



NCU HOLDINGS, LLC AND SUBSIDIARY

CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2017 and 2016

NCU HOLDINGS, LLC AND SUBSIDIARY
San Diego, California

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December 31, 2017 and 2016

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INDEPENDENT AUDITOR'S REPORT

Board of Directors
NCU Holdings, LLC and Subsidiary
San Diego, California

Report on the Financial Statements

We have audited the accompanying consolidated financial statements of NCU Holdings, LLC and Subsidiary, which comprise the consolidated balance sheets as of December 31, 2017 and 2016, and the related consolidated statements of income, comprehensive income, changes in members' equity, and cash flows for the years then ended, and the related notes to the financial statements.

Management's Responsibility for the Financial Statements

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

Auditor's Responsibility

Our responsibility is to express an opinion on these consolidated financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free from material misstatement.

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

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

Opinion

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of NCU Holdings, LLC and Subsidiary as of December 31, 2017 and 2016, and the results of their operations and their cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

A handwritten signature in cursive script that reads "Crowe Horwath LLP".

Crowe Horwath LLP

Franklin, Tennessee

April 10, 2018

NCU HOLDINGS, LLC AND SUBSIDIARY
CONSOLIDATED BALANCE SHEETS
December 31, 2017 and 2016

	2017	2016
ASSETS		
Current assets:		
Cash and cash equivalents (Note 2)	\$ 6,243,335	\$ 14,888,343
Restricted cash (Note 2)	666,708	324,919
Accounts receivable, net (Note 3)	8,039,734	8,371,533
Miscellaneous receivables	6,050	25,357
Inventory	38,386	35,660
Prepaid income taxes (Note 9)	572,793	197,101
Prepaid expenses (Note 4)	2,061,335	1,458,870
Deposits	10,645	127,100
Total current assets	17,638,986	25,428,883
Long-term deposits	14,052	47,489
Property and equipment, net (Note 5)	9,425,549	8,007,094
Intangible assets, net (Note 6)	9,380,532	9,852,444
Goodwill	48,145,915	48,145,915
Total assets	\$ 84,605,034	\$ 91,481,825

NCU HOLDINGS, LLC AND SUBSIDIARY
CONSOLIDATED BALANCE SHEETS
December 31, 2017 and 2016

	2017	2016
LIABILITIES AND MEMBERS' EQUITY		
Current liabilities:		
Accounts payable	\$ 2,396,252	\$ 513,637
Accrued expenses (Note 7)	6,169,416	6,229,565
Students' credit balances	171,126	321,267
Title IV students' credit balances	686,810	354,877
Unearned tuition	10,530,936	11,626,297
Accrued vacation and sick	165,306	126,683
Income taxes payable (Note 9)	-	34,266
Derivatives contract, current portion (Note 17)	-	350
Deferred lease incentive, current portion (Note 12)	152,736	232,341
Deferred rent, current portion	1,378	-
Long-term debt, current portion (Note 10)	6,393,750	7,581,250
Total current liabilities	26,667,710	27,020,533
Long-term debt (Note 10)	13,684,296	26,978,046
Deferred financing fees, net (Note 11)	(105,145)	(210,616)
Long-term debt, net of deferred financing fees	13,579,151	26,767,430
Other liabilities:		
Deferred tax liability, net (Note 9)	721,990	1,200,273
Deferred lease incentive (Note 12)	852,778	154,895
Deferred rent	212,820	302,517
Total other liabilities	1,787,588	1,657,685
Total liabilities	42,034,449	55,445,648
Members' equity (Note 14 and Note 15):		
Preferred units (aggregate redemption value of \$13,000,000 and \$16,468,011 in 2017 and 2016, respectively)	13,000,000	13,000,000
Common units	16,623,306	16,623,306
Additional paid-in capital	624,722	606,868
Warrants	651,635	651,635
Retained earnings	36,729,122	30,210,178
Accumulated other comprehensive income, net of tax	-	2,390
	67,628,785	61,094,377
Less: treasury units, at cost	(25,058,200)	(25,058,200)
Total members' equity	42,570,585	36,036,177
Total liabilities and members' equity	\$ 84,605,034	\$ 91,481,825

NCU HOLDINGS, LLC AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF INCOME
Years Ended December 31, 2017 and 2016

	2017	2016
Net revenues:		
Tuition and fees	\$ 119,834,048	\$ 113,513,113
Miscellaneous income	248,897	76,564
Net revenues	120,082,945	113,589,677
Operating expenses:		
Payroll, instruction, unit-based compensation and related costs	49,152,498	46,991,941
Advertising (Note 8)	24,167,518	22,923,842
Administrative	10,139,125	8,276,536
Rent (Note 12)	1,947,479	2,759,039
Insurance and benefits	3,096,273	2,736,080
Bad debt expense	4,906,090	5,051,677
Credit card processing	391,409	439,438
Management fees (Note 13)	771,791	688,850
Total operating expenses	94,572,183	89,867,403
Income from operations	25,510,762	23,722,274
Other expenses:		
Interest expense	1,524,945	2,076,730
Loss on exchange rate	3,206	1,259
Loss on disposal of property and equipment	15,464	2,055
Depreciation and amortization	5,063,487	5,501,508
Total other expenses	6,607,102	7,581,552
Income before income tax expense	18,903,660	16,140,722
Income tax expense (Note 9)	7,244,865	6,464,482
Net income	\$ 11,658,795	\$ 9,676,240

NCU HOLDINGS, LLC AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
Years Ended December 31, 2017 and 2016

	<u>2017</u>	<u>2016</u>
Net income	\$ 11,658,795	\$ 9,676,240
Other comprehensive income (loss):		
Change in fair value of interest rate swap, gross	350	58,795
Income tax benefit related to other comprehensive income	(2,740)	(22,424)
Comprehensive income	<u><u>\$ 11,656,405</u></u>	<u><u>\$ 9,712,611</u></u>

NCU HOLDINGS, LLC AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF CHANGES IN MEMBERS' EQUITY
Years Ended December 31, 2017 and 2016

	Preferred Units		Common Units		Additional Paid in Capital	Warrants		Retained Earnings	Accumulated Other Comprehensive Income	Treasury Units		Total
	Number	Amount	Number	Amount		Number	Amount		(Loss)	Number	Amount	
Balance at January 1, 2016	74,608	\$ 13,000,000	236,995	\$ 16,601,906	\$ 647,000	6,517	\$ 651,635	\$ 20,533,938	\$ (33,981)	76,290	\$ (25,048,000)	\$ 26,352,498
Unit-based compensation benefit (Note 15)	-	-	-	-	(21,624)	-	-	-	-	-	-	(21,624)
Change in fair value of interest rate swap, net of tax	-	-	-	-	-	-	-	-	36,371	-	-	36,371
Options exercise	-	-	214	21,400	(70,604)	-	-	-	-	-	-	(49,204)
Windfall tax from options	-	-	-	-	52,096	-	-	-	-	-	-	52,096
Treasury units purchase	-	-	-	-	-	-	-	-	-	34	(10,200)	(10,200)
Net income	-	-	-	-	-	-	-	9,676,240	-	-	-	9,676,240
Balance at December 31, 2016	74,608	13,000,000	237,209	16,623,306	606,868	6,517	651,635	30,210,178	2,390	76,324	(25,058,200)	36,036,177
Unit-based compensation expense (Note 15)	-	-	-	-	17,854	-	-	-	-	-	-	17,854
Change in fair value of interest rate swap, net of tax	-	-	-	-	-	-	-	-	(2,390)	-	-	(2,390)
Accumulated preferred yield payments	-	-	-	-	-	-	-	(5,139,851)	-	-	-	(5,139,851)
Net income	-	-	-	-	-	-	-	11,658,795	-	-	-	11,658,795
Balance at December 31, 2017	74,608	\$ 13,000,000	237,209	\$ 16,623,306	\$ 624,722	6,517	\$ 651,635	\$ 36,729,122	\$ -	76,324	\$ (25,058,200)	\$ 42,570,585

