

**STEPHENS INSTITUTE
dba ACADEMY OF ART UNIVERSITY**

OPE ID No. 00753100

Financial Statements

For the Year Ended December 31, 2017

with

Independent Auditors' Report

CONFIDENTIAL

STEPHENS INSTITUTE
dba ACADEMY OF ART UNIVERSITY

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INDEPENDENT AUDITORS' REPORT ON THE FINANCIAL STATEMENTS AND OTHER INFORMATION

To the Board of Directors and Stockholder of
Stephens Institute dba Academy of Art University:

Report on the Financial Statements

We have audited the accompanying financial statements of Stephens Institute dba Academy of Art University (a California corporation), which comprise the balance sheet as of December 31, 2017, and the related statements of income and retained earnings 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 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 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 financial statements based on our audit. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditors' judgment, including the assessment of the risks of material misstatement of the 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 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 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 financial statements referred to above present fairly, in all material respects, the financial position of Stephens Institute dba Academy of Art University as of December 31, 2017, and the results of its operations and its cash flows for the year then ended in accordance with accounting principles generally accepted in the United States of America.

Report on Required Supplementary Information and Other Regulatory Requirements

Our audit was conducted for the purpose of forming an opinion on the financial statements taken as a whole. The accompanying supplementary information beginning on page 15 on Stephens Institute dba Academy of Art University's calculation of its Title IV 90/10 revenue test and on related party transactions are required by the U.S. Department of Education and are presented for purposes of additional analysis and are not a required part of the 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 financial statements. Such information has been subjected to the auditing procedures applied in the audit of the financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the financial statements or to the financial statements themselves, and other additional procedures in accordance with auditing standards generally accepted in the United States of America. In our opinion, the accompanying supplementary information is fairly stated, in all material respects, in relation to the financial statements taken as a whole.

Other Reporting Required by Government Auditing Standards

In accordance with *Government Auditing Standards*, we have also issued our report dated April 24, 2018, on our consideration of Stephens Institute dba Academy of Art University's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the Stephens Institute dba Academy of Art University's internal control over financial reporting and compliance.



Lake Forest, California
April 24, 2018

STEPHENS INSTITUTE
dba ACADEMY OF ART UNIVERSITY
Balance Sheet
December 31, 2017

Assets

Current assets:	
Cash and cash equivalents	\$ 7,712,108
Accounts receivable, net of allowance for doubtful accounts of \$1,810,199	3,680,596
Due from related party	303,950
Other accounts receivable	1,282,537
Prepaid expenses	7,481,138
Total current assets	<u>20,460,329</u>
Property, equipment and improvements, net of accumulated depreciation and amortization of \$98,266,540	35,460,735
Construction in progress	10,267,420
Classic car collection	28,692,768
Deposits and other	10,847,509
	<u><u>\$ 105,728,761</u></u>

Liabilities and Stockholder's Equity

Current liabilities:	
Accounts payable	\$ 12,669,044
Accrued expenses	4,997,676
Dormitory and other deposits	951,628
Current portion of capital lease obligations	3,151,843
Deferred tuition and dormitory rent	3,688,089
Total current liabilities	<u>25,458,280</u>
Revolving credit facility	26,000,000
Capital lease obligations, net of current portion	2,814,407
Total liabilities	<u>54,272,687</u>
Stockholder's equity:	
Common stock, no par value, 5,000 shares authorized, issued and outstanding	25,980
Additional paid-in capital	17,401,830
Retained earnings	34,028,264
Total stockholder's equity	<u>51,456,074</u>
	<u><u>\$ 105,728,761</u></u>

See notes to financial statements

STEPHENS INSTITUTE
dba ACADEMY OF ART UNIVERSITY
Statement of Income and Retained Earnings
For the Year Ended December 31, 2017

Revenues:	
Student tuition	\$ 223,098,257
Registration and other fees	9,331,150
Dormitory	19,070,875
Total revenues	<u>251,500,282</u>
Costs and expenses:	
Instructional salaries	77,284,972
Student services	40,888,764
Instructional expenses and course materials	11,158,398
Selling and promotion	11,068,485
General and administrative	35,468,700
Occupancy costs	61,843,946
Depreciation and amortization	13,250,417
Total costs and expenses	<u>250,963,682</u>
Income from operations	<u>536,600</u>
Other income (expense):	
Interest income	1,324
Interest expense	(351,974)
Other ancillary activities, net	41,515
Total other income (expense)	<u>(309,135)</u>
Income before provision for income taxes	227,465
Provision for income taxes	(3,893)
Net income	223,572
Retained earnings, beginning of year	<u>33,804,692</u>
Retained earnings, end of year	<u><u>\$ 34,028,264</u></u>

