

NARCONON FRESH START

DECEMBER 31, 2015



August 18, 2017

INDEPENDENT AUDITORS' REPORT

Board of Directors
Narconon Fresh Start
Los Angeles, California

Report on the Financial Statements

We have audited the accompanying financial statements of Narconon Fresh Start (a nonprofit organization) (NNFS), which comprise the statement of financial position as of December 31, 2015, and the related statements of activities, functional expenses, 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. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of 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 qualified audit opinion.

INDEPENDENT AUDITORS' REPORT

Basis for Qualified Opinion

Because of inadequacies in NNFS's accounting records, we were unable to form an opinion regarding a portion of program service revenue in the amount of \$2,229,820, third-party payer adjustment in the amount of \$353,817, and bad debt expense in the amount of \$488,016, in the accompanying statement of activities.

We were unable to confirm third-party payer amounts received in excess of established program costs, totaling \$401,733, and included in Third-party payer collections due to students in the statement of financial position at December 31, 2015, and were unable to obtain sufficient appropriate audit evidence about the completeness of this account by other auditing procedures.

Qualified Opinion

In our opinion, except for the possible effects of the matters described in the Basis for Qualified Opinion paragraph, the financial statements referred to above present fairly, in all material respects, the financial position of NNFS as of December 31, 2015, and the statements of activities, functional expenses and cash flows for the year then ended in accordance with accounting principles generally accepted in the United States of America.

Emphasis of Matter Regarding Going Concern

The accompanying financial statements have been prepared assuming that NNFS will continue as a going concern. As discussed in Note 12 to the financial statements as of December 31, 2015, NNFS is in default of its mortgage payable. As of the date of this report, the mortgage had been assigned to another lender, and NNFS had obtained a forbearance agreement to extend the due date of the mortgage through December 31, 2018. NNFS has developed an action plan in 2016 and 2017 as described in Note 12 to the financial statements.

In addition, NNFS was unable to meet multiple obligations including but not limited to payroll tax liabilities and lease obligations as described in Notes 7 and 8. These conditions raise substantial doubt about NNFS's ability to continue as a going concern. NNFS's ability to achieve the elements of its business plan, which may be necessary to permit the realization of assets and satisfaction of liabilities in the ordinary course of business, is uncertain.

The financial statements do not include any adjustments that might result from the outcome of these uncertainties. Our opinion is not modified with respect to these matters.

INDEPENDENT AUDITORS' REPORT

Report on Summarized Comparative Information

We have previously audited NNFS 2014 financial statements, and our report dated September 25, 2015 expressed an unmodified opinion on these audited financial statements. In our opinion, the summarized comparative information presented herein as of and for the year ended December 31, 2014, is consistent, in all material respects, with the audited financial statements from which it has been derived.

NSBN LLP

NSBN LLP

Los Angeles, California

NARCONON FRESH START
STATEMENT OF FINANCIAL POSITION
DECEMBER 31, 2015
WITH COMPARATIVE TOTALS AT DECEMBER 31, 2014

ASSETS	<u>2015</u>	<u>2014</u>
Cash and cash equivalents	\$ 11,974	\$ 85,698
Accounts receivable	198,210	247,612
Accounts receivable related party (net of allowance for doubtful accounts of \$116,138)	-	-
Deposits and other assets	218,462	263,688
Contributions receivable from another nonprofit organization	331,484	-
Inventory	5,625	-
Property and equipment, net	<u>7,216,965</u>	<u>7,250,199</u>
 TOTAL ASSETS	 <u>\$ 7,982,720</u>	 <u>\$ 7,847,197</u>
 LIABILITIES		
Accounts payable	\$ 887,922	\$ 728,681
Due to another nonprofit organization	693,472	-
Third-party payer collections due to students	401,733	4,259
Accrued payroll and other accrued expenses	333,842	257,855
Payroll tax related liabilities	823,780	136,691
Deferred rent	-	224,789
Deferred revenue	-	62,000
Licensing fees payable	215,431	155,408
Refunds and settlements payable	1,008,976	751,441
Capital lease obligations	10,435	23,787
Loans payable	214,280	62,764
Mortgages payable, net	<u>4,231,286</u>	<u>4,437,291</u>
 TOTAL LIABILITIES	 8,821,157	 6,844,966
 NET (DEFICIT) ASSETS - unrestricted	 <u>(838,437)</u>	 <u>1,002,231</u>
 TOTAL LIABILITIES AND NET ASSETS	 <u>\$ 7,982,720</u>	 <u>\$ 7,847,197</u>

See accompanying independent auditors' report.
The notes are an integral part of these financial statements.