NCU HOLDINGS, LLC AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF CASH FLOWS
Years Ended December 31, 2017 and 2016

	2017	2016
Cash flows from operating activities:		
Net income	\$ 11,658,795	\$ 9,676,240
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	5,063,487	5,501,508
Loss on disposal of property and equipment	15,464	2,055
Provision for bad debts	4,906,090	5,051,677
Amortization of debt discount and financing cost	105,471	230,955
Deferred income taxes	(478,283)	(376,185)
Decrease in interest rate swaps	(2,740)	(22,424)
Unit-based compensation expense (benefit)	17,854	(21,624)
Amortization of deferred rent	(294,126)	(493,588)
Employer tax expense for options exercised	-	9,832
Changes in assets and liabilities:		
Increase in accounts receivable	(4,574,291)	(5,114,389)
(Increase) decrease in prepaid expenses and other assets	(435,992)	284,466
Increase in prepaid income taxes	(409,958)	(283,023)
Increase in accounts payable	1,882,615	142,542
Increase in students' credit balances	181,792	91,788
(Decrease) increase in unearned tuition	(1,095,361)	1,065,216
(Decrease) increase in accrued expenses	(21,526)	1,694,864
Net cash provided by operating activities	16,519,291	17,439,910

NCU HOLDINGS, LLC AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF CASH FLOWS
Years Ended December 31, 2017 and 2016

	2017	2016
Cash flows from investing activities:		
Purchase of property and equipment	(5,201,409)	(3,986,992)
Net cash used in investing activities	(5,201,409)	(3,986,992)
Cash flows from financing activities:		
Deferred financing costs	-	(118,330)
Payments made on long-term debt	(14,481,250)	(6,568,750)
Payments related to the exercise of equity options	-	(59,036)
Tax benefit for exercise of options	-	52,096
Payments related to purchase of treasury stock	-	(10,200)
Accumulated preferred yield payments	(5,139,851)	-
Net cash used in financing activities	(19,621,101)	(6,704,220)
Net (decrease) increase in cash, cash equivalents and restricted cash	(8,303,219)	6,748,698
Cash, cash equivalents and restricted cash, beginning of year	15,213,262	8,464,564
Cash, cash equivalents and restricted cash, end of year	\$ 6,910,043	\$ 15,213,262
Supplemental disclosure of cash flows information:		
Cash paid during the year for interest	\$ 1,416,218	\$ 1,893,771
Cash paid during the year for income taxes	\$ 8,107,540	\$ 7,080,815
Supplemental disclosure of non-cash items:		
Fixed assets - tenant improvement allowance	\$ 824,085	\$ -
Deferred rent - tenant improvement allowance	\$ (824,085)	\$ -

NCU HOLDINGS, LLC AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2017 and 2016

NOTE 1 – NATURE OF OPERATIONS AND SIGNIFICANT ACCOUNTING POLICIES

Consolidation: The consolidated financial statements include the accounts of NCU Holdings, LLC and its wholly-owned subsidiary, Innova Management Group, Inc. ("Innova") and Innova's wholly owned subsidiary, Northcentral University, Inc. (the "Company" or "Northcentral University"). All significant intercompany transactions and balances have been eliminated in consolidation.

The Company began operations on December 30, 2008 when NCU Holdings, LLC acquired 100% of the outstanding common stock of Innova Management Group, Inc.

Business Activity: The Company operates a private, distance learning educational institution with its headquarters in San Diego, California and an administrative location in Scottsdale, Arizona. During 2016, the Company filed reincorporation documents in California and, concurrently, changed its headquarters to California from Arizona. Northcentral University offers bachelor, master and doctoral degree programs in Psychology, Education, Business, Technology, Health Sciences and Marriage & Family Sciences, as well as post-baccalaureate and post-master's certificate programs. Using distance learning technologies, Northcentral University provides working professionals throughout the world a doctoral faculty member who provides personal attention through the one-to-one teaching model. Northcentral University's regional accreditor is The Western Association of Schools and Colleges, a Commission of WASC Senior College and University Commission ("WSCUC") located in Alameda, California. Northcentral University is licensed by the California Bureau for Private Postsecondary Education.

Accounting Basis: The Company prepares its consolidated financial statements using the accrual method of accounting, which recognizes revenues when earned and expenses when incurred.

Accounts Receivable and Allowance for Doubtful Accounts: The Company provides an allowance for doubtful accounts for estimated uncollectible accounts. Delinquent accounts are balances owed from students who have withdrawn and primarily represent funds returned to Department of Education in relation to Title IV funding. No interest is charged on accounts receivable. The Company uses estimates that are subjective and require judgment in determining the allowance for doubtful accounts, which are principally based on historical collection experience and write-offs, the aging of receivables and current trends. Accounts receivable are written off once the account is deemed to be uncollectible, which typically occurs after outside collection agencies have pursued collection for approximately two years.

Adoption of New Accounting Policies: In November 2015, the FASB issued ASU 2015-17, *Income Taxes (Topic 740): Balance Sheet Classification of Deferred Taxes*. The standard update was issued to simplify the presentation of deferred income taxes and required deferred income tax liabilities and assets to be classified as non-current in a classified statement of financial position. The requirement that deferred tax liabilities and assets of a tax-paying component of an entity be offset and presented as a single amount was not affected by the amendments of this standard. ASU 2015-17 is effective for nonpublic entities for financial statements issued for fiscal years beginning after December 15, 2017, and early adoption is permitted. The Company early adopted ASU 2015-17 and applied the amendments retrospectively to all deferred tax liabilities and assets presented. The effect of the adoption on the consolidated balance sheet for December 31, 2016, was the offset of long-term deferred tax liabilities of \$4,672,270 by current deferred tax assets of \$3,471,997 for a net long-term deferred tax liability of \$1,200,273.

In July 2015, the FASB issued ASU 2015-11, *Simplifying the Measurement of Inventory*. This guidance replaced the lower of cost or market basis of measuring inventory with measuring inventory at the lower of cost or net realizable value. While prior guidance did not provide clarity on the definition of "market", ASU 2015-11 clearly defines net realizable value as the ultimate selling price in the ordinary course of business, less reasonably predictable costs of completion, disposal, and transportation. The Company has adopted this guidance effective January 1, 2017.

Advertising Costs: Costs of advertising are expensed as incurred because it is not direct response advertising.

Cash and Cash Equivalents: Cash and cash equivalents are defined as cash on hand, cash in banks, and highly liquid debt instruments purchased with an original maturity of three months or less. Cash and cash equivalents consist primarily of bank deposits in accounts that are federally insured up to \$250,000 per financial institution.

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

Restricted Cash: Restricted cash primarily represents funds that were received from Title IV program funds that are in the process of being transferred to students. As a trustee of Title IV program funds, the Company is required to maintain and restrict these funds pursuant to the terms of our program participation agreement with the U.S. Department of Education. Restricted cash is excluded from cash and cash equivalents on the consolidated balance sheets. The Company adopted ASU 2016-18 *Statement of Cash Flows (Topic 230): Restricted Cash* in 2016. The provisions of ASU 2016-18 require that the statement of cash flows explains the change during the period in the total of cash, cash equivalents, and amounts generally described as restricted cash. Therefore, amounts generally described as restricted cash should be included with cash and cash equivalents when reconciling the beginning-of-period and end-of-period total amounts shown on the statement of cash flows. Restricted cash consists primarily of bank deposits in accounts that are federally insured up to \$250,000 per financial institution.

Capitalized Curriculum Development Costs: The Company internally develops curriculum, which is accessed via the web-based learning management system. The Company capitalizes curriculum developments costs incurred during the application development stage in accordance with FASB ASC 350-40, *Internal-Use Software*. Costs that qualify for capitalization are external direct costs and payroll and payroll-related costs related to the development of the curriculum, including any applicable testing during development. These costs are classified in property and equipment. Overhead costs related to general and administrative functions are not capitalized and are expensed as incurred.