See notes to financial statements

STEPHENS INSTITUTE
dba ACADEMY OF ART UNIVERSITY
Statement of Cash Flows
For the Year Ended December 31, 2017

Cash flows from operating activities:	
Net income	\$ 223,572
Adjustments to reconcile net income to net cash provided by operating activities:	
Depreciation and amortization	13,250,417
Changes in assets and liabilities:	
Accounts receivable, net	(377,207)
Due from related party	(303,950)
Other accounts receivable	(643,999)
Prepaid expenses	(1,612,911)
Deposits and other	(2,245,313)
Bank overdraft	(1,879,293)
Accounts payable	(653,581)
Accrued expenses	(2,598,076)
Dormitory and other deposits	(63,559)
Deferred tuition and dormitory rent	(2,591,754)
Net cash provided by operating activities	<u>504,346</u>
Cash flows from investing activities:	
Purchases of property, equipment and improvements	<u>(7,851,189)</u>
Net cash used by investing activities	<u>(7,851,189)</u>
Cash flows from financing activities:	
Principal payments on capital lease obligations	(3,611,559)
Borrowings on revolving credit facility	53,100,000
Principal repayments on revolving credit facility	<u>(35,100,000)</u>
Net cash provided by financing activities	<u>14,388,441</u>
Increase in cash and cash equivalents	7,041,598
Cash and cash equivalents, beginning of year	<u>670,510</u>
Cash and cash equivalents, end of year	<u><u>\$ 7,712,108</u></u>
Supplemental cash flows information:	
Cash paid for -	
Interest	<u>\$ 351,974</u>
Income taxes	<u>\$ -</u>
Supplemental schedule of noncash investing and financing activities:	
Equipment acquired under capital lease obligations	<u><u>\$ 5,129,548</u></u>

See notes to financial statements

STEPHENS INSTITUTE
dba ACADEMY OF ART UNIVERSITY
Notes to Financial Statements
December 31, 2017

NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Organization

Stephens Institute dba Academy of Art University (the Academy) was established in 1929 and was incorporated in 1966 in the state of California. The Academy is located in San Francisco, California and provides professional education in the fine arts and applied arts fields of study. The Academy offers certificate programs, Associate of Arts, Bachelor of Fine Arts, Bachelor of Arts, Bachelor of Architecture, Bachelor of Science, Master of Fine Arts, Master of Arts and Master of Architecture degrees. Courses are offered in the spring, summer and fall semesters and in intersessions.

Cash Equivalents

The Academy considers all highly liquid instruments with an initial maturity of three months or less to be cash equivalents.

Accounts Receivable

Accounts receivable are recorded at the net realizable value expected to be received from students or third-party payors and are not collateralized. The Academy bills on a semester by semester basis. Accounts receivable include amounts billed to students less payments received. The allowance for doubtful accounts associated with the Academy's accounts receivable is management's best estimate based upon historical experience. Management continually monitors and adjusts the allowance associated with the Academy's receivables to address any credit risks associated with the Academy's accounts receivable. When uncertainty exists as to the collection of receivables, the Academy records an allowance for doubtful accounts and a corresponding charge to bad debt expense.

Revenue Recognition

Revenues are derived primarily from courses taught at the Academy. Revenues from tuition, course fees and dormitory charges are recognized on a straight-line basis over the term of the students' instruction taking into consideration expected refunds. Deferred tuition and dormitory rent represent amounts received from students for the payment of tuition and dormitory charges in excess of amounts recognized as revenues.

Property, Equipment and Improvements

Property, equipment and improvements are stated at cost and depreciated or amortized utilizing the straight-line method over the following estimated useful lives:

Buildings	20 to 40 years
Building improvements	10 to 15 years
Furniture, fixtures, equipment and software	3 to 5 years
Leasehold improvements	Shorter of lease term or est. useful life

Expenditures that increase the life of property, equipment and improvements are capitalized. Maintenance, repairs, and minor renewals and betterments are expensed as incurred.

