



**OPERATION SMILE, INC.**

Consolidated Financial Statements

June 30, 2018

(With Independent Auditors' Report Thereon)

**OPERATION SMILE, INC.**

**Table of Contents**

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



KPMG LLP  
Suite 1900  
440 Monticello Avenue  
Norfolk, VA 23510

## Independent Auditors' Report

The Board of Directors  
Operation Smile, Inc.:

We have audited the accompanying consolidated financial statements of Operation Smile, Inc., which comprise the consolidated statement of financial position as of June 30, 2018, and the related consolidated statements of activities, cash flows, and functional expenses for the year then ended, and the related notes to the consolidated financial statements.

### Management's Responsibility for the Financial Statements

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

### Auditors' Responsibility

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

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

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

### Opinion

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Operation Smile, Inc. as of June 30, 2018, and the changes in their net assets and their cash flows for the year then ended in accordance with U.S. generally accepted accounting principles.

**KPMG LLP**

Norfolk, Virginia  
November 20, 2018

**OPERATION SMILE, INC.**  
Consolidated Statement of Financial Position  
June 30, 2018

**Assets**

Cash	\$	20,358,680
Investments		1,294,370
Prepaid expenses and other assets		823,596
Mission advances and other receivables		256,689
Inventories		2,214,484
Contributions receivable, net (note 2)		9,224,987
Property and equipment, net (notes 3, 5, 9, and 10)		<u>19,670,192</u>
Total assets	\$	<u><u>53,842,998</u></u>

**Liabilities and Net Assets**

Liabilities:		
Accounts payable and accrued expenses	\$	6,160,772
Deferred revenue		236,964
Line of credit (note 9)		1,495,000
Capital lease obligations (notes 3 and 5)		106,816
Long-term debt (note 10)		<u>7,486,116</u>
Total liabilities		<u>15,485,668</u>
Net assets:		
Unrestricted		29,836,567
Temporarily restricted (note 6)		<u>8,520,763</u>
Total net assets		38,357,330
Commitments and contingencies (notes 5 and 9)		
Total liabilities and net assets	\$	<u><u>53,842,998</u></u>

See accompanying notes to consolidated financial statements.

**OPERATION SMILE, INC.**

Consolidated Statement of Activities

Year ended June 30, 2018

	<b>Unrestricted net assets</b>	<b>Temporarily restricted net assets</b>	<b>Total</b>
Revenues:			
Contributions (note 8)	\$ 52,232,503	18,184,393	70,416,896
Gifts-in-kind (note 4)	2,234,873	—	2,234,873
Contributed services (note 4)	31,181,848	—	31,181,848
Program service revenue	750,955	—	750,955
Foreign currency transaction losses, net	(71,065)	—	(71,065)
Other income, net	111,451	—	111,451
Net assets released from restrictions	19,478,771	(19,478,771)	—
Total revenues	105,919,336	(1,294,378)	104,624,958
Expenses and loss:			
Expenses:			
Program services:			
Medical missions (note 4)	46,936,741	—	46,936,741
Education and sustainability	20,120,882	—	20,120,882
Total program services	67,057,623	—	67,057,623
Supporting services:			
Fund-raising	19,404,254	—	19,404,254
Administration	6,182,639	—	6,182,639
Total supporting services	25,586,893	—	25,586,893
Total expenses	92,644,516	—	92,644,516
Loss on contributions receivable	1,413,353	—	1,413,353
Total expenses and loss	94,057,869	—	94,057,869
Change in net assets	11,861,467	(1,294,378)	10,567,089
Net assets at beginning of year	17,975,100	9,815,141	27,790,241
Net assets at end of year	\$ 29,836,567	8,520,763	38,357,330

See accompanying notes to consolidated financial statements.