NARCONON FRESH START
STATEMENT OF ACTIVITIES
YEAR ENDED DECEMBER 31, 2015
WITH COMPARATIVE TOTALS FOR THE YEAR ENDED DECEMBER 31, 2014

REVENUE AND SUPPORT	<u>2015</u>	<u>2014</u>
Program service revenue	\$ 11,474,566	\$ 12,108,320
Less: third-party payer adjustment	(353,817)	(53,989)
Net program service revenue	<u>11,120,749</u>	<u>12,054,331</u>
Contributions from another nonprofit organization	2,000,303	866,739
Donations	369,920	135,601
Narconon program material sales	154,701	177,928
Other revenue	<u>4</u>	<u>33,760</u>
TOTAL REVENUE AND SUPPORT	<u>13,645,677</u>	<u>13,268,359</u>
EXPENSES		
Program services		
Drug rehabilitation services	11,745,582	10,645,473
Drug education and prevention	431,502	483,055
Public awareness and information campaigns	959,738	921,771
Supporting services		
Management and General	2,334,045	1,745,959
Fundraising	<u>15,478</u>	<u>13,055</u>
TOTAL EXPENSES	<u>15,486,345</u>	<u>13,809,313</u>
CHANGE IN NET ASSETS	(1,840,668)	(540,954)
NET ASSETS, unrestricted - January 1	<u>1,002,231</u>	<u>1,543,185</u>
NET (DEFICIT) ASSETS, unrestricted - December 31	<u>\$ (838,437)</u>	<u>\$ 1,002,231</u>

See accompanying independent auditors' report.
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NARCONON FRESH START
STATEMENT OF CASH FLOWS
YEAR ENDED DECEMBER 31, 2015
WITH COMPARATIVE TOTALS FOR THE YEAR ENDED DECEMBER 31, 2014

	<u>2015</u>	<u>2014</u>
CASH FLOWS FROM OPERATING ACTIVITIES		
Change in net assets	\$ (1,840,668)	\$ (540,954)
Adjustments to reconcile change in net assets to net cash provided by (used in) operating activities:		
Depreciation	225,023	255,506
Amortization of loan fees	9,343	11,800
(Gain) loss on disposition of property and equipment	23,295	(33,760)
(Increase) decrease in assets:		
Accounts receivable	49,402	(180,680)
Deposits and other assets	45,226	(51,098)
Contributions receivable from another nonprofit organization	(331,484)	-
Inventory	(5,625)	-
Increase (decrease) in liabilities:		
Accounts payable	159,241	(19,526)
Due to another nonprofit organization	693,472	-
Third-party payer collections due to students	397,474	4,259
Accrued payroll and other accrued expenses	75,986	(8,645)
Payroll tax related liabilities	687,089	136,691
Deferred rent	(224,789)	(33,559)
Deferred revenue	(62,000)	(17,000)
Licensing fees payable	60,023	155,408
Refunds and settlements payable	<u>257,536</u>	<u>248,790</u>
NET CASH PROVIDED BY (USED IN) OPERATING ACTIVITIES	<u>218,544</u>	<u>(72,768)</u>
CASH FLOWS FROM INVESTING ACTIVITIES		
Acquisition of property and equipment	(218,252)	(14,716)
Proceeds from disposition of property and equipment	<u>3,168</u>	<u>143,417</u>
NET CASH PROVIDED BY (USED IN) INVESTING ACTIVITIES	<u>(215,084)</u>	<u>128,701</u>
CASH FLOWS FROM FINANCING ACTIVITIES		
Payments on capital lease obligations	(13,352)	(14,509)
Proceeds from loans payable	510,414	62,764
Payments on loans payable	(358,898)	-
Payments on mortgages payable	<u>(215,348)</u>	<u>(266,105)</u>
NET CASH (USED IN) FINANCING ACTIVITIES	<u>(77,184)</u>	<u>(217,850)</u>
NET (DECREASE) IN CASH AND CASH EQUIVALENTS	(73,724)	(161,917)
CASH AND CASH EQUIVALENTS, January 1	<u>85,698</u>	<u>247,615</u>
CASH AND CASH EQUIVALENTS, December 31	<u>\$ 11,974</u>	<u>\$ 85,698</u>
SUPPLEMENTAL CASH FLOW DISCLOSURE		
Interest paid	<u>\$ 211,534</u>	<u>\$ 309,410</u>