STEPHENS INSTITUTE
dba ACADEMY OF ART UNIVERSITY
Notes to Financial Statements
December 31, 2017

NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Long-lived assets are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. When such factors indicate that assets should be evaluated for possible impairment, management would prepare an analysis comparing the carrying value of the assets to future undiscounted cash flows of the underlying assets. The net book value of the underlying assets is adjusted to fair value if the sum of the expected undiscounted future cash flows is less than book value. To date, management has not identified any such factors pertaining to the Academy's long-lived assets.

Student Services, Instructional Expenses and Course Materials, and Selling and Promotion Costs

Student services, instructional expenses and course materials, as well as selling and promotion costs are expensed as incurred.

Fair Value Measurements

The carrying value of the Academy's financial instruments approximates fair value due to the relative short-term nature of these instruments. All financial instruments of the Academy are carried at estimated fair market value based on observable quoted market prices in active markets for identical assets.

Recent Accounting Pronouncements

In May 2014, the Financial Accounting Standards Board (FASB) issued *Accounting Standards Update (ASU) 2014-09, Revenue from Contracts with Customers*, which establishes a comprehensive revenue recognition standard for virtually all industries in U.S. GAAP, including those that previously followed industry-specific guidance. This ASU will be effective for the Company for the year ending December 31, 2019. The Company is currently evaluating the effect the provisions of ASU 2014-09 will have on the financial statements.

In February 2016, FASB issued *ASU No. 2016-02, Leases*. The guidance in this ASU supersedes the leasing guidance in *Topic 840, Leases*. Under the new guidance, lessees are required to recognize lease assets and lease liabilities on the balance sheet for all leases with terms longer than twelve months. Leases will be classified as either finance or operating, with classification affecting the pattern of expense recognition in the statement of operations and member's equity. This ASU will be effective for the Company for the year ending December 31, 2020. The Company is currently evaluating the effect that the provisions of ASU 2016-02 will have on the financial statements.

Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect amounts reported in the financial statements and accompanying notes. Accordingly, actual results could differ from those estimates.

Subsequent Events

The Academy has evaluated subsequent events through the date of the auditors' report, April 24, 2018, which is the date the accompanying financial statements were available to be issued.

STEPHENS INSTITUTE
dba ACADEMY OF ART UNIVERSITY
Notes to Financial Statements
December 31, 2017

NOTE 2 – PROPERTY, EQUIPMENT AND IMPROVEMENTS

Property, equipment and improvements consisted of the following as of December 31, 2017:

Land	\$ 2,497,538
Buildings and improvements	3,340,546
Leasehold improvements	45,661,614
Equipment	21,150,087
Software	39,981,322
Furniture and fixtures	225,376
Transportation equipment	9,835,510
Equipment under capital leases	11,035,282
	<hr/> 133,727,275
Less: accumulated depreciation and amortization	(98,266,540)
	<hr/> <u>\$ 35,460,735</u>

Depreciation and amortization expense associated with property, equipment and improvements was \$13,250,417 for the year ended December 31, 2017.

Included within construction in progress on the accompanying balance sheet are approximately \$3.8 million of leasehold improvement projects which are underway and approximately \$6.4 million of software development costs for projects not yet in production.

NOTE 3 – CLASSIC CAR COLLECTION

The Academy has acquired classic vintage automobiles for use in its transportation and design department. The automobiles are of museum quality and are kept in secure facilities. The automobiles are not depreciated as their current fair market value approximates or exceeds their purchased fair market value.

NOTE 4 – ENVIRONMENTAL IMPACT REPORT

The Academy is currently incurring substantial costs associated with a requirement set forth by the city of San Francisco to produce an Environmental Impact Report (EIR). The EIR is a requirement for all for-profit entities including universities operating in the city and provides historical details surrounding the various buildings in which the Academy operates from, including the impact on transportation and other environmental considerations associated with the buildings. Completion of the EIR is a requirement for future approval of building permits for renovations, improvements and repairs. Such amounts incurred for completion of the EIR are being capitalized by the Academy and have been included within deposits and other on the accompanying balance sheet in the amount of approximately \$10.6 million as of December 31, 2017. Upon completion of the EIR and its approval by the city, the Academy will begin amortizing the total capitalized costs over the remaining periods of applicable facility leases and/or the life of the owned buildings. Academy management and its legal counsel expect completion of the EIR and submission to the city during the year ending December 31, 2018.