Curriculum costs capitalized as part of the purchase by NCU Holdings, LLC are included in intangible assets by the Company at December 31, 2017 and 2016 and are being amortized over their estimated useful life as determined at time of purchase.

Credit Risk: Financial instruments, which potentially subject the Company to concentrations of credit risk, consist principally of cash and cash equivalents and accounts receivable. Northcentral University places its cash and cash equivalents with creditworthy, high-quality financial institutions. Northcentral University has not experienced any losses of its cash and cash equivalents. Credit risk with respect to accounts receivable is limited because the Company deals with a large number of students throughout the world with no one student owing the Company more than 1% of the total accounts receivable balance in 2017 and 2016.

Deferred Financing Fees: Deferred financing fees are paid in conjunction with obtaining bank financing. Deferred financing fees are amortized using the effective interest method over the contractual term of the debt. The Company adopted ASU 2015-03 *Interest – Imputation of Interest (Subtopic 835-30): Simplifying the Presentation of Debt Issuance Costs* in 2016. The provisions of ASU 2015-03 require that debt issuance costs related to a recognized debt liability be presented on the balance sheet as a direct deduction of the carrying amount of the debt liability.

Derivatives: The Company selectively enters into interest rate swap agreements as part of its interest rate risk management strategy, not for speculation. The Company believes the derivatives in effect during the years ended December 31, 2017 and 2016 qualify as hedges.

The Company discontinues hedge accounting when it determines that the derivative is no longer highly effective in offsetting changes in the cash flows of the hedged item; the derivative is settled or terminates; the hedged item no longer exists; a hedged forecasted transaction is no longer probable; or treatment of the derivative as a hedge is no longer appropriate or intended.

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

Fair Value of Financial Instruments: The Company follows FASB ASC 820, *Fair Value Measurements and Disclosures*. FASB ASC 820 establishes a common definition for fair value to be applied to U.S. GAAP requiring use of fair value, establishes a framework for measuring fair value, and expands disclosure about such fair value measurements. FASB ASC 820 defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date (exit price). FASB ASC 820 classifies the inputs used to measure fair value into the following hierarchy:

Level 1: Quoted prices (unadjusted) for identical assets or liabilities in active markets that the entity has the ability to access as of the measurement date.

Level 2: Significant other observable inputs other than Level 1 prices such as quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data.

Level 3: Significant unobservable inputs that reflect a reporting entity's own assumptions about the assumptions that market participants would use in pricing an asset or liability.

Fair values for cash and cash equivalents, receivables, and accounts payable approximate carrying values for these financial instruments since they are relatively short-term in nature. The carrying amount of debt approximates fair value due to either length of maturity or existence of interest rates that approximate prevailing rates. Interest rate swaps are used to hedge the Company's exposure to fluctuations in interest on certain variable rate debt and are recorded at fair value. The differentials to be received or paid are recognized as adjustments to interest expense when incurred.

The fair value of derivative contracts is determined using quoted market prices and significant other observable inputs. Such financial instruments consist of interest rate swaps. Interest rate swaps do not have observable market quotes. For these financial instruments, the Company's swap counterparty provides an annual valuation using the difference between the fixed rate paid by the Company and the counterparty's interest rate forecast discounted using the swap yield curve. The models are based on observable inputs for forward interest rates and discount rates. As such, these derivative instruments are classified within Level 2 of the fair value hierarchy.

Goodwill: Goodwill represents the excess of costs over the fair value of the tangible assets and liabilities and identifiable intangible assets of the business acquired. The Company adopted the provisions of FASB ASC 350, *Intangibles – Goodwill and Other*. Goodwill and certain separately identifiable intangible assets acquired in a purchase or business combination and determined to have an indefinite useful life are not amortized, but instead are tested for impairment annually or more frequently if events and circumstances indicate that the assets might be impaired, in accordance with the provisions of FASB ASC 350. An impairment charge is recognized to the extent that the carrying amount exceeds the asset's fair value. No impairment was recorded during the years ended December 31, 2017 or 2016.

Intangible Assets: As a part of the Company's acquisition, management determined that certain amortizing identifiable intangible assets existed at the acquisition date. These assets were recorded at fair value as of the acquisition date and are being amortized using the straight-line method over the estimated useful lives of the respective assets.

Impairment of Long-Lived Assets: The Company periodically evaluates potential impairments of its long-lived assets, under the provisions of FASB ASC 360, *Property, Plant, and Equipment*, whenever events or changes in circumstances indicate that the carrying values may not be recoverable. The Company evaluates the projected undiscounted cash flows related to the assets. If these cash flows are less than the carrying value of the assets, the Company measures the impairment using discounted cash flows or other methods of determining fair value. Long-lived assets to be disposed of are carried at the lower of cost or fair value less estimated costs of disposal. No impairment was recorded during the years ended December 31, 2017 or 2016.

Inventory: Inventory consists of miscellaneous "Northcentral University store" items for resale. The inventory is stated at the lower of cost (first in, first out) or net realizable value. Inventories are reduced for estimated excess and obsolete inventory.

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

Income Taxes: The Company's members have elected to have the Company's consolidated income taxed as a corporation under the provisions of the Internal Revenue Code and a similar section of state income tax law.

The Company accounts for income taxes following the provisions of FASB ASC 740, *Accounting for Income Taxes*. FASB ASC 740 requires deferred tax assets or liabilities to be recognized for the estimated future tax effects of temporary differences between the financial reporting and tax bases of assets and liabilities based on the enacted tax law and statutory tax rates applicable to the periods in which the temporary differences are expected to affect taxable income. Deferred tax assets are reduced by a valuation allowance if it is more likely than not that some portion or the entire deferred tax asset will not be realized.

The Company has adopted guidance issued by the FASB with respect to accounting for uncertainty in income taxes. The Company will recognize a tax benefit or liability only if it is more likely than not the tax position would be sustained in a tax examination, with a tax examination being presumed to occur. The amount recognized will be the largest amount of tax benefit or liability that is greater than 50% likely of being realized on examination. For tax positions not meeting the more-likely-than-not test, no tax benefit or liability would be recorded.

The Company recognizes interest and penalties related to income tax matters in income tax expense. The Company has no amounts accrued for interest or penalties as of December 31, 2017 or 2016.

No tax benefit or liability from uncertain tax positions was recognized for the years ended December 31, 2017 or 2016. The Company does not expect the total amount of unrecognized tax benefits to significantly change in the next 12 months.

The Company and its subsidiary are subject to U.S. federal income tax and state income taxes.

Leases: Northcentral University enters into various lease agreements to conduct business. Lease agreements are evaluated at the inception of the lease to determine whether the lease is an operating or capital lease. Additionally, the lease agreements may contain renewal options, tenant improvement allowances, rent holidays and/or rent escalation clauses. When such items are included in the lease, a deferred rent asset or liability is recorded on the consolidated balance sheets; and rent expense is recorded evenly over the term of the lease. For leases with renewal options, rent expense is on a straight-line basis over the initial non-cancelable lease term.

The Company is also required to make additional payments under lease terms for taxes, insurance, and other operating expenses incurred during the lease period, which are expensed as incurred over the appropriate period. Rental deposits are provided for lease agreements that specify payments in advance or deposits held in security that are refundable, less any damage at lease end.

Loss Contingencies: Northcentral University is subject to various claims and contingencies including those related to regulation, litigation, business transactions, employee-related matters and taxes, among others. When the Company becomes aware of a claim or potential claim, the likelihood of any loss or exposure is assessed. If it is probable that losses will result and the amount of the loss or range of loss can be reasonably estimated, the Company records a liability for the loss. The liability recorded includes probable and estimable legal costs incurred to date and future legal costs to the point in the legal matter where the Company believes a conclusion to the matter will be reached. The liability excludes any anticipated loss recoveries from third parties such as insurers, which are recorded as a receivable if it is determined that recovery is probable. If the loss is not probable or the amount of the loss or range of loss cannot be reasonably estimated, the claim is disclosed if the likelihood of a potential loss is reasonably possible and the amount of the potential loss could be material. The assessment of the likelihood of a potential loss and the estimation of the amount of a loss or range of loss are subjective and require judgment.

