepaid expenses	(544,070)
Mission advances and other receivables	(20,626)
Contributions receivable, net	(4,541,442)
Inventories	(68,977)
Accounts payable and accrued expenses	586,070
Other liabilities	(500,000)
Deferred revenue	58,168
Net cash provided by operating activities	<u>3,177,685</u>
Cash flows from investing activities:	
Purchases of property and equipment	(1,846,192)
Purchases of investments	(362,215)
Net cash used in investing activities	<u>(2,208,407)</u>
Cash flows from financing activities:	
Principal payments on long-term debt	(452,980)
Net borrowings on line of credit	(83,593)
Principal payments on capital lease obligations	(68,347)
Net cash used in financing activities	<u>(604,920)</u>
Net increase in cash	364,358
Cash at beginning of year	<u>5,362,732</u>
Cash at end of year	<u>\$ 5,727,090</u>
Supplemental cash flow information:	
Cash paid for interest	\$ 225,167

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, 2015

	<u>Program services</u>			<u>Supporting services</u>			<u>Total expenses</u>
	<u>Medical missions</u>	<u>Education and sustainability</u>	<u>Total</u>	<u>Fund-raising</u>	<u>Administration</u>	<u>Total</u>	
Grants	\$ 1,488,192	6,716,534	8,204,726	—	—	—	8,204,726
Salaries and benefits	3,170,095	2,115,146	5,285,241	2,945,960	2,740,014	5,685,974	10,971,215
Professional services	663,591	904,601	1,568,192	1,019,609	721,636	1,741,245	3,309,437
Advertising and promotion	119,390	349,614	469,004	1,032,100	73,258	1,105,358	1,574,362
Supplies and equipment	1,499,298	182,673	1,681,971	173,911	1,108,532	1,282,443	2,964,414
Mission supplies	5,290,036	38,912	5,328,948	—	—	—	5,328,948
Occupancy	240,381	131,425	371,806	77,252	120,107	197,359	569,165
Travel and conferences	2,989,171	1,538,053	4,527,224	434,518	253,462	687,980	5,215,204
Interest	6,096	2,354	8,450	1,829	214,885	216,714	225,164
Depreciation	334,124	115,921	450,045	49,204	343,498	392,702	842,747
Insurance	37,781	10,716	48,497	6,267	39,567	45,834	94,331
Other mission expense	376,655	—	376,655	—	—	—	376,655
Fundraising	—	—	—	10,695,685	—	10,695,685	10,695,685
Public education and awareness	—	4,984,629	4,984,629	—	509,116	509,116	5,493,745
Contributed services	28,919,994	42,022	28,962,016	—	—	—	28,962,016
Other	35,980	15,796	51,776	27,598	41,369	68,967	120,743
Total expenses	<u>\$ 45,170,784</u>	<u>17,148,396</u>	<u>62,319,180</u>	<u>16,463,933</u>	<u>6,165,444</u>	<u>22,629,377</u>	<u>84,948,557</u>

See accompanying notes to consolidated financial statements.

OPERATION SMILE, INC.

Notes to Consolidated Financial Statements

June 30, 2015

(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 five 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) *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 statement of activities based on the existence of 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.

OPERATION SMILE, INC.

Notes to Consolidated Financial Statements

June 30, 2015

(d) Cash

Cash consists primarily of cash in banks. Cash in banks exceeded federally insured limits at June 30, 2015.

(e) Investments

Investment securities consist of exchange-traded 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 statements of activities.

(f) Prepaid Expenses

Prepaid expenses are stated at cost less applicable amortization and include expenses prepaid for events that will occur in the next fiscal year and for insurance premiums, which are expensed over their estimated useful lives using the straight-line method.

(g) 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.

(h) 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, 2015 was \$842,747.

(i) Deferred Revenue

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

(j) 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.

OPERATION SMILE, INC.

Notes to Consolidated Financial Statements

June 30, 2015

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, 2015.

(k) 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.

(l) 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, 2015:

Medical missions	\$	27,666
Education and sustainability		6,322,045
Fund-raising		12,796,899
Administration		717,682
Total joint costs	\$	<u>19,864,292</u>

(m) 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.

(n) 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

OPERATION SMILE, INC.

Notes to Consolidated Financial Statements

June 30, 2015

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, 2015, 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, 2015.

(o) ***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, 2015, there was no indication of impairment. Any assets to be disposed of within the next fiscal year would be separately presented in the consolidated statements 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 statements of financial position.