STEPHENS INSTITUTE
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Notes to Financial Statements
December 31, 2017

NOTE 5 – COMMITMENTS AND CONTINGENCIES

Facility Leases

The Academy operates from forty-six separate facilities located throughout San Francisco, California. Four of the facilities are owned by the Academy, forty-one facilities are leased from entities which are held by an entity owned by the stockholder and family members, and one facility is leased from an unrelated third-party. The facilities include twenty-five buildings where classes are held, studios, galleries, an auditorium and administrative facilities, seventeen dormitory facilities and four facilities utilized by the Academy for other purposes. The leases with related parties expire at various times through December 2022 and contain renewal options. All of the leases require the Academy to pay various operating expenses associated with the facilities and provide for mutual agreement of periodic rent adjustments.

During the year ended December 31, 2017, rent expense paid to an entity owned by the Academy's stockholder and family members was approximately \$24.5 million, and is included within occupancy costs in the accompanying statement of income and retained earnings. Rent expense paid to unrelated third-parties for the year ended December 31, 2017 was approximately \$3.7 million and is included within occupancy costs in the accompanying statement of income and retained earnings

The Academy subleases parking areas and several storefronts to various merchants under month-to-month and non-cancellable operating lease agreements expiring at various times through May 2021. Rental income from these agreements was approximately \$2.3 million for the year ended December 31, 2017 and is included within other ancillary activities, net, on the accompanying statement of income and retained earnings.

Future minimum lease payments under the terms of the facility lease agreements were as follows as of December 31, 2017:

<u>Year Ending December 31,</u>	<u>Operational Facilities</u>	<u>Dormitory Facilities</u>	<u>Total</u>
2018	\$ 17,256,678	\$ 10,722,036	\$ 27,978,714
2019	5,328,403	3,503,400	8,831,803
2020	4,552,776	3,503,400	8,056,176
2021	3,009,538	3,503,400	6,512,938
2022	464,574	-	464,574
	<u>30,611,969</u>	<u>21,232,236</u>	<u>51,844,205</u>
Less: sublease income	<u>(3,554,778)</u>	<u>-</u>	<u>(3,554,778)</u>
	<u>\$ 27,057,191</u>	<u>\$ 21,232,236</u>	<u>\$ 48,289,427</u>

STEPHENS INSTITUTE
dba ACADEMY OF ART UNIVERSITY
Notes to Financial Statements
December 31, 2017

NOTE 5 – COMMITMENTS AND CONTINGENCIES (Continued)

Equipment Leases

The Academy also rents various equipment, including aircraft, under the terms of non-cancellable operating leases expiring at various times through December 2024. Minimum future rental payments under the terms of the equipment lease agreements were as follows as of December 31, 2017:

<u>Year Ending</u> <u>December 31,</u>	
2018	\$ 1,620,873
2019	1,503,762
2020	1,149,400
2021	1,048,392
2022	1,048,392
Thereafter	<u>2,096,785</u>
	<u><u>\$ 8,467,604</u></u>

Contingencies

The Academy is involved in various claims and lawsuits arising in the ordinary course of its business. In the opinion of management and legal counsel, the ultimate disposition of these matters will not have a material adverse effect upon the financial condition of the Academy. In addition, the following matter represents a certain legal proceeding as of and for the year ended December 31, 2017 which is determined to be outside of the scope of ordinary routine litigation incidental to the Academy's operations.

San Francisco City Attorney

On May 6, 2016, the San Francisco City Attorney filed a lawsuit against the Academy and twenty-three of the forty-one entities owned by the stockholder and family members that lease facilities to the Academy, as described above. The lawsuit asserts violations of the city's administrative code, planning code, building code and California's unfair competition law, based on allegations of failures to obtain proper approvals for use of the buildings.

On November 15, 2016, the parties entered into a Term Sheet for Global Resolution (the Term Sheet). The Term Sheet sets forth generally the terms on which the San Francisco City Attorney and the Academy intend to work together to resolve all of the outstanding issues pending between the parties and establish appropriate land use principles and processes for the Academy properties and future operations, in a timely and mutually satisfactory manner. The Term Sheet does not include any financial penalty assessment to the Academy but does require operational changes to certain of the Academy's leased properties. The parties are continuing to implement the Term Sheet in order to reach final resolution of this matter. If those efforts remain on course, it is expected that there will be a final judgment consistent with the Term Sheet some time in 2018.