Property and Equipment: Property and equipment are recorded at cost less accumulated depreciation. Major additions and betterments of \$1,500 or more are capitalized; maintenance and repairs are expensed as incurred. When property and equipment are disposed of, the cost and related accumulated depreciation or amortization are removed from the respective accounts, and resulting gains or losses are reflected in earnings. Depreciation and amortization are computed on the straight-line method over the estimated useful lives of the assets for financial statement purposes and accelerated methods for income tax purposes. Leasehold improvements are depreciated over the lesser of the life of the lease or the estimated useful life of the asset.

NCU HOLDINGS, LLC AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2017 and 2016

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

Reclassifications: Northcentral University has reclassified certain items in the accompanying consolidated financial statements for prior periods to be comparable with the classification for the year ended December 31, 2017. These reclassifications have no effect on previously reported net income or members' equity.

Revenue Recognition: Substantially all of the Company's net revenue is composed of tuition and fees from educational programs. The Company's students fund their education through loans and/or grants from U.S. federal financial aid programs established by Title IV of the Higher Education Act and regulations promulgated thereunder ("Title IV"), military benefit programs, tuition assistance from employers, or personal funds.

In Northcentral University's non-term academic delivery model, students generally enroll in a program of study encompassing a series of eight to twelve week courses taken either overlapping or consecutively over the length of the program. Students are billed separately for each course when the student completes the seventh day of the course, resulting in the recording of a receivable from the student and unearned revenue in the amount of the billing. Tuition is recognized by the proportional performance method where revenue is recognized on a straight-line basis as instruction is provided over the length of the course. Unearned tuition represents tuition billed to the student for courses not yet completed at the balance sheet dates.

Northcentral University's refund policy is to refund 100% of the tuition for the first seven days of the course, but full tuition is charged for any courses for which the student has entered the course room and more than seven days, including the course start date, have elapsed.

Discounts reflect reductions of revenue from standard rates and include military, corporate, and other employer discounts, along with institutional scholarships, grants and promotions. Discounts are generally recognized over the period of instruction in the same manner as the related revenue to which the discount applies.

In July 2016, Northcentral University implemented a Course Materials Fee (CMF) to students to cover the costs of providing the student all the appropriate course materials, whether in electronic form from third parties or prepared internally. Students are billed the CMF per course, and revenue is recognized upon billing, as the materials are provided to the student at that time.

Promotions, such as a certificate to the bookstore, are recognized as a reduction in revenue when granted at the expected cost of redemption.

Students' Credit Balances: Students' credit balances represent the prepaid tuition amounts paid by students for courses not yet taken.

Subsequent Events: Management has performed an analysis of the activities and transactions subsequent to December 31, 2017 to determine the need for any adjustments to and/or disclosure within the consolidated financial statements for the year ended December 31, 2017. Management has performed their analysis through April 10, 2018, the date the consolidated financial statements were available to be issued. See Note 19 for further discussion on subsequent events.

Use of Estimates and Assumptions: The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America ("U.S. GAAP") requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the consolidated financial statements, the reported amounts of revenues and expenses during the reporting periods, and disclosure of contingent assets and liabilities at the date of the consolidated balance sheets. Significant items subject to such estimates and assumptions include the carrying amount of intangibles and goodwill and allowance for doubtful accounts. Actual results may differ from those estimates.

NCU HOLDINGS, LLC AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2017 and 2016

NOTE 2 – CASH, CASH EQUIVALENTS AND RESTRICTED CASH

Cash, cash equivalents and restricted cash consisted of the following at December 31, 2017 and 2016:

	2017	2016
Citizens Bank, checking accounts	\$ 6,907,229	\$ 15,210,934
Other checking accounts and petty cash	2,814	2,328
Total cash, cash equivalents and restricted cash	\$ 6,910,043	\$ 15,213,262

NOTE 3 – ACCOUNTS RECEIVABLE, NET

Accounts receivable, net consisted of the following at December 31, 2017 and 2016:

	2017	2016
Student accounts receivable	\$ 17,419,975	\$ 17,223,971
Less: allowance for doubtful accounts	(9,380,241)	(8,852,438)
Total accounts receivable, net	\$ 8,039,734	\$ 8,371,533

Student accounts receivable is composed primarily of amounts due related to tuition and educational services. Student receivables are not collateralized; however, credit risk is mitigated as the amount owed by an individual student is small relative to total student receivables, and the student base is geographically diverse.

The following summarizes the activity in allowances for doubtful accounts for the respective years:

	2017	2016
Beginning allowance for doubtful accounts	\$ 8,852,438	\$ 7,908,368
Provision for uncollectible accounts receivable	4,906,090	5,051,677
Write-offs, net of recoveries	(4,378,287)	(4,107,607)
Ending allowance for doubtful accounts	\$ 9,380,241	\$ 8,852,438

NOTE 4 – PREPAID EXPENSES

Prepaid expenses consisted of the following at December 31, 2017 and 2016:

	2017	2016
Advertising	\$ 110,647	\$ 132,628
Rent	156,465	284,734
Reference materials	302,270	307,591
Insurance	131,433	43,440
Computer licenses	667,101	368,315
Student services	335,686	-
Outside consulting contracts	50,386	58,654
Other	307,347	263,508
Total prepaid expenses	\$ 2,061,335	\$ 1,458,870

NCU HOLDINGS, LLC AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2017 and 2016

NOTE 5 – PROPERTY AND EQUIPMENT, NET

Property and equipment, net consisted of the following at December 31, 2017 and 2016:

	Estimated Life (Years)	2017	2016
Computer equipment	5	\$ 3,769,462	\$ 3,337,292
Software and software development	3	19,377,752	17,197,503
Capitalized curriculum	3	7,450,673	5,212,436
Furniture and fixtures	7	1,991,133	1,763,833
	Lease life		
Leasehold improvements	7 yr maximum	2,465,167	1,533,092
Gross property and equipment		35,054,187	29,044,156
Accumulated depreciation and amortization		(25,628,638)	(21,037,062)
Property and equipment, net		\$ 9,425,549	\$ 8,007,094

Depreciation and amortization expense during the years ended December 31, 2017 and 2016 amounted to \$4,591,575 and \$5,029,596, respectively.

NOTE 6 – INTANGIBLE ASSETS

Intangible assets consisted of the following at December 31, 2017 and 2016:

		2017			2016		
	Estimated Life (Years)	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount
Trade name	50	\$ 6,859,930	\$ (1,234,794)	\$ 5,625,136	\$ 6,859,930	\$ (1,097,594)	\$ 5,762,336
Student relationships	15	2,600,975	(1,560,584)	1,040,391	2,600,975	(1,387,186)	1,213,789
"Compass" software	5	1,827,100	(1,827,100)	-	1,827,100	(1,827,100)	-
Accreditations	50	3,192,140	(574,589)	2,617,551	3,192,140	(510,746)	2,681,394
Developed curriculum	10	974,705	(877,251)	97,454	974,705	(779,780)	194,925
Total intangible assets, net		\$ 15,454,850	\$ (6,074,318)	\$ 9,380,532	\$ 15,454,850	\$ (5,602,406)	\$ 9,852,444

The weighted average amortization period as of December 31, 2017 is 40.5 years.

Amortization expense was \$471,912 and \$471,912 for the years ended December 31, 2017 and 2016, respectively.