(2) **Contributions Receivable**

Contributions receivable at June 30, 2015 are expected to be received as follows:

Within one year	\$	6,487,248
From one to five years		<u>6,590,923</u>
		13,078,171
Less discount to present value at rates, which range from 0.6% to 2.5%		<u>388,050</u>
	\$	<u><u>12,690,121</u></u>

OPERATION SMILE, INC.

Notes to Consolidated Financial Statements

June 30, 2015

(3) Property and Equipment

Property and equipment consist of the following at June 30, 2015:

Work in process	\$	660,217
Medical equipment		3,572,421
Furniture, fixtures, and office equipment		2,774,237
Buildings		14,952,301
Building improvements		774,384
Land		3,094,293
Artwork		221,697
		<u>26,049,550</u>
Less accumulated depreciation		<u>4,919,725</u>
Property and equipment, net	\$	<u><u>21,129,825</u></u>

As of June 30, 2015, furniture, fixtures, and office equipment recorded under capital leases have a cost basis of \$220,401 and related accumulated amortization of \$96,067 for a net book value of \$124,334.

(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. Services are also contributed within the United States for medical and dental care. These 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 statements of activities. Such services amounted to \$28,962,016 in 2015. OSI's medical missions are staffed by volunteer administrative support staff. These administrative personnel services are not recorded in the accompanying consolidated financial statements.

Donated mission supplies are received throughout the year 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 statements of activities. Such donations amounted to \$6,736,487 in 2015. These supplies are expensed as they are used on missions and are classified as medical missions expenses in the accompanying consolidated statements of activities. Use of donated mission supplies amounted to \$3,912,086 in 2015.

Other donated nonmission supplies amounted to \$102,335 in 2015.

(5) Leases

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

OPERATION SMILE, INC.

Notes to Consolidated Financial Statements

June 30, 2015

Future minimum lease payments under the operating leases and the present value of future minimum capital lease payments as of June 30, 2015 are as follows:

	Capital leases	Operating leases
Year ending June 30:		
2016	\$ 55,337	18,577
2017	22,486	4,275
2018	5,881	—
Total minimum lease payments	83,704	\$ 22,852
Less amount representing interest	11,841	
Present value of net minimum lease payments	71,863	
Less current maturities of capital lease obligations	46,361	
Capital lease obligations, excluding current maturities	\$ 25,502	

Total rent expense was \$56,643 in 2015.

(6) Temporarily Restricted Net Assets

Temporarily restricted net assets consist of the following at June 30, 2015:

Care centers	\$ 144,132
Domestic programs	43,383
Global education and sustainability	557,561
International programs	1,403,490
Research	816,392
Other programs	36,765
Total purpose restricted	3,001,723
Total time restricted	8,663,757
Total temporarily restricted net assets	\$ 11,665,480

(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, 2015 were \$578,834.

OPERATION SMILE, INC.

Notes to Consolidated Financial Statements

June 30, 2015

(8) Related-Party Transactions

OSI recognized contributions from its Board of Directors, respective committee members, officers and relatives of those charged with governance of \$98,196 for the year ended June 30, 2015. Some board members may also contribute directly to independent, affiliated Operation Smile international foundations.

(9) Revolving Line of Credit

In April 2015, OSI renewed a line of credit agreement with a financial institution to provide for borrowings up to \$3,000,000. The line of credit bears interest payable monthly at the rate of LIBOR + 2.5% and expires in April 2016. OSI had \$216,407 outstanding on the line of credit at June 30, 2015, which was secured by the OSI global center property.

(10) Other Liabilities

On July 11, 2013, OSI effectuated a spin-off of Operation Smile Foundation, also a 501c(3) organization, to a nonaffiliated organization. As part of the agreement, OSI agreed to pay \$3,500,000 in cash plus another \$500,000 in inventory and supplies. Through June 30, 2015 \$3,011,930 had been paid. One remaining annual installment of cash is due on December 31, 2015.

(11) Long-Term Debt

Long-term debt at June 30, 2015 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	\$ 8,122,053
Noninterest bearing promissory note	<u>700,000</u>
Total long-term debt	<u>\$ 8,822,053</u>

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, as well as a \$500,000 compensating balance to be held by the financial institution 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.

OPERATION SMILE, INC.

Notes to Consolidated Financial Statements

June 30, 2015

(12) Subsequent Events

OSI has evaluated subsequent events from the consolidated statement of financial position date through October 28, 2015, the date these consolidated financial statements were available to be issued, and determined there are no other items to disclose.