STEPHENS INSTITUTE
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Notes to Financial Statements
December 31, 2017

NOTE 6 – REVOLVING CREDIT FACILITY AND REAL ESTATE MASTER CREDIT FACILITY

Revolving Credit Facility

The Academy is party to a \$28.0 million revolving credit facility with a bank maturing March 31, 2019. The revolving credit facility provides for borrowings at a variable rate (4.57% as of December 31, 2017). Any unused portion of the revolving loan facility is assessed a one-quarter of one percent (0.25%) per annum commitment fee. The revolving credit facility requires monthly payments of interest only until maturity and outstanding balances are secured by real estate owned by the Academy. As of December 31, 2017, the outstanding balance on the revolving credit facility was \$26.0 million.

Real Estate Master Credit Facility

Certain other entities held by the Academy's stockholder and family members are parties to a \$164,392,910 real estate master credit facility with a bank expiring March 31, 2019. The real estate master credit facility provides for borrowings under the agreement at a variable rate (4.82% as of December 31, 2017). Outstanding principal balances require monthly principal plus interest payments. Outstanding balances are secured by real estate owned by these related entities and amounted to \$148,638,590 at December 31, 2017.

The terms of the above facility agreements require maintenance of certain covenants by the Academy, as defined, including profitability, tangible net worth and capital expenditures, among others. The agreements also require the Academy to comply with the U.S. Department of Education's financial responsibility standards. As of December 31, 2017, the Academy was in compliance with these covenants.

NOTE 7 – CAPITAL LEASE OBLIGATIONS

The Academy leases various office and instructional equipment under the terms of non-cancellable capital lease agreements. As of December 31, 2017, the cost of assets under capital lease agreements was approximately \$11.0 million; the related accumulated amortization was approximately \$5.2 million.

Future minimum lease payments under the terms of the non-cancellable capital lease agreements were as follows as of December 31, 2017:

Year Ending December 31,	
2018	\$ 3,181,903
2019	1,928,263
2020	829,808
2021	52,449
2022	7,403
Total future minimum lease payments	5,999,826
Less: amount representing interest	(33,576)
Present value of future minimum lease payments	5,966,250
Less: current portion	(3,151,843)
	<u>\$ 2,814,407</u>

STEPHENS INSTITUTE
dba ACADEMY OF ART UNIVERSITY
Notes to Financial Statements
December 31, 2017

NOTE 8 – DUE FROM RELATED PARTY

As of December 31, 2017, the Academy had advanced funds in the aggregate amount of \$303,950 to an entity owned by the Academy's stockholder and family members. These amounts were unsecured, non-interest bearing and had no stipulated terms for repayment. In April 2018, the advanced funds were repaid to the Academy.

NOTE 9 – INCOME TAXES

The Academy operates as a Subchapter S corporation. As such, the income and expenses of the Academy are passed through to the stockholder and reported on the individual income tax returns. For financial reporting purposes, the Academy uses the asset and liability method of accounting for income taxes. The provision for income taxes reflected in the accompanying financial statements includes California state taxes computed at 1.5%.

Deferred income taxes result primarily from the use of the reserve method of accounting for estimated uncollectible accounts receivable for financial statement purposes and the use of accelerated methods of depreciation for tax purposes. As of December 31, 2017, deferred income taxes were not material.

NOTE 10 – 401(K) EMPLOYEE SAVINGS PLAN

The Academy has a 401(k) savings plan for its employees which provides for participation by all employees with one year of service over the age of twenty-one who have worked a minimum of 1,000 hours during the year. Employer and employee contributions are fully vested at all times. For the year ended December 31, 2017, Academy matching contributions amounted to approximately \$750,000.

NOTE 11 – REGULATORY MATTERS

The Academy is subject to extensive regulation by federal and state governmental agencies and accrediting bodies. In particular, the Higher Education Act of 1965 (the Act) and the regulations promulgated thereunder by the U.S. Department of Education (ED) subject the Academy to significant regulatory scrutiny on the basis of numerous standards that schools must satisfy in order to participate in the various federal student financial assistance programs under Title IV of the Act. These standards include, among others, financial responsibility, student default rates, and the "90/10" rule. Ineligibility to participate in the Title IV programs would have a material adverse effect on the Academy's enrollments, revenue and results of operations.