**OPERATION SMILE, INC.**

Consolidated Statement of Cash Flows

Year ended June 30, 2018

Cash flows from operating activities:	
Change in net assets	\$ 10,567,089
Adjustments to reconcile change in net assets to net cash provided by operating activities:	
Depreciation and amortization expense	1,214,991
Loss on contributions receivable	1,413,353
Loss on disposal of asset	261
Net realized and unrealized gains on investments	(62,124)
Net usage of in-kind donations of supplies and inventory	1,303,925
Changes in operating assets and liabilities:	
Prepaid expenses	45,298
Mission advances and other receivables	66,029
Contributions receivable, net	(1,888,535)
Inventories	82,296
Accounts payable and accrued expenses	(6,949)
Deferred revenue	(91,257)
Net cash provided by operating activities	<u>12,644,377</u>
Cash flows from investing activities:	
Purchases of property and equipment	(209,857)
Sale of property and equipment	9,867
Purchases of investments	(27,345)
Sale of investments	9,906
Net cash used in investing activities	<u>(217,429)</u>
Cash flows from financing activities:	
Principal payments on long-term debt	(167,090)
Net repayments on line of credit	(905,975)
Principal payments on capital lease obligations	(33,265)
Net cash used in financing activities	<u>(1,106,330)</u>
Net increase in cash	11,320,618
Cash at beginning of year	<u>9,038,062</u>
Cash at end of year	<u>\$ 20,358,680</u>
Supplemental cash flow information:	
Cash paid for interest	\$ 389,531

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

See accompanying notes to consolidated financial statements.

**OPERATION SMILE, INC.**

Consolidated Statement of Functional Expenses

Year ended June 30, 2018

	<u>Program services</u>			<u>Supporting services</u>			<u>Total expenses</u>
	<u>Medical missions</u>	<u>Education and sustainability</u>	<u>Total</u>	<u>Fund-raising</u>	<u>Administration</u>	<u>Total</u>	
Grants	\$ 2,513,036	2,203,079	4,716,115	—	—	—	4,716,115
Salaries and benefits	3,714,759	2,913,884	6,628,643	2,931,246	2,896,033	5,827,279	12,455,922
Professional services	579,359	705,886	1,285,245	1,624,175	722,085	2,346,260	3,631,505
Advertising and promotion	49,966	757,425	807,391	1,941,587	215,025	2,156,612	2,964,003
Supplies and equipment	1,191,975	297,448	1,489,423	236,661	839,332	1,075,993	2,565,416
Mission supplies	4,755,132	396,901	5,152,033	—	—	—	5,152,033
Occupancy	220,397	168,378	388,775	72,934	88,807	161,741	550,516
Travel and conferences	2,637,767	2,190,374	4,828,141	293,529	127,532	421,061	5,249,202
Interest	2,097	1,535	3,632	1,273	384,626	385,899	389,531
Depreciation and amortization	492,898	216,190	709,088	83,481	422,422	505,903	1,214,991
Insurance	21,710	4,169	25,879	2,175	79,717	81,892	107,771
Other mission expense	319,332	15,950	335,282	—	—	—	335,282
Fundraising	—	—	—	12,186,661	—	12,186,661	12,186,661
Public education and awareness	—	9,435,737	9,435,737	—	361,152	361,152	9,796,889
Contributed services	30,403,712	778,135	31,181,847	—	—	—	31,181,847
Other	34,601	35,791	70,392	30,532	45,908	76,440	146,832
Total expenses	<u>\$ 46,936,741</u>	<u>20,120,882</u>	<u>67,057,623</u>	<u>19,404,254</u>	<u>6,182,639</u>	<u>25,586,893</u>	<u>92,644,516</u>

See accompanying notes to consolidated financial statements.

## OPERATION SMILE, INC.

### Notes to Consolidated Financial Statements

June 30, 2018

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

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

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

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

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

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

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

##### ***(c) Contributions***

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

##### ***(d) Cash***

Cash consists primarily of cash in banks. Cash in banks exceeded federally insured limits at June 30, 2018.

## OPERATION SMILE, INC.

### Notes to Consolidated Financial Statements

June 30, 2018

**(e) Investments**

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

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

Prepaid expenses are stated at cost less applicable amortization and include expenses prepaid for events that will occur in the next fiscal year, deferred direct response advertising costs and insurance premiums, which are expensed over their estimated useful lives using the straight-line method. Total amortization expense for the year ended June 30, 2018 was \$119,830.

**(g) Inventories**

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

**(h) Property and Equipment**

Property and equipment are stated at cost except for donated equipment, artwork, and land, which are stated at fair value at the date of receipt. Medical equipment and furniture, fixtures, and office equipment are depreciated using the straight-line method over estimated useful lives ranging from 3 to 10 years. No provision for depreciation is made on land or artwork. Additionally, no provision for depreciation is made on work in process until such time as the relevant assets are completed and placed into service. Buildings and building improvements are depreciated using the straight-line method over their estimated useful lives of 40 years. Property and equipment held under capital leases are amortized using the straight-line method over the shorter of the lease term or the estimated useful life of the asset. Total depreciation expense for the year ended June 30, 2018 was \$1,095,161.