See accompanying independent auditors' report.
The notes are an integral part of these financial statements.

NARCONON FRESH START
STATEMENT OF FUNCTIONAL EXPENSES
YEAR ENDED DECEMBER 31, 2015
WITH COMPARATIVE TOTALS FOR THE YEAR ENDED DECEMBER 31, 2014

	2015						2014	
	Program Services			Supporting Services			Total Expenses	Total Expenses
	Drug Rehabilitation	Drug Education	Public Awareness	Total Program Services	Management and General	Fundraising		
Salaries and employee benefits	\$ 3,780,856	\$ 264,935	\$ 588,518	\$ 4,634,309	\$ 967,339	\$ 9,427	\$ 5,611,075	\$ 5,800,281
Payroll taxes	299,424	20,834	46,432	366,690	76,615	757	444,062	457,881
	<u>4,080,280</u>	<u>285,769</u>	<u>634,950</u>	<u>5,000,999</u>	<u>1,043,954</u>	<u>10,184</u>	<u>6,055,137</u>	<u>6,258,162</u>
Cost of Narconon program materials sold	75,998	-	-	75,998	-	-	75,998	98,455
Insurance	290,666	20,224	45,073	355,963	75,455	735	432,153	337,645
Interest	178,892	12,040	26,832	217,764	44,919	437	263,120	321,210
Legal settlement	18,419	-	-	18,419	455,000	-	473,419	183,516
Maintenance	91,568	6,371	14,199	112,138	43,958	232	156,328	62,564
Narconon program license fees	924,860	459	1,023	926,342	1,712	17	928,071	1,060,379
Office and administrative	167,154	5,184	11,553	183,891	57,965	188	242,044	222,202
Postage and shipping	33,941	2,362	5,263	41,566	8,811	86	50,463	48,385
Bad debt expense	1,031,263	5,435	12,113	1,048,811	20,278	197	1,069,286	348,543
Printing and promotion	222,095	248	554	222,897	927	9	223,833	207,515
Professional fees	2,024,947	1,715	3,822	2,030,484	235,840	62	2,266,386	1,138,824
Program delivery costs	1,205,825	-	-	1,205,825	-	-	1,205,825	1,336,884
Referral fees	81,848	-	-	81,848	-	-	81,848	142,848
Rent	326,319	22,706	50,603	399,628	84,709	825	485,162	684,506
Staff training	80,213	5,581	12,439	98,233	20,822	203	119,258	19,820
Taxes, dues and fees	16,718	1,163	2,592	20,473	4,341	42	24,856	21,907
Telephone	340,183	23,670	52,752	416,605	88,307	860	505,772	459,177
Travel	117,379	8,167	18,202	143,748	10,308	296	154,352	144,492
Utilities	285,664	19,877	44,298	349,839	74,155	722	424,716	456,773
Total expenses before depreciation and amortization	11,594,232	420,971	936,268	12,951,471	2,271,461	15,095	15,238,027	13,553,807
Depreciation	151,350	10,531	23,470	185,351	39,289	383	225,023	255,506
Loss on disposition of fixed assets	-	-	-	-	23,295	-	23,295	-
Total Expenses	<u>\$ 11,745,582</u>	<u>\$ 431,502</u>	<u>\$ 959,738</u>	<u>\$ 13,136,822</u>	<u>\$ 2,334,045</u>	<u>\$ 15,478</u>	<u>\$ 15,486,345</u>	<u>\$ 13,809,313</u>

See accompanying independent auditors' report.
The notes are an integral part of these financial statements.