Institutions participating in Title IV programs are required by ED to demonstrate financial responsibility. ED determines an institution's financial responsibility through the calculation of a composite score based upon certain financial ratios as defined in regulations. Institutions receiving a composite score of 1.5 or greater are considered fully financially responsible. Institutions receiving a composite score between 1.0 and 1.4 are subject to additional monitoring. Institutions receiving a composite score below 1.0 are required to submit financial guarantees in order to continue participation in the Title IV programs. As of and for the year ended December 31, 2017, the Academy's composite score was 2.4.

STEPHENS INSTITUTE
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Notes to Financial Statements
December 31, 2017

NOTE 11 – REGULATORY MATTERS (Continued)

For each federal fiscal year, ED calculates a rate of student defaults for each educational institution known as a “cohort default rate”. Under certain defined circumstances, an institution may lose its eligibility to participate in some or all Title IV programs. As of December 31, 2017, management believes that the Academy was in compliance with ED’s requirements concerning cohort default rates.

Substantial portions of the Academy’s revenue and collection of accounts receivable are dependent upon its continued participation in the Title IV programs of the Act. To continue to participate in the Title IV programs, the Academy must comply with certain regulations of ED. ED regulations restrict the proportion of cash receipts for tuition and fees from eligible programs to not more than 90 percent from the Title IV programs. The failure of an institution to meet the 90 percent limitation could result in the loss of an institution’s ability to participate in Title IV programs. For the year ended December 31, 2017, the Academy was in compliance with the 90/10 rule. ED requires an institution to provide additional disclosures with respect to the 90/10 rule, which are included in the accompanying supplementary information beginning on page 15.

As a result of operating in a highly regulated industry, the Academy may be subject from time to time to audits, investigations, claims of noncompliance or lawsuits by governmental agencies, regulatory bodies, or other third parties. While there can be no assurance that such matters will not occur and if they do occur will not have a material adverse effect on the Academy’s business, results of operations or financial condition, management believes that the Academy has complied with all regulatory requirements.

On October 30, 2014, ED released its final rule concerning gainful employment which was formally published in the Federal Register October 31, 2014 and became effective July 1, 2015. The final rule applies to all gainful employment programs, which include all non-degree programs at public and private non-profit institutions, and all programs offered at for-profit institutions. The final rule assesses continued eligibility of gainful employment programs by their performance against specific defined debt-to-earnings measures. Gainful employment programs that fail in two out of any three consecutive years or are in the zone for four consecutive years will be ineligible. In addition, institutions are required to certify that each of their gainful employment programs meet state and federal licensure, certification, and accreditation requirements, as well as make public disclosures regarding performance and outcomes of their gainful employment programs, such as costs, earnings, debt and completion rates.

In January 2017, ED released its final debt-to-earnings rates and underlying data applicable for the first measurement year. Of the 125 programs offered by the Academy, ten of its programs were determined to fail and six programs were determined to be in the zone. The Academy appealed the annual earnings that ED included in its gainful employment calculations, utilizing ED’s Recent Graduate Employment Earnings Survey (RGEES) platform to conduct surveys in order to meet all ED requirements. The results of these surveys were sent to ED before the revised due date of February 1, 2018. Out of the ten programs that failed, five programs were determined to either be passing or in the zone; the remaining five programs did not pass and were not submitted to ED for appeal. 575 Students in the five remaining failed programs were sent the required ED letters to inform students that the program could lose financial aid eligibility if they failed again when second year rates are released.

STEPHENS INSTITUTE
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Notes to Financial Statements
December 31, 2017

NOTE 11 – REGULATORY MATTERS (Continued)

ED's future enforcement of the gainful employment rule is currently uncertain. However, if the five remaining failed programs are determined to fail a second time if and when the new rates are released in 2018, the failing programs would lose eligibility for Title IV financial aid under the current guidelines. If these events occur, the Academy will assist students' matriculation and graduation efforts by offering them private educational loans, scholarships or extended payment plans. The Academy will also have the option to transfer the affected students into other similar programs that are eligible for Title IV funding, or into equivalent four-year certificate programs that meet the gainful employment requirements. The Academy will also pursue the option to implement new programs into which the affected students could transfer.

The Academy is also surveying students in the six programs that were determined to be in the zone category in January 2017. These programs would only become ineligible for Title IV funding if they stay in the zone or fail over a four-year period. The Academy is reviewing its programs that might be affected over the next four years and will adjust its strategic planning efforts accordingly.