**(i) Deferred Revenue**

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

**(j) Classification of Net Assets**

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

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

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

## OPERATION SMILE, INC.

### Notes to Consolidated Financial Statements

June 30, 2018

*Permanently Restricted Net Assets* – Permanently restricted net assets result from contributions whose use by the organization is limited by donor stipulation that neither expire by passage of time nor can be fulfilled or otherwise removed by OSI. There were no permanently restricted net assets at June 30, 2018.

#### **(k) Functional Expenses**

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

#### **(l) Joint Cost Allocation**

OSI incurred expenses that were identifiable with a particular function but served joint purposes. Expenses related to certain events, donor communication, and program materials jointly support medical missions, education and sustainability, fundraising, and administration and were allocated by their function classification as follows for the year ended June 30, 2018:

Medical missions	\$	81,735
Education and sustainability		11,275,291
Fund-raising		14,996,153
Administration		<u>935,861</u>
Total joint costs	\$	<u>27,289,040</u>

#### **(m) Use of Estimates**

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

#### **(n) Fair Value Measurements**

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

- Level 1 Inputs: Unadjusted quoted prices in active markets for identical assets or liabilities accessible to OSI at the measurement date.
- Level 2 Inputs: Other than quoted prices included in Level 1 inputs that are observable for the asset or liability, either directly or indirectly.

## OPERATION SMILE, INC.

### Notes to Consolidated Financial Statements

June 30, 2018

- Level 3 Inputs: Unobservable inputs for the asset or liability used to measure fair value to the extent that observable inputs are not available, thereby allowing for situations in which there is little, if any, market activity for the asset or liability at measurement date.

OSI's investments represent the financial assets that are accounted for at fair value on a recurring basis. At June 30, 2018, the carrying value of all the investments was considered to be the fair value determined using Level 1 inputs in the fair value hierarchy. There were no transfers in and out of Levels 1, 2 or 3 for the year ended June 30, 2018.

#### **(o) Impairment of Long-Lived Assets**

Long-lived assets, such as property and equipment, are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to estimated undiscounted future cash flows expected to be generated by the asset. If the carrying amount of an asset exceeds its estimated future cash flows, an impairment charge is recognized by the amount by which the carrying amount of the asset exceeds the fair value of the asset. As of June 30, 2018, there was no indication of impairment. Any assets to be disposed of within the next fiscal year would be separately presented in the consolidated statement of financial position and reported at the lower of the carrying amount or fair value less costs to sell, and are no longer depreciated. The assets and liabilities of a disposal group classified as held-for-sale would be presented separately in the appropriate asset and liability sections of the consolidated statement of financial position.

#### **(2) Contributions Receivable**

Contributions receivable at June 30, 2018 are expected to be received as follows:

Within one year	\$	7,282,141
From one to five years		<u>2,005,448</u>
		9,287,589
Less discount to present value at rates, which range from 1.05% to 2.71%		<u>62,602</u>
	\$	<u><u>9,224,987</u></u>

OSI had a conditional promise of \$5,274,132 as of June 30, 2018, representing a grant from an English Registered Charity for a large-scale project in Africa.

**OPERATION SMILE, INC.**

Notes to Consolidated Financial Statements

June 30, 2018

**(3) Property and Equipment**

Property and equipment consist of the following at June 30, 2018:

Work in process	\$	76,866
Medical equipment		5,020,376
Furniture, fixtures, and office equipment		3,188,160
Buildings		14,952,301
Building improvements		953,367
Land		3,094,293
Artwork		<u>221,697</u>
		27,507,060
Less accumulated depreciation		<u>7,836,868</u>
Property and equipment, net	\$	<u>19,670,192</u>

As of June 30, 2018, furniture, fixtures, and office equipment recorded under capital leases have a cost basis of \$173,101 and related accumulated amortization of \$43,047 for a net book value of \$130,054.

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

OSI's medical missions are staffed by volunteer surgical teams. In addition, when patients require treatment in the United States under the World Care Program, the hospital stay and related services are fully or partially donated by the hospitals and physicians. The donated medical services are recorded at their estimated fair values and are classified as contributed services revenues and medical missions expenses in the accompanying consolidated statement of activities. Such services amounted to \$31,181,848 in 2018. OSI's medical missions are staffed by volunteer administrative support staff. These administrative personnel services are not recorded in the accompanying consolidated financial statements.