NARCONON FRESH START
NOTES TO FINANCIAL STATEMENTS
DECEMBER 31, 2015

Note 1 NATURE OF ACTIVITIES AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES -

Description of Reporting Entity-

Narconon Fresh Start (NNFS), previously known as Narconon Southern California, is a tax-exempt nonprofit organization dedicated to rehabilitating people from the harmful effects of drugs and eliminating drug abuse and drug addiction by providing drug awareness campaigns and information, drug education and drug rehabilitation services. NNFS is organized to operate exclusively for charitable purposes.

The Narconon drug and alcohol rehabilitation program offers a unique approach to rehabilitation through the use of methodologies researched and developed by author and humanitarian, L. Ron Hubbard. This includes safe, drug-free withdrawal, detoxification to cleanse the body of residues of drugs and other chemicals and a carefully designed program of courses that enables students to develop essential life skills. Graduates of the Narconon drug rehabilitation program are able to break out of the trap of addiction and rejoin society as stable, ethical, contributing citizens.

NNFS operates four drug rehabilitation centers delivering the Narconon program with facilities to serve more than 135 students at a time. NNFS also operates a drug rehabilitation center through a shared facility in Colorado with "A Life Worth Living" (dba Narconon Colorado). A Life Worth Living is a tax-exempt nonprofit organization, that is licensed to use the Narconon rehabilitation program. In 2016, A Life Worth Living began operating solely on its own.

NNFS also conducts public awareness and education campaigns through the different mediums of the Internet, radio, television and print media. The information provided informs listeners and readers about the mechanics of drug and alcohol addiction and the harmful effects of drug use. Narconon drug education and prevention programs take a comprehensive approach to preventing drug use through effective educational programs with school children, parents and educators.

Tax Exempt Status-

NNFS is recognized by the Internal Revenue Service as exempt from Federal income tax under Section 501(c)(3). NNFS is also recognized by the California Franchise Tax Board as exempt from California Corporation Franchise Tax and income tax under Section 23701(d). NNFS qualifies for the charitable contribution deduction under Section 170(b)(1)(A)(vi) and has been classified as an organization other than a private foundation under Section 509(a)(2).

Income Taxes-

NNFS files Form 990, Return of Organization Exempt from Income Tax, and Form 199, California Exempt Organization Annual Information Return.

NARCONON FRESH START
NOTES TO FINANCIAL STATEMENTS
DECEMBER 31, 2015

Note 1 NATURE OF ACTIVITIES AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES -
(Continued)

Income Taxes- (Continued)

NNFS has evaluated its tax positions and the certainty as to whether those tax positions will be sustained in the event of an audit by taxing authorities at the federal and state level. It has determined that all income tax positions are more likely than not (greater than 50% chance) of being sustained upon potential audit or examination; therefore, no recognition or disclosure of uncertain income tax positions are required in the financial statements.

With few exceptions, NNFS is no longer subject to U.S. federal and state examinations by tax authorities for years before 2012 and 2011, respectively.

Basis of Accounting-

The financial statements of NNFS have been prepared on the accrual basis of accounting and conform to accounting principles generally accepted in the United States of America.

Certain 2014 amounts are reclassified to conform to the 2015 presentations.

Basis of Presentation-

The financial statements of NNFS have been presented in accordance with the AICPA's Audit and Accounting Guide, "Not-For-Profit Organizations." The accounting policies followed are described below.