NOTE 12 – CONCENTRATION OF CREDIT RISK

As of December 31, 2017, the Academy maintained cash balances with a bank in excess of the federally insured amount.

STEPHENS INSTITUTE
dba ACADEMY OF ART UNIVERSITY
Supplementary Information
(Information Required by the U.S. Department of Education)
December 31, 2017

Institution's Calculation of 90/10 Revenue Test

Stephens Institute dba Academy of Art University (the Institution) derives a substantial portion of its revenues from Student Financial Aid (SFA) received by its students under the Title IV programs administered by the U.S. Department of Education pursuant to the Higher Education Act of 1965, as amended (HEA). To continue to participate in the SFA programs the Institution must comply with the regulations promulgated under HEA. The regulations restrict the proportion of cash receipts for tuition and fees from eligible programs to not more than 90 percent from the Title IV programs. In July 2008, modifications to the regulations were made with respect to amounts to be included in the 90 percent calculations including the allowance for the inclusion of funds received for certain qualifying non-Title IV programs. In addition, the modifications included provisions for institutions that do not comply with the 90 percent rule for a single fiscal year, whereby such institutions would be placed on provisional certification status for a period of two years. Institutions that do not comply with the 90 percent rule for two consecutive fiscal years are subject to the loss of their ability to participate in the SFA programs. For the year ended December 31, 2016, the Institution was in compliance with the 90 percent rule.

For the year ended December 31, 2017, the Institution's 90/10 revenue test percentage was computed as follows:

Revenue by Fund Source	<u>Amount Disbursed</u>	<u>Adjusted Amount</u>
Adjusted Student Title IV Revenue		
Subsidized Loan	\$ 17,231,438	\$ 17,231,438
Unsubsidized Loan	45,504,654	45,504,654
Federal Pell Grant	12,228,026	12,228,026
FSEOG (subject to matching reduction)	921,825	691,369
Federal Work Study applied to tuition and fees (subject to matching reduction)	-	-
Federal Direct PLUS Loan	35,885,233	35,885,233
All Other Title IV Loans and Grants	<u>2,709</u>	<u>2,709</u>
Student Title IV Revenue	<u>\$ 111,773,885</u>	<u>\$ 111,543,429</u>
Revenue Adjustment - If the amount of funds applied first plus Student Title IV revenue is more than tuition and fees, then reduce Title IV revenue by the amount over tuition and fees		(24,935,755)
Title IV funds returned for a student under 34 C.F.R § 668.22 (withdrawal), reduce Student Title IV Revenue		<u>(2,771,677)</u>
Adjusted Student Title IV Revenue		<u>\$ 83,835,997</u>

STEPHENS INSTITUTE
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Revenue by Fund Source	<u>Amount Disbursed</u>	<u>Adjusted Amount</u>	
Student Non-Title IV Revenue			
Grant funds for the student from non-Federal public agencies or private sources independent of the institution	\$ 159,391		
Funds provided for the student under a contractual arrangement with a Federal, State, or local government agency for the purpose of providing job training to low income individuals	-		
Funds used by a student from savings plans for educational expenses established on or behalf of the student that qualify for special tax treatment under the Internal Revenue Service	-		
Institutional scholarships disbursed to the student	-		
Student Payments	<u>160,331,979</u>		
Student Non-Title IV Revenue	<u>\$ 160,491,370</u>		
Revenue from Other Sources (Totals for the Fiscal Year)			
Activities conducted by the institution that are necessary for education and training	\$ -		
Funds paid by a student, or on behalf of a student, by a party other than the school for an education or training program that is not eligible	-		
Allowable student payments plus allowable amounts from account receivable or institutional loan sales minus any required payments under a recourse agreement	<u>-</u>		
Revenue from Other Sources	<u>\$ -</u>		
<u>Adjusted Title IV Revenue</u>		<u>\$ 83,835,997</u>	
Adjusted Title IV Revenue + Adjusted Student Non-Title IV Revenue + Total Revenue from other sources		\$ 244,327,367	34.31%

This information is required by the U.S. Department of Education and is presented for purposes of additional analysis and is not a required part of the financial statements.

Related Party Transactions

Stephens Institute dba Academy of Art University (the Institution) participates in Student Financial Aid (SFA) under the Title IV programs administered by the U.S. Department of Education pursuant to the Higher Education Act of 1965, as amended (HEA). The Institution must comply with the regulations promulgated under HEA. Those regulations require that all related party transactions be disclosed, regardless of their materiality to the financial statements.