Future amortization expense as of December 31, 2017 is as follows:

	2018	2019	2020	2021	2022	Thereafter	Total
Future amortization expense	\$ 471,896	\$ 374,440	\$ 374,440	\$ 374,440	\$ 374,440	\$ 7,410,876	\$ 9,380,532

NCU HOLDINGS, LLC AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2017 and 2016

NOTE 7 – ACCRUED EXPENSES

Accrued expenses consisted of the following at December 31, 2017 and 2016:

	<u>2017</u>	<u>2016</u>
Advertising and marketing	\$ 942,468	\$ 1,497,681
Bonus	1,527,884	1,380,005
Book promotion	7,408	300,239
Faculty fees	368,163	278,312
Other	546,016	435,413
Outside consulting	724,189	359,732
Payroll, payroll tax and benefits	1,694,934	1,658,937
Textbooks and related materials	358,354	319,246
Total accrued expenses	<u>\$ 6,169,416</u>	<u>\$ 6,229,565</u>

NOTE 8 – ADVERTISING EXPENSES

Total advertising expenses incurred during the years ended December 31, 2017 and 2016 amounted to \$24,167,518 and \$22,923,842, respectively.

NOTE 9 – INCOME TAXES

On December 22, 2017, the Tax Cuts and Jobs Act (the “Act”) was signed into law making significant changes to the Internal Revenue Code. For businesses, the Act reduces the corporate federal tax rate from a maximum of 35% to a flat 21% rate for tax years beginning after December 31, 2017. The Company has concluded that the Act will cause the Company’s deferred tax assets and liabilities to be revalued. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. As changes in tax laws or rates are enacted, deferred tax assets and liabilities are adjusted through income tax expense. The Company’s deferred tax assets and liabilities were revalued as of December 22, 2017. The Company recorded a \$334,463 income tax benefit related to the revaluation of its net deferred tax assets and liabilities. Excluding this income tax benefit in 2017, the Company’s effective tax rate would have been 40%.

On December 22, 2017, Staff Accounting Bulletin No. 118 (“SAB 118”) was issued to address the application of U.S. GAAP in situations when a Company does not have the necessary information available, prepared, or analyzed (including computations) in reasonable detail to complete the accounting for certain income tax effects of the Act. In accordance with SAB 118, the Company does not have the necessary information to determine the impact of the Act on state and local income taxes. Any subsequent adjustments will be recorded to current income tax expense in 2018 when the analysis is complete.

The provision for income taxes consisted of the following at December 31, 2017 and 2016:

	<u>2017</u>	<u>2016</u>
Current - federal*	\$ 6,412,171	\$ 5,704,817
Current - state	1,310,977	1,158,273
Deferred - federal revaluation benefit	(334,463)	-
Deferred - federal	(128,129)	(368,814)
Deferred - state	(15,691)	(29,794)
	<u>\$ 7,244,865</u>	<u>\$ 6,464,482</u>

* Includes \$13,588 and \$13,191 in interest and penalties for the years ended December 31, 2017 and 2016, respectively and \$4,373 in foreign tax for the year ended December 31, 2017.

NCU HOLDINGS, LLC AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2017 and 2016

NOTE 9 – INCOME TAXES (Continued)

As of December 31, 2017 and 2016, the Company paid federal and state estimated income tax payments of \$7,882,637 and \$6,888,115, respectively. As of December 31, 2017, there was a federal and foreign refund of \$410,151 and net state refund of \$162,642 recorded as prepaid income taxes.

Deferred income taxes on the consolidated balance sheets at December 31, 2017 and 2016 include deferred tax assets (with a valuation allowance of \$74,784 and \$0 for the years ended December 31, 2017 and 2016, respectively) and deferred tax liabilities as follows:

Deferred tax assets:	2017	2016
Accrued bonus and severance	\$ -	\$ 13,892
Accrued vacation	41,019	44,955
Accumulated deferred rent	56,144	93,953
Allowance for doubtful accounts	2,458,683	3,376,299
Book vouchers	-	36,717
Deferred Lease Incentive	205,594	-
Derivative instruments	-	133
Kickstarter	30,016	-
Legal expenses	74,784	-
Valuation allowance for above	(74,784)	-
Learner management fee	68,745	-
Unit-based compensation expense	90,835	125,364
VDA federal benefit	9,005	-
Total deferred tax asset	2,960,041	3,691,313
Deferred tax liabilities:		
Amortization	(2,458,760)	(3,757,699)
Deferred lease incentive	(297,284)	(369,227)
Deferred leasehold improvement	(216,003)	-
Depreciation	(709,984)	(764,660)
Total deferred tax liability	(3,682,031)	(4,891,586)
Deferred income taxes, net	<u>\$ (721,990)</u>	<u>\$ (1,200,273)</u>

The provision for income taxes differs from the tax computed using the statutory U.S. federal income tax rate as a result of the following items for the respective periods:

	2017	2016
Statutory U.S. federal income tax rate	34.0%	34.0%
State income taxes, net of federal benefit	4.4%	4.4%
Deferred tax revaluation (federal rate change)	-1.8%	0.0%
Other, net	1.6%	1.1%
Effective income tax rate	<u>38.2%</u>	<u>39.5%</u>

NCU HOLDINGS, LLC AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2017 and 2016

NOTE 10 – LONG-TERM DEBT

Long-term debt consisted of the following at December 31, 2017 and 2016:

	2017	2016
Term loan	\$ 20,078,046	\$ 34,559,296
Less: current portion of debt	(6,393,750)	(7,581,250)
Long-term debt	\$ 13,684,296	\$ 26,978,046

The Company obtained a term loan for \$46,500,000 dated June 18, 2014. The term loan requires principal payments of \$871,875 quarterly for the first two quarters of 2016, \$1,162,500 quarterly from September 30, 2016 to September 30, 2017 and \$1,453,125 quarterly from September 30, 2018 to March 31, 2019, with a balloon payment of \$11,940,546 due in June 2019. The term loan requires excess cash flow payments to be made if the leverage ratio is greater than 1.75. In September 2017, the Company executed the Third Amendment to the loan which allowed for quarterly payments of the accrued PIK interest if certain covenants are met. In March 2017, the Company executed the Second Amendment to the loan which revised the Total Leverage Ratio, required payment of \$1,900,000 and allowed for the accumulated preferred yield payment to be made. For 2017, no excess cash flow payment is required due to a leverage ratio less than 1.75. In February 2016, the Company executed the First Amendment to the loan which relieved the 2015 excess cash flow payment and revised the Total Leverage Ratio. Interest is charged at variable rates using a base rate plus an applicable margin. The effective rate at December 31, 2017 and 2016 was 4.32% (30 day LIBOR plus 2.75%) and 3.52% (30 day LIBOR plus 2.75%), respectively. The credit agreement underlying the term loan contains covenants that require the maintenance of certain defined financial ratios and limits capital expenditures. The Company was in compliance with all of these covenants at December 31, 2017 and 2016. The term loan is secured by substantially all the assets of the Company. Revolving credit and swingline loan commitments, which follow the same terms as the term loan, of \$20,000,000 are also available at December 31, 2017. The Company has an outstanding existing required Department of Education letter of credit of \$12,091,783, as described in Note 12. The Company has an outstanding letter of credit required for the Scottsdale lease of \$600,000.

Maturities of principal on the term loan as of December 31, 2017 are as follows:

	2018	2019	Total
Loan payments	\$ 6,393,750	\$ 13,684,296	\$ 20,078,046

NOTE 11 - DEFERRED FINANCING FEES

In accordance with ASU 2015-03, the Company has reclassified the deferred financing fees from an asset to a contra-liability. Deferred financing fees consisted of the following at December 31, 2017 and 2016:

	2017	2016
Deferred financing fees	\$ 479,999	\$ 479,999
Accumulated amortization	(374,854)	(269,383)
Deferred financing fees, net	\$ 105,145	\$ 210,616

Interest expense related to deferred financing fees during the years ended December 31, 2017 and 2016 amounted to \$105,471 and \$230,955, respectively.

The Company incurred \$118,330 of deferred financing fees as a result of the First Amendment to the loan agreement in 2016.