Net Asset Classes-

The accompanying financial statements present information regarding NNFS financial position and activities according to three classes of net assets: unrestricted, temporarily restricted and permanently restricted. The three classes are differentiated by donor restrictions:

a- Unrestricted

Net assets that are not subject to donor-imposed restrictions, or donor-restricted contributions whose restrictions are met within the same reporting period.

b- Temporarily Restricted

Net assets that are subject to donor-imposed time or use restrictions that have not been met as of year-end. Temporarily restricted net assets are restricted for time (e.g., multi-year pledges) or specific programs. There were no temporarily restricted net assets at December 31, 2015 and 2014.

c- Permanently Restricted

Net assets subject to donor-imposed restrictions that are maintained permanently. There were no permanently restricted net assets at December 31, 2015 and 2014.

NARCONON FRESH START
NOTES TO FINANCIAL STATEMENTS
DECEMBER 31, 2015

Note 1 NATURE OF ACTIVITIES AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES -
(Continued)

Functional Expense Allocation-

The costs of providing NNFS' programs and the supporting services have been summarized on a functional basis in the statement of activities, and in the statement of functional expenses. Accordingly, certain costs have been allocated between program and supporting services in reasonable ratios determined by management.

Summarized Comparative Financial Information-

The financial statements include certain prior-year summarized comparative information in total but not by net asset class. Such information does not include sufficient detail to constitute a presentation in conformity with accounting principles generally accepted in the United States of America. Accordingly, such information should be read in conjunction with the NNFS' financial statements for the year ended December 31, 2014, from which the summarized information was derived.

Use of Estimates in the Preparation of Financial Statements-

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 certain reported amounts and disclosures. Accordingly, actual results could differ from those estimates.

Cash and Cash Equivalents-

Cash and cash equivalents include all funds in banks. The carrying value approximates fair value.

Property and Equipment-

Property and equipment are carried at cost. Depreciation is computed using primarily the straight-line method, with the following estimated useful lives:

	<u>Years</u>
Buildings and building improvements	10-40
Land improvements	15
Furniture and equipment	3-7
Leasehold improvements	5
Vehicles held under capital leases	3-7
Drug dogs	7

Expenditures for maintenance, repairs and renewals of minor items are charged to expense as incurred. Major renewals and improvements are capitalized. Upon disposition, the cost and related accumulated depreciation are removed from the accounts and the resulting gain or loss is reflected in operations for the period.

NARCONON FRESH START
NOTES TO FINANCIAL STATEMENTS
DECEMBER 31, 2015

Note 1 NATURE OF ACTIVITIES AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES -
(Continued)

Accounts Receivable-

Accounts receivable represents amounts owed to NNFS by students for the Narconon drug rehabilitation program and is stated at fair value. Management believes no provision for allowance is necessary at December 31, 2015 and 2014.

Derivative Financial Instruments-

NNFS makes limited use of derivative instruments for the purpose of managing interest rate risks. An interest rate swap agreement is used to convert NNFS' floating rate mortgage payable to a fixed rate (Note 4). The differentials paid or received on the interest rate swap agreement are accrued or recognized as an adjustment to interest expense; gains and losses realized upon settlement of this agreement are deferred until the underlying hedged instrument is settled.

Revenue Recognition

NNFS recognizes net program service revenue associated with services provided to students who have third-party payer coverage on the basis of contractual rates for the services rendered. For uninsured students, NNFS recognizes revenue on the basis of its standard rates for services provided (or on the basis of discounted rates, if negotiated or provided by policy). On the basis of historical experience, a portion of NNFS' uninsured students will be unable or unwilling to pay for the services provided. Bad debt expense results from services rendered to a student who is determined by NNFS, following a reasonable collection effort, who will not meet their financial obligations for amounts due. Thus, NNFS records a significant bad debt expense related to uninsured students in the period for the services are provided. Net program service revenue is reported at the estimated net realizable amounts from students, third-party payers, and others for services rendered, including estimated retroactive adjustments under reimbursement agreements with third-party payers.

Subsequent Events-

Management has evaluated subsequent events through August 18, 2017, the date the financial statements were available to be issued.

New Accounting Standards-

In April 2015, the Financial Accounting Standards Board (FASB) issued Accounting Standards Updates (ASU) No. 2015-03, "Interest - Imputation of Interest: Simplifying the Presentation of Debt Issuance Costs" (ASU 2015-03), which resulted in the reclassification of debt issuance costs from other assets to inclusion as a reduction reportable mortgage payable balance on the statement of financial position. NNFS elected to early adopt ASU 2015-03, with full retrospective application as required by the guidance. This standard did not have a material impact on NNFS' statement of financial position and had no impact on the cash flows provided by or used in operations for any period presented.