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Organization – The Institution was established in 1929 and was incorporated in 1966 in the state of California. The Institution is located in San Francisco, California and provides professional education in the fine arts and applied arts fields of study. The Institution offers certificate programs, Associate of Arts, Bachelor of Fine Arts, Bachelor of Arts, Bachelor of Architecture, Bachelor of Science, Master of Fine Arts, Master of Arts and Master of Architecture degrees. Courses are offered in the spring, summer and fall semesters and in intersessions.

Facility leases with related parties – The Institution operates from forty-six separate facilities located throughout San Francisco, California. Forty-one of these facilities are leased from entities held by the stockholder and family members and are scheduled to expire at various times through December 2022, with renewal options available at expiration. All of the leases require the Institution to pay various operating expenses associated with the facilities and provide for mutual agreement of periodic rent adjustments. During the year ended December 31, 2017, rent expense paid to the entities held by the stockholder and family members was approximately \$24.5 million.

Real estate master credit facility – Certain other entities owned by the Institution’s stockholder and family members are parties to a \$164,392,910 master credit facility with a bank expiring March 31, 2019. The real estate master credit facility provides for borrowings under the agreement at a variable rate (4.82% as of December 31, 2017). Outstanding principal balances require monthly principal plus interest payments. Outstanding balances are secured by real estate owned by these related entities and amounted to \$148,638,590 at December 31, 2017.

The terms of the master credit facility require maintenance of certain covenants by the Institution, as defined, including profitability, tangible net worth and capital expenditures, among others. The master credit facility also requires the Institution to comply with the U.S. Department of Education’s financial responsibility standards. As of December 31, 2017, the Institution was in compliance with these covenants.

Due from related party - As of December 31, 2017, the Institution had advanced funds in the aggregate amount of \$303,950 to an entity owned by the Institution’s stockholder and family members. These amounts were unsecured, non-interest bearing and had no stipulated terms for repayment. In April 2018, the advanced funds were repaid to the Institution.

This information is required by the U.S. Department of Education and is presented for purposes of additional analysis and is not a required part of the financial statements.

ALMICH & ASSOCIATES

AN ACCOUNTANCY CORPORATION

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INDEPENDENT AUDITORS' REPORT ON COMPLIANCE AND ON INTERNAL CONTROL OVER FINANCIAL REPORTING BASED ON AN AUDIT OF FINANCIAL STATEMENTS PERFORMED IN ACCORDANCE WITH *GOVERNMENT AUDITING STANDARDS*

To the Board of Directors and Stockholder of
Stephens Institute dba Academy of Art University:

We have audited, in accordance with auditing standards generally accepted in the United States of American and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States, the financial statements of Stephens Institute dba Academy of Art University (the Academy, a California corporation), which comprise the balance sheet as of December 31, 2017, and the related statements of income and retained earnings and cash flows for the year then ended, and the related notes to the financial statements, and have issued our report thereon dated April 24, 2018.

Internal Control Over Financial Reporting

In planning and performing our audit, we considered the Academy's internal control over financial reporting (internal control) to determine audit procedures that are appropriate in the circumstances for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control. Accordingly, we do not express an opinion on the effectiveness of the Company's internal control.

A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct misstatements on a timely basis. A material weakness is a deficiency, or combination of deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis. A significant deficiency is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

Our consideration of internal control was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies. Given these limitations, during our audit we did not identify any deficiencies in internal control that we consider to be material weaknesses. However, material weaknesses may exist that have not been identified.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the Academy's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements, non-compliance with which could have a direct and material effect on the determination of financial statement amounts. Such tests included compliance tests as set forth in the *Guide for Audits of Proprietary Schools and for Compliance Attestation Engagements of Third-Party Servicers Administering Title IV Programs, issued by the U.S. Department of Education, Office of Inspector General* (the Guide), including those relating to related parties and percentage of revenue derived from Title IV programs. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed no instances of non-compliance or other matters that are required to be reported under *Government Auditing Standards* or the Guide.

Purpose of this Report

The purpose of this report is solely to describe the scope of our testing of internal control and compliance and the results of that testing, and not to provide an opinion on the effectiveness of the entity's internal control or on compliance. This report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the entity's internal control and compliance. Accordingly, this communication is not suitable for any other purpose.

Admich + Associates

Lake Forest, California
April 24, 2018