NCU HOLDINGS, LLC AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2017 and 2016

NOTE 12 – LETTERS OF CREDIT, SURETY BONDS, GUARANTEES, LEASES AND LITIGATION

Letters of Credit

The Company amended its letter of credit arrangement with Citizens Bank effective November 10, 2017 to a total of \$12,091,783, an increase from \$10,526,857 in 2016. This letter of credit will expire November 30, 2018 and is for the Department of Education in connection with the Title IV Programs. The applicable rate charged was 3.0% per annum. The letter of credit fees are paid quarterly, and no amounts were due at December 31, 2017 or 2016. Letter of credit fees expensed in the years ended December 31, 2017 and 2016 were \$338,260 and \$404,320, respectively, and are included in interest expense. No amount has been drawn on the letter of credit. The Company can incur up to \$15,000,000 in letters of credit and revolving loans. This letter of credit and revolving loan limit is a subset of the \$20,000,000 revolving credit and swingline loan commitment described in Note 10.

The Company has an outstanding letter of credit arrangement with Citizens Bank effective August 14, 2017 required for the Scottsdale lease of \$600,000. The letter of credit will decrease by \$150,000 annually for three years on the 30th, 42nd and 54th month anniversaries. The remaining amount of \$150,000 will expire on July 31, 2024. The applicable rate charged was 3.0% per annum. The letter of credit fees are paid quarterly, and no amounts were due at December 31, 2017 or 2016. Letter of credit fees expensed in the year ended December 31, 2017 were \$7,450 and are included in interest expense.

Surety Bonds

Insurers issue surety bonds for the Company that are required by various states where it operates. The Company is obligated to reimburse insurers for any surety bonds that are paid. As of December 31, 2017 and 2016, the face amounts of these surety bonds were \$1,388,153 and \$1,375,653, respectively.

Guarantees

Northcentral University has agreed to indemnify its officers and directors for certain events or occurrences. The maximum potential amount of future payments that the Company could be required to make under these indemnification agreements is unlimited; however, the Company has director and officer liability insurance policies that mitigate exposure and enable recovery of future amounts paid.

Leases

The Company currently has non-cancellable leases for its headquarters in San Diego, California and an administrative office in Scottsdale, Arizona. The Company entered into a lease for its San Diego, California location effective June 2014 through October 2019 with no renewal option. The Company entered into a lease for its Scottsdale location effective November 2012 through August 2018. In August 2017, the Company extended the Scottsdale lease and added additional space. This extended the lease through July 2024, with an option to extend for 60 months. Depending upon the leasing arrangement, Northcentral University could pay the property taxes, insurance, maintenance and expenses related to the leased properties. Rental expense recognized for the years ended December 31, 2017 and 2016 was \$1,947,479 and \$2,759,039, respectively.

Minimum future obligations on operating leases for rent in effect at December 31, 2017 are:

	2018	2019	2020	2021	2022	Thereafter	Total
Minimum future obligations	<u>\$ 1,291,993</u>	<u>\$ 2,426,512</u>	<u>\$ 2,370,868</u>	<u>\$ 2,434,604</u>	<u>\$ 2,498,340</u>	<u>\$ 4,084,864</u>	<u>\$ 15,107,181</u>

The Company expanded its Scottsdale location and occupied the new space in November 2012. As part of the expansion, a tenant improvement allowance was extended to the Company amounting to \$1,355,325. In August 2017, the Scottsdale lease was extended to July 2024 and the unamortized allowance of \$158,063 is amortized over the remaining life of the lease. The renewal terms under the amended lease agreement include a non-cash tenant improvement allowance of \$824,085 for existing space renovations that are expected to be completed in 2018. These amounts are recorded as a liability on the consolidated balance sheets and are being amortized as a reduction to rent on a straight-line basis over the life of the lease. Subsequent to year end as described in Note 19, the August 2017 lease extension included an increase in leased space which was occupied in February 2018. An additional non-cash tenant improvement allowance of \$1,271,430 for the additional space was granted in January 2018 and will be amortized as a reduction to rent on a straight-line basis over the remaining life of the lease.

NOTE 12 – LETTERS OF CREDIT, SURETY BONDS, GUARANTEES, LEASES AND LITIGATION (Continued)

Litigation and Other Matters

The Company is party to various legal actions arising in the ordinary course of business, none of which management deems significant.

NOTE 13 – RELATED PARTY TRANSACTIONS

During the years ended December 31, 2017 and 2016, the Company had the following related party activity with its owners and directors:

	<u>2017</u>	<u>2016</u>
Management fees	\$ 771,791	\$ 688,850
Board fees and expense reimbursements	291,754	202,950
Accumulated yield on preferred units	-	3,468,011
Accumulated preferred yield payments	5,139,851	-

As of December 31, 2017 and 2016, the amount due to related parties was \$223,027 and \$72,968, respectively.

NOTE 14 – MEMBERS' EQUITY

Preferred Units: The Company has authorized and issued 74,608 preferred units in the amount of \$13,000,000 at a unit value of \$174.24. There are no additional preferred units authorized and available for issuance. The units yield a preferred return of 12%, which increases to 15% in April 2018. The units contain preferred redemption features, as defined, based upon various future events of the Company. These units can be converted to common units based on the preferred unit conversion rate as defined by the operating agreement. Final payment of the obligation is due upon redemption, which is optional, by the holder of the preferred units, or April 30, 2018, whichever is later. The cumulative preferred obligation at December 31, 2017 amounted to \$0 and at December 31, 2016 amounted to \$3,468,011.

Common Units: The Company has issued 237,209 common units in the amount of \$16,623,306. The units consist of capital contributed of \$16,000,000 at a par value of \$100 per unit and carryover basis of the stockholder in the predecessor company of \$515,406 and \$107,900 of exercised options. Total authorized common units are 356,466, of which 160,885 are outstanding and 76,324 are held as treasury stock. In 2016, the Company added 34 units to treasury stock at a price of \$300 per unit. Of the total issued amount, 39,211 are reserved for issuance pursuant to the terms of the unit option plan, of which 1,079 common units have been issued, 74,608 are reserved for conversion of the preferred units, and 6,517 are reserved for exercise of warrants.

Warrants: Pursuant to the agreement with Falcon Strategic Partners III, LP, the Company has authorized and issued warrants to purchase 6,517 shares of its common stock. The initial value of the warrants was \$651,635, based upon an estimate of the Company's fair value at the time the warrants were issued.

Unit Options: The Company has a Unit Option Plan for executives and key employees. The number of units with respect to which options may be granted under the Plan is 39,211. At December 31, 2017 and 2016, 21,908 and 22,208 units, respectively, have been granted and were outstanding. See Note 15.

Voting Rights: Each of the units carry voting rights based on common unit equivalents in accordance with redemption features as defined in the members' operating agreement.

NOTE 15 – UNIT OPTIONS

The Unit Option Plan (the "Plan") was adopted by the Board of Managers of the Company on December 31, 2008 for executives and other key members of the Company. The availability and offering of unit options under the Plan increases the Company's ability to attract and retain individuals of exceptional managerial talent upon whom, in large measure, the sustained progress, growth and profitability of the Company depends. The number of units with respect to which options may be granted under the Plan and which may be issued upon the exercise thereof shall not exceed, in the aggregate, 39,211 units at December 31, 2017 and 2016 or such other amount as may be approved by the Board of Managers from time to time. In general, the options granted under the Plan have either a four year service vesting schedule or a performance vesting trigger. The options have a maximum contractual term of ten years.

At December 31, 2017, 47,986 units had been cumulatively granted, offset by 17,000 cancelled options and 9,078 exercised options, resulting in 21,908 outstanding with 16,418 available for future awards. It is management's current intention to issue new units upon the exercise of unit options, as opposed to reissuing treasury shares.

The options are considered equity awards under ASC 718, *Compensation – Stock Compensation*.