NARCONON FRESH START
NOTES TO FINANCIAL STATEMENTS
DECEMBER 31, 2015

Note 1 NATURE OF ACTIVITIES AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES -
(Continued)

New Accounting Standards- (Continued)

During 2015, NNFS adopted the provisions of FASB ASU 2011-07 related to the presentation of bad debt expense associated with program service revenue. That guidance, which must be applied retrospectively, allows bad debt expense associated with program service revenue to be presented on the statement of activities as a subtraction from program service revenue (net of contractual allowances and discounts). NNFS reclassified bad debt expense of \$53,989 for the year ended December 31, 2014, from operating expenses to an offset against program service revenue. Net assets for the year ended December 31, 2014, were not affected by the adoption of this guidance.

Note 2 PROPERTY AND EQUIPMENT

	2015	2014
Land	\$ 4,012,712	\$ 4,012,712
Buildings and building improvements	3,895,223	3,895,223
Land improvements	191,807	191,807
Furniture and equipment	633,140	473,553
Leasehold improvements	15,484	58,508
Vehicles	514,086	577,636
Drug dogs	12,000	-
	9,274,452	9,209,439
Less: accumulated depreciation	(2,057,487)	(1,959,240)
	\$ 7,216,965	\$ 7,250,199

Land and buildings with original combined purchase prices of approximately \$7,580,000 are pledged as collateral for the mortgages payable (Note 3).

Vehicles with original combined purchase prices of approximately \$47,000 are pledged as collateral for the capital leases (Note 6).

Furniture and equipment with original combined purchase prices of approximately \$18,000 are pledged as collateral for a loan payable (Note 5).

NARCONON FRESH START
NOTES TO FINANCIAL STATEMENTS
DECEMBER 31, 2015

Note 3 MORTGAGES PAYABLE

	2015	2014
Mortgage payable, due on October 20, 2015, secured by a first deed of trust, with monthly payments of approximately \$32,000, at the rate of 5.5775% in accordance with the interest rate swap agreement (Note 4). The mortgage was in default with the lender and was assigned to another creditor subsequently.	\$ 3,527,574	\$ 3,718,735
Mortgage payable, due on or before October 21, 2027, secured by a first deed of trust. Principal and interest at 5.25%, in monthly installments of \$2,652 to be paid to maturity. Prepayment penalties apply through 2017.	279,085	295,581
Mortgage payable due on or before May 10, 2016, secured by a first deed of trust, with monthly payments of \$3,589, including interest at 8.25% per annum, and a final balloon payment of \$424,627 due at maturity. Prepayment penalties apply. Subsequent to year end, the loan was assigned to another creditor.	424,627	432,318
Less: unamortized loan fees	-	(9,343)
	\$ 4,231,286	\$ 4,437,291

Five year maturities are as follows:

2016	\$ 442,256
2017	18,577
2018	3,547,151
2019	20,629
2020	21,739
Thereafter	180,934
	\$ 4,231,286

Subsequent to year end, NNFS' mortgage payable in the amount of \$3,527,574 had been assigned to another lender by its original lender with a due date of June 30, 2016. NNFS was able to obtain multiple forbearance agreements to extend the due date of the mortgage through December 31, 2018, while giving NNFS management time to sell the property.

NARCONON FRESH START
NOTES TO FINANCIAL STATEMENTS
DECEMBER 31, 2015

Note 3 MORTGAGES PAYABLE (Continued)

In 2015, NNFS elected to early adopt retrospectively the requirements of ASU 2015-03, Simplifying the Presentation of Debt Issuance Costs, to present debt issuance costs as a reduction of carrying amount of the debt rather than as an asset. Mortgages payable as of December 31, 2014 was previously reported on the statement of financial position as \$4,446,634, with associated unamortized debt issuance costs included in other assets. Amortization of debt issuance costs of \$11,800 is reported as interest expense in the statement of activities and was previously presented as amortization expense.