Donated supplies and equipment are received throughout the year for use in the overall Operation Smile mission, are recorded at their estimated fair values, and are classified as gifts-in-kind revenues in the accompanying consolidated statement of activities. These supplies are expensed as they are used and are classified as mission supplies in the accompanying consolidated statement of activities. Donated

**OPERATION SMILE, INC.**

Notes to Consolidated Financial Statements

June 30, 2018

equipment is depreciated using an estimated useful life and is included in Property and Equipment. Such donations and uses amounted to:

Donated:	
Medical supplies	\$ 1,640,973
Nonmedical supplies	24,376
Equipment	<u>569,524</u>
Total gifts-in-kind received	\$ <u><u>2,234,873</u></u>
Usage:	
Medical supplies	\$ 3,501,614
Nonmedical supplies	6,402
Equipment donated out, net	<u>30,782</u>
Total gifts-in-kind expensed, net	\$ <u><u>3,538,798</u></u>

**(5) Leases**

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

Future minimum lease payments under the operating leases and the present value of future minimum capital lease payments as of June 30, 2018 are as follows:

	<u>Capital leases</u>	<u>Operating leases</u>
Year ending June 30:		
2019	\$ 38,897	38,357
2020	38,782	22,391
2021	29,837	—
2022	16,595	—
2023	<u>—</u>	<u>—</u>
Total minimum lease payments	124,111	\$ <u><u>60,748</u></u>
Less amount representing interest	<u>17,295</u>	
Present value of net minimum lease payments	106,816	
Less current maturities of capital lease obligations	<u>33,473</u>	
Capital lease obligations, excluding current maturities	\$ <u><u>73,343</u></u>	

Total rent expense was \$51,339 in 2018.

**OPERATION SMILE, INC.**

Notes to Consolidated Financial Statements

June 30, 2018

**(6) Temporarily Restricted Net Assets**

Temporarily restricted net assets consist of the following at June 30, 2018:

Care centers	\$	13,194
Domestic programs		47,271
Global education and sustainability		929,276
International programs		4,450,900
Research		369,402
Other programs		<u>232,352</u>
Total purpose restricted		6,042,395
Total time restricted		<u>2,478,368</u>
Total temporarily restricted net assets	\$	<u><u>8,520,763</u></u>

**(7) Retirement Savings Plan**

OSI has a 401(k) retirement savings plan. Employees are eligible to participate beginning as of the first of the quarter following four months of employment. OSI matches a portion of the employee contributions and makes a safe harbor contribution on behalf of each employee. OSI's contributions to the retirement savings plans for the year ended June 30, 2018 were \$679,240.

**(8) Related-Party Transactions**

OSI recognized contributions from its Board of Directors, respective committee members, officers and relatives of those charged with governance of \$47,603 for the year ended June 30, 2018. Some board members may also contribute directly to independent, affiliated Operation Smile international foundations.

**(9) Revolving Line of Credit**

In January 2018, OSI renewed a line of credit agreement with a financial institution to provide for borrowings up to \$5,000,000. The line of credit bears interest payable monthly at the rate of LIBOR + 2.5% and expires in November 2018. OSI had \$1,495,000 outstanding on the line of credit at June 30, 2018, which was secured by the OSI global center property.

**(10) Long-Term Debt**

Long-term debt at June 30, 2018 consists of a promissory note in the amount of \$8,500,000, with interest at LIBOR + 2.25%, payable in 83 monthly installments of \$37,932 (principal and interest) beginning January 2014 through November 2020 and a balloon payment of remaining principal due in December 2020.

## **OPERATION SMILE, INC.**

### Notes to Consolidated Financial Statements

June 30, 2018

In December 2013, OSI issued a promissory note to a financial institution which provided proceeds of \$8,500,000 used primarily to refinance the nonrevolving construction loan entered into in July 2011. The note is secured by the OSI global center property. The promissory note requires OSI to maintain a minimum debt service coverage ratio, as defined, while the loan is outstanding. The note is callable at the lender's option any time beginning December 30, 2018. At the end of the five-year term, one two-year extension will be available subject to certain conditions, as defined. OSI had \$7,486,116 outstanding on the promissory note as of June 30, 2018.

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

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

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

The Special Fund raised approximately \$427,000 for the year ended June 30, 2018. This amount was contributed by independent donors within China during fiscal year 2018. Approximately \$356,000 was spent within China from the Special Fund during fiscal year 2018, of which \$344,000 represented surgical mission and other programmatic expenses.

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

OSI has evaluated subsequent events from the consolidated statement of financial position date through November 20, 2018, the date these consolidated financial statements were available to be issued, and determined there are no other items to disclose.