The fair value of each time (service) based option grant was estimated on the date of grant using the Black-Scholes option pricing model. There were no new time based option grants during 2017, 2016, 2015, 2014 or 2012; the following assumptions were used for the following time based grants:

	2013	2011	2010	2009	2008
Expected dividend yield	0%	0%	0%	0%	0%
Expected volatility	58.0%	55.0%	60.0%	61.5%	61.0%
Risk-free interest rate	0.78%	0.27%	1.30%	1.90%	1.50%
Expected term	3.0 years	2.1 years	3.5 years	4.7 years	5.0 years
Contractual term	10 years	10 years	10 years	10 years	10 years

Expected volatility for private companies may be estimated based on the average volatilities of otherwise similar public entities that have sufficient historical data to allow comparable and useful information to determine volatility and then applied to the option at grant date.

Since the Company has limited empirical evidence of weighted-average historical data related to expected term, the expected term (estimated period of time outstanding) of the unit options granted was estimated based on the SEC's Statement of Accounting Bulletin No. 107 ("SAB 107," updated by "SAB 110") which provides guidance for a simplified method of determining expected term until more empirical data becomes available. This method calculates the average of the weighted vesting period and the contractual term of the options.

The risk-free interest rate assumption was based on the interest rate of U.S. Treasuries on the dates the options were granted.

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NOTE 15 – UNIT OPTIONS (Continued)

Unit option activity is as follows:

	Options Outstanding	Weighted Average Exercise Price	Cumulative Unit Based Compensation Expense	Aggregate Intrinsic Value
Balance, December 31, 2015	22,915	\$ 392.43	\$ 708,566	
Granted	900	\$ 511.00		
Exercised	(750)	\$ 300.00		
Forfeited	(857)	\$ 100.00		
Balance, December 31, 2016	22,208	\$ 411.64	\$ 686,942	
Forfeited	(300)	\$ 511.00		
Balance, December 31, 2017	21,908	\$ 410.28	\$ 704,796	\$346,251
Vested as of December 31, 2017	7,829	\$ 318.87		\$346,251

A summary of the nonvested option activity is as follows:

	Nonvested Options	Weighted Average Exercise Price
Balance, December 31, 2015	13,805	\$ 460.13
Granted	900	\$ 511.00
Vested	(174)	\$ 511.00
Balance, December 31, 2016	14,531	\$ 462.67
Forfeited	(300)	\$ 511.00
Vested	(152)	\$ 511.00
Balance, December 31, 2017	14,079	\$ 461.12

The total unit-based compensation expense (benefit) from unit options recognized in the consolidated financial statements was \$17,854 and \$(21,624) for the years ended December 31, 2017 and 2016, respectively, which (increased)/reduced net operating income accordingly and was included in payroll, instruction, unit-based compensation and related costs in the consolidated statements of income. As of December 31, 2017 and 2016, the total unrecognized costs related to non-vested unit options granted was \$0 and \$17,854, respectively.

Certain of the unit-based option grants include both service-based and performance-based criteria. The Company records compensation expense, net of forfeitures, for all service-based awards over the requisite service period using the straight-line method. Performance-based options are not recorded as expense until the occurrence of the criteria attached to those options is attained.

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December 31, 2017 and 2016

NOTE 15 – UNIT OPTIONS (Continued)

The following summarizes information related to outstanding and vested options at December 31, 2017:

		Outstanding		Vested	
		Weighted Average Contractual Life	Weighted Average Exercise per Share		Weighted Average Exercise per Share
Exercise Prices	Number of Shares	Remaining (Years)		Number of Shares	
\$ 300.00	12,476	3.87	\$ 300.00	7,129	\$ 300.00
\$ 511.00	7,650	7.03	\$ 511.00	700	\$ 511.00
\$ 750.00	1,782	3.87	\$ 750.00	-	\$ 750.00
	<u>21,908</u>	<u>4.97</u>	<u>\$ 410.28</u>	<u>7,829</u>	<u>\$ 318.87</u>

In 2016, there was a cashless exercise of options by an employee who had left the Company. The exercise was accounted for under the equity method. The exercise resulted in a reduction of additional paid-in capital of \$70,604. The exercise generated a tax windfall of \$124,368 due to greater compensation deduction for tax purposes. The cumulative compensation expense of fair value for the vested exercised options was \$33,882. The actual tax benefit realized for the tax deductions from option exercise of the share-based payment arrangements totaled \$52,096. The Company paid \$59,036 for the exercise for employee and employer tax withholdings.

NOTE 16 – 401(k) PLAN

The Company has a 401(k) plan which covers all eligible employees who are at least 21 years old and have completed three months of service. Eligible employees may elect to defer a portion of their salaries and contribute to the plan, subject to federal limitations. Northcentral University is a member of a controlled group for this plan.

Employees are 100% vested in their deferred contributions.

The Company changed its retirement plan effective February 2014 to include a non-discretionary match to employee contributions. In addition to changing 401(k) administrators, the Company provides a match of 2% when an employee contributes 5% or more of their pre-tax pay.

Below is the breakdown of employee contribution and company match effective February 2014:

When an employee contributes	NCU will match an additional	Cumulative Company Match
the first 1% of their pay	.25% to their 401(k) account	0.25%
the second 1% of their pay	.25% to their 401(k) account	0.50%
the third 1% of their pay	.50% to their 401(k) account	1.00%
the fourth 1% of their pay	.50% to their 401(k) account	1.50%
the fifth 1% of their pay	.50% to their 401(k) account	2.00%

NCU HOLDINGS, LLC AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2017 and 2016

NOTE 16 – 401(k) PLAN (Continued)

In addition, new employees hired after February 1, 2014 will vest in the Company's matching contribution and non-elective contributions as follows:

<u>Years of Service</u>	<u>Vested %</u>
Less than 1 year	0%
At least 1 year, but less than 2	33%
At least 2 years, but less than 3	66%
3 years or more	100%

Employees hired before February 1, 2014 will be grandfathered in for years of service incurred prior to February 1, 2014. Therefore, if an existing employee has three years of service prior to February 1, 2014, they are 100% vested in Company matches in 2014.

During the years ending December 31, 2017 and 2016, the Company made matching contributions of \$328,625 and \$345,864, respectively.

NOTE 17 – DERIVATIVE INSTRUMENTS

To manage exposure to changing interest rates, the Company selectively enters into interest rate swap agreements. Effective during 2017 and 2016, the interest rate swaps qualify for and are designated as highly effective cash flow hedges. The effective portion of changes in the fair value of derivatives designated and qualifying as cash flow hedges is recorded in accumulated other comprehensive income (loss) on the consolidated balance sheets and is subsequently reclassified into earnings in the period that the hedged forecasted transaction affects earnings.

The Company's term loan principal amount is greater than the notional amount under the swap. The following table details the terms of the Company's interest rate swaps:

<u>Counterparty</u>	<u>Floating rate</u>	<u>Fixed rate</u>	<u>Start date</u>	<u>End date</u>	<u>12/31/2017</u> <u>notional</u>	<u>12/31/2016</u> <u>notional</u>
Citizens	1M LIBOR	1.2%	4/4/2012	1/31/2017	\$ -	\$ 984,375
Fifth Third	1M LIBOR	1.0%	4/30/2014	10/31/2016	\$ -	\$ -
Total notional					\$ -	\$ 984,375

Assets and liabilities, measured at fair value, on a recurring basis are summarized below:

	<u>Fair Value</u> <u>Measurement</u> <u>(Level Two)</u> <u>2017</u>	<u>Fair Value</u> <u>Measurement</u> <u>(Level Two)</u> <u>2016</u>
Current liability	\$ -	\$ (350)
Noncurrent liability	-	-
Total derivative liability, net	\$ -	\$ (350)

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NOTE 17 – DERIVATIVE INSTRUMENTS (Continued)

The following table presents the effect of the Company's interest rate swaps on the consolidated statements of income for the years ended December 31, 2017 and 2016:

	Amount of Gain Recognized in Other Comprehensive Income on Derivative (Effective Portion)	Amount of Tax on Gain Recognized in Other Comprehensive Income on Derivative (Effective Portion)	Location of Loss Reclassified from Accumulated Other Comprehensive Income (Loss) into Income Statement (Effective Portion)	Amount of Loss Reclassified from Accumulated Other Comprehensive Income (Loss) into Income Statement (Effective Portion)
2017	\$ 350	\$ (2,740)	Interest expense	\$ 350
2016	\$ 58,795	\$ (22,424)	Interest expense	\$ 59,014

NOTE 18 – REGULATORY MATTERS

COMPLIANCE WITH 90/10 RULE

The Company derives a substantial portion of its revenues from Student Financial Aid (SFA) received by its students under the Title IV programs administered by the Department of Education pursuant to the Higher Education Act, as reauthorized (HEA). To continue to participate in the SFA programs, the Company must comply with the regulations promulgated under the HEA. The regulations restrict the proportion of cash receipts for tuitions and fees from eligible programs to not more than 90 percent from the Title IV programs. The failure of the Company to meet the 90 percent limitation over two years would result in the loss of the ability to participate in SFA programs. For the year ended December 31, 2017, the Company received \$95,033,589 of Title IV funds and total eligible cash receipts of \$114,896,013, resulting in a percentage of 82.7%. In accordance with the Code of Federal Regulations, 34 CFR 668.28, the calculation of the Company's revenue percentage must be performed using the cash basis of accounting.

Revenue Sources at December 31:	2017	2016
Subsidized loans	\$ 192,344	\$ 318,636
Unsubsidized loans	106,565,652	104,851,827
Grad Plus loans	22,920,795	17,130,337
Federal Pell grants	164,681	237,199
Revenue adjustment	(34,809,883)	(33,942,105)
Total student Title IV revenue	95,033,589	88,595,894
Student non-Title IV revenue	19,862,424	22,003,953
Total revenue	\$ 114,896,013	\$ 110,599,847
90/10 percentage	82.71%	80.10%

WASC SENIOR COLLEGE AND UNIVERSITY COMMISSION ("WSCUC")

In July 2015, Northcentral University received initial accreditation from WSCUC for a five year period.

NCU HOLDINGS, LLC AND SUBSIDIARY
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NOTE 18 – REGULATORY MATTERS (Continued)

PROGRAMMATIC ACCREDITATION

Programmatic accreditation is described below:

Institution/Program	Accrediting Body	Status
Masters of Marriage and Family Therapy	Commission on Accreditation for Marriage and Family Therapy Education ("COAMFTE")	Initial five year accreditation received in December 2012
PhD of Marriage and Family Therapy	Commission on Accreditation for Marriage and Family Therapy Education ("COAMFTE")	Initial five year accreditation received in April 2015
Business degrees	Association of Collegiate Business Schools and Programs ("ACBSP")	Initial ten year accreditation received in May 2007; Ten year reaccreditation received in 2017
MED program with specializations in Athletic Coaching, Curriculum and Teaching, Early Childhood Education, Educational Leadership, English as a Second Language, Instructional Leadership, PK-12 Principal Leadership, Special Education, and Sports Management	Council for the Accreditation of Educator Preparation (CAEP) (Formerly Teacher Education Accreditation Council ("TEAC"))	Initial five year accreditation received in July 2013; extended through 2020

JURISDICTIONAL AUTHORIZATIONS

Northcentral University is specifically authorized to operate in all of the domestic jurisdictions in which it operates. Some states assert authority to regulate all degree-granting institutions if their educational programs are available to their residents, whether or not the institution maintains a physical presence within those states. Northcentral University has obtained licensure in states which require such licensure. As part of the headquarter transition to California, Northcentral University was licensed by the California Bureau for Private Postsecondary Education ("CBPPE") since March 2015.

STUDENT LOAN COHORT DEFAULT RATES

To remain eligible to participate in Title IV programs, an educational institution's student loan cohort default rates must remain below certain specified levels. Educational institutions will lose eligibility to participate in Title IV programs if the three-year cohort default rate equals or exceeds 40% for any given year or 30% for three consecutive years. The Company's three-year cohort default rates for the 2014 and 2013 federal fiscal years were 5.6% and 4.5%, respectively. The Company utilizes an outside agency to assist in monitoring and improving cohort default rates.

REFUND INFORMATION

The Company had no obligations payable to the Department of Education as a result of any audits or program reviews. All refund liabilities are paid within 45 days of their due date.

STANDARDS OF FINANCIAL RESPONSIBILITY

Pursuant to Title IV program regulations, each eligible higher education institution must satisfy a measure of financial responsibility that is based on a weighted average of the following three annual ratios which assesses the financial condition of the institution:

- Primary Reserve Ratio – measure of an institution's financial viability and liquidity;
- Equity Ratio – measure of an institution's capital resources and its ability to borrow; and
- Net Income Ratio – measure of an institution's profitability

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NOTE 18 – REGULATORY MATTERS Standards of Financial Responsibility (Continued)

These ratios provide three individual scores which are converted into a single composite score. The maximum composite score is 3.0. If the institution achieves a composite score of at least 1.5, it is considered financially responsible. A composite score from 1.0 to 1.4 is also considered financially responsible, and the institution may continue to participate as a financially responsible institution for up to three years, subject to additional monitoring and other consequences. If an institution does not achieve a composite score of at least 1.0, it can retain full eligibility for Title IV funds by posting a letter of credit equal to 50% of Title IV funds received during its most recently completed fiscal year. Alternatively, the institution may post a letter of credit equal to 10% of the Title IV funds received in its most recently completed fiscal year and be placed on provisional certification, which includes certain restrictions, including heightened cash monitoring.

NCU Holdings, LLC's consolidated composite score was as follows:

Composite score as of December 31:	2017	2016
Primary reserve ratio:	(1.00)	(1.00)
Equity ratio:	(1.00)	(1.00)
Net income ratio:	3.00	3.00
Composite Score	0.20	0.20

The low composite score is a result of goodwill from the 2008 purchase of the Company. The institution operates with the Department of Education under a provisional certification alternative which requires the institution to post a 10% letter of credit and follow the Heightened Cash Monitoring 1 payment method.

The institution, Northcentral University, on a standalone basis, composite score was as follows:

Composite score as of December 31:	2017	2016
Primary reserve ratio:	(0.40)	1.71
Equity ratio:	1.56	2.62
Net income ratio:	3.00	3.00
Composite Score	1.40	2.46

NOTE 19 – SUBSEQUENT EVENT DISCUSSION

Subsequent to December 31, 2017, the Company noted the following events had occurred:

- In January 2018, there was an option forfeiture of 300 performance based options.
- As discussed under Note 12, in January 2018 effective with the August 2017 Scottsdale lease extension, possession of additional leased space occurred with occupancy of the expansion space effective February 2018. A non-cash tenant improvement allowance of \$1,271,430 was recorded in January 2018 and will be amortized as a reduction to rent on a straight-line basis over the remaining life of the lease.
- In August 2017, the Company received a request from the Internal Revenue Service (IRS) to review certain items related to its 2015 tax return. The Company provided the requested information on time. The Company received the final closing letter in April 2018 indicating the audit is complete without any findings.

NOTE 20 – NON-GAAP DISCLOSURES – UNAUDITED

STUDENTS

Total enrollment at December 31, 2017 and 2016:

	2017	2016
Students	<u>9,548</u>	<u>10,056</u>

EMPLOYEES

As of December 31, 2017 and 2016, Northcentral University had approximately 469 and 436 non-faculty employees, respectively, the substantial majority of which were employed full-time. The Company also had approximately 108 and 112 full time faculty members as of December 31, 2017 and 2016, as well as 380 and 382 adjunct faculty members, respectively. Adjunct faculty principally consist of Northcentral University faculty who have taught Northcentral University courses in the last twelve months and are eligible to teach future courses. Northcentral University believes that its employee relations are satisfactory.