Note 4 DERIVATIVE TRANSACTIONS

NNFS entered into an interest rate swap agreement to reduce the impact of changes in interest rates on its floating rate mortgage payable (Note 3). At October 2015, the interest rate swap agreement matured with the Bank of America mortgage payable. At December 31, 2015, the interest rate swap agreement no longer exist.

Note 5 LOANS PAYABLE

	2015	2014
Loan payable, due on December 2, 2018, secured, with monthly payments of \$601, at the rate of 16.37%.	\$ 18,080	\$ -
Loan payable, due on November 2, 2016, secured, with monthly payments range from \$1,820 to \$2,356, at the rate of \$1% to \$3%.	16,250	-
Loans payable, on demand, no interest, unsecured.	179,950	62,764
	\$ 214,280	\$ 62,764

Note 6 CAPITALIZED LEASES

NNFS acquired vehicles under capitalized leases expiring in 2018 used for transporting students on the Narconon Program as well as for the executives. The total original cost of the vehicles in the aggregate was \$66,300. The accumulated depreciation for the capitalized equipment is \$19,471. Depreciation of assets held under capital leases is included with depreciation expense.

NARCONON FRESH START
NOTES TO FINANCIAL STATEMENTS
DECEMBER 31, 2015

Note 6 CAPITALIZED LEASES (Continued)

Future minimum payments under these leases for each of the next four years and in the aggregate are:

2016	\$	6,269
2017		4,014
2018		<u>577</u>
Total minimum payments		10,860
Less amount representing interest		<u>(425)</u>
	\$	<u><u>10,435</u></u>

Interest on the capitalized lease is imputed based on the lessor's implicit rate of return.

Note 7 OPERATING LEASES

NNFS has non-cancellable operating leases on various facilities expiring through 2018. Total rent expense under these operating leases were approximately \$404,714 and \$359,034 for 2015 and 2014, respectively.

NNFS moved out of the facilities covered under the aforementioned leases during 2015. Subsequent to year end, the landlord sued NNFS and they have reached a settlement of \$455,000, which is included in Refunds and Settlements Payable, in the Statement of Financial Position, NNFS agreed to make payments of (a) \$10,000 before May 31, 2017; (b) \$20,000 before July 3, 2017; (c) \$25,000 before August 3, 2017; and (d) monthly installment of \$10,000 starting September 4, 2017 for a total of 40 months. As of report date, NNFS has been making payments according to the settlement agreement.

Note 8 PAYROLL TAX RELATED LIABILITIES

NNFS was delinquent on payroll taxes liability during 2015. Included in payroll taxes related liabilities are \$707,642 owed for federal and states payroll taxes and penalties and interest of \$116,138 as of December 31, 2015. The penalties and interest of \$116,138 have been recorded as related party accounts receivable as NNFS is not to use organization funds to pay for avoidable costs such as penalties and interest. NNFS has entered monthly installment agreements with both the IRS and the EDD in the amount of \$12,000 and \$2,859 per month, respectively. Subsequent to year end, the IRS levied against the proceeds from the sale of a former executive's personal residence in the amount of \$200,521 to reduce the payroll tax liability.

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Note 9 RELATED PARTY TRANSACTIONS

NNFS is licensed by and related to Narconon International, a tax-exempt nonprofit corporation.

NNFS is related to Narconon Western United States, a tax-exempt nonprofit corporation.

NNFS is related to A Life Worth Living (dba Narconon Colorado) through operation of a shared facility.

NNFS is affiliated with other Narconon centers. All U.S. Narconon centers are tax-exempt nonprofit corporations; all Narconon centers outside the U.S. are nonprofit corporations.

All Narconon program license fees were paid or to be paid to Narconon International and Narconon Western United States.

NNFS paid referral fees for the amount of \$20,500 and \$2,170 in 2015 and 2014 to other Narconon centers.

During 2015, NNFS collected \$1,465,468 in program service revenue, and reimbursed \$303,890 in expenses relating to service and care for students in the Narconon Colorado facility. During 2014, NNFS collected \$2,588,699 in program service revenue, and reimbursed \$449,089 in expenses relating to service and care for those students in the Colorado facility.

During 2015, NNFS received a donation of \$314,980 from its executive officer.

Included in loans payable are amounts borrowed from NNFS' officers in the amount of \$98,200 and \$62,764 in 2015 and 2014, respectively.

Included in accounts receivable is an amount of \$7,500 and \$0 in 2015 and 2014, respectively, owed by another Narconon center.

Accounts receivable related party consists of penalties and interest in the amount of \$116,138 generated from delinquent payroll tax that directors and officers will be personally responsible for.

Subsequent to year end, NNFS paid former officers \$36,000 as part of negotiated severance agreements.

Note 10 RETIREMENT PLAN

NNFS established a retirement plan 401(k) for all eligible employees effective May 1, 2011. NNFS stopped matching contribution in 2015. Employer contributions were \$0 and \$52,567 for 2015 and 2014, respectively.

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Note 11 TRANSACTIONS WITH ANOTHER NONPROFIT ORGANIZATION

Included in Due to another nonprofit organization are expenses incurred for purchasing rehabilitation materials and facilities upgrades to better deliver NNFS' rehabilitation services.

Included in Contributions receivable from another nonprofit organization are amounts paid on behalf of NNFS for the defense of the joint lawsuits against various Narconon centers.

Note 12 GOING CONCERN MATTERS

The financial statements have been prepared on a going concern basis, which contemplates the realization of assets and the satisfaction of liabilities in the normal course of business. In accordance with the mortgage agreement, the entire loan balance is due on October 20, 2015 (Note 3). NNFS is in default of this mortgage agreement, and the lender has assigned the loan to another lender. The forbearance agreement allows the loan to be extended through December 31, 2018.

NNFS was unable to meet multiple obligations during 2015 including its lease obligations as well as required payroll tax payments to both the IRS and the EDD.

Management has developed business plans since 2015 to date in order to reduce operating costs including executive compensation and economizing on various bills as well as reducing rent. There is also a change in management team and operations have improved since. NNFS has also hired a professional billing company to improve on insurance collections. NNFS is working on obtaining Joint Commission on Accreditation of Healthcare Organizations (JCAHO) accreditation. This will allow more insurance payments to be authorized to supplement the income.

The ability of NNFS to continue as a going concern is dependent upon the success of these continuing efforts. The financial statements do not include any adjustments that might be necessary if NNFS is unable to continue as a going concern.

Note 13 CONTINGENCY

During 2015, there were six asserted claims filed against NNFS, among other defendants. Five of the cases had been subsequently dismissed and/or settled by insurance. The remaining case is still pending. According to legal counsel, it is not possible at this stage to make a reasonable estimate of what liability, if any, NNFS is responsible for. Accordingly, the accompanying financial statements do not include an adjustment for any liability that may result from this claim.

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Note 13 CONTINGENCY (Continued)

Subsequent to year end, there were three civil actions filed against NNFS. Two of the cases were settled in 2017, one of which is for the breach of lease contract, the settlement is recorded in the financial statements and referred to in Note 8. The other case was settled for an immaterial amount and the financial statements do not include an adjustment for that liability. On the remaining pending case, according to legal counsel, it is not possible at this stage to make a reasonable estimate of what liability, if any, NNFS may be responsible for. Accordingly, the accompanying financial statements do not include an adjustment for any liability that may result from these claims.

Subsequent to year end, there were four threatened civil actions filed against NNFS. According to legal counsel, should the plaintiffs file lawsuits or arbitration demands, NNFS will vigorously contest the matters.

Note 14 VIOLATION OF LAWS AND REGULATIONS

NNFS received a delinquency notice from the California Department of Justice State Attorney General's office regarding the late filling of the audited financial statements for the year ended December 31, 2015 pursuant to the provisions of Government Code section 12586. Management can not determine the ultimate resolution of this matter at this time.

NNFS is delinquent in submitting its payroll tax payment to the IRS as well as EDD as described in Note 8.