Great Hearts America – Texas

Financial and Compliance Report

June 30, 2016 and 2015

Great Hearts America – Texas

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PS&Co.

Great Hearts America – Texas

Federal Employer Identification Number: 43-1973126

Certificate of Board

We, the undersigned, certify that the attached Financial and Compliance Report of Great Hearts America – Texas was reviewed and (check one) __X__ approved ______ disapproved for the year ended June 30, 2016 at a meeting of the governing body of the charter holder on the 25 day of October, 2016.

Ward Huseth, Board Secretary

James J Heiler

Jay Heiler, Board President

If the governing body of the charter holder disapproved the independent auditor's report, the reason(s) for disapproving it is (are): (attach list as necessary)

PS&Co.

Padgett Stratemann

Independent Auditor's Report

To the Board of Directors
Great Hearts America – Texas
San Antonio, Texas

Report on the Financial Statements

We have audited the accompanying financial statements of Great Hearts America – Texas (the "Organization"), which comprise the statements of financial position as of June 30, 2016 and 2015, and the related statements of activities 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 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.

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's 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 Organization'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 Organization's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

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

Opinion

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Organization as of June 30, 2016 and 2015, and the changes in its net assets and cash flows for the years then ended, in accordance with accounting principles generally accepted in the United States of America.

Other Matters

Other Information

Our audit was conducted for the purpose of forming an opinion on the financial statements as a whole. The Other Supplemental Information, as listed in the table of contents, is presented for purposes of additional analysis and is not a required part of the financial statements. Such information is the responsibility of management and was derived from, and relates directly to, the underlying accounting and other records used to prepare the financial statements. The information has been subjected to the auditing procedures applied in the audit of the financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the financial statements or to the financial statements themselves, and other additional procedures in accordance with auditing standards generally accepted in the United States of America. In our opinion, the Other Supplemental Information is fairly stated, in all material respects, in relation to the financial statements as a whole.

Other Reporting Required by Government Auditing Standards

In accordance with *Government Auditing Standards*, we have also issued our report dated October 25, 2016 on our consideration of the Organization's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the Organization's internal control over financial reporting and compliance.

Padgett, Stratemann + Co., L.L.P.

San Antonio, Texas
October 25, 2016

Financial Statements

PS&Co.

Great Hearts America – Texas

Statements of Financial Position

Exhibit A-1

June 30, 2016 and 2015

	2016	2015
Current Assets		
Cash and cash equivalents	$ 2,087,584	$ 319,056
Due from government agencies	2,686,712	629,877
Prepaid expenses	319,264	29,508
Unconditional promises to give – current portion	1,796,452	783,000
Other current assets	5,894	45,111
Total current assets	6,895,906	1,806,552
Noncurrent Assets		
Property and equipment – net	11,459,808	9,005,997
Land held for sale	267,878	267,878
Lease deposits	140,640	140,640
Loan issuance costs – net of amortization of $0 ($82,359 in 2015)	489,493	284,854
Unconditional promises to give – net	844,927	1,680,295
Total noncurrent assets	13,202,746	11,379,664
Total assets	$ 20,098,652	$ 13,186,216
Current Liabilities		
Accounts payable and other liabilities	$ 382,837	$ 1,084,065
Due to related party	180,055	102,742
Retainage payable	7,710	528,988
Accrued expenses	560,616	44,530
Deferred revenue	104,612	607,371
Total current liabilities	1,235,830	2,367,696
Long-Term Liabilities – notes payable	12,528,917	8,280,222
Total liabilities	13,764,747	10,647,918
Net Assets		
Unrestricted	1,721,027	1,680,789
Temporarily restricted	4,612,878	857,509
Total net assets	6,333,905	2,538,298
Total liabilities and net assets	$ 20,098,652	$ 13,186,216

Notes to the financial statements form an integral part of these statements.

Great Hearts America – Texas

Statement of Activities

Exhibit A-2

Year Ended June 30, 2016

	Unrestricted	Temporarily Restricted	Total
Revenues and Other Support			
Local support:			
Contributions	$ 2,812,576	$ 1,050,000	$ 3,862,576
Food service	-	208,056	208,056
Other revenue	926,781	-	926,781
Total local support	3,739,357	1,258,056	4,997,413
State program revenues:			
Foundation School Program – State of Texas	-	14,796,891	14,796,891
Other state aid	-	289,985	289,985
Total state program revenues	-	15,086,876	15,086,876
Federal program revenues:			
Title I	-	12,938	12,938
IDEA B cluster	-	107,418	107,418
Title II, Part A	-	41,588	41,588
Child Nutrition cluster	-	123,267	123,267
Total federal program revenues	-	285,211	285,211
Net assets released from restrictions – restrictions satisfied by payments	12,874,774	(12,874,774)	-
Total revenues and other support	16,614,131	3,755,369	20,369,500
Expenses			
11 Instructional	8,285,584	-	8,285,584
13 Curriculum development and instructional staff development	14,240	-	14,240
23 School leadership	1,146,428	-	1,146,428
31 Guidance, counseling, and evaluation services	50,760	-	50,760
33 Health services	165,648	-	165,648
35 Food services	414,010	-	414,010
36 Extracurricular activities	280,646	-	280,646
41 General administration	1,979,141	-	1,979,141
51 Plant maintenance and operations	2,237,988	-	2,237,988
53 Data processing services	279,580	-	279,580
61 Community services	258,861	-	258,861
71 Debt service	826,975	-	826,975
81 Fundraising	634,032	-	634,032
Total expenses	16,573,893	-	16,573,893
Change in net assets	40,238	3,755,369	3,795,607
Net assets at beginning of year	1,680,789	857,509	2,538,298
Net assets at end of year	$ 1,721,027	$ 4,612,878	$ 6,333,905

Notes to the financial statements form an integral part of these statements.

Great Hearts America – Texas

Statement of Activities

Exhibit A-2

Year Ended June 30, 2015

	Unrestricted	Temporarily Restricted	Total
Revenues and Other Support			
Local support:			
Contributions	$ 3,881,086	$ 500,000	$ 4,381,086
Food service	-	28,008	28,008
Other revenue	252,786	-	252,786
Total local support	4,133,872	528,008	4,661,880
State program revenues:			
Foundation School Program – State of Texas	-	3,963,412	3,963,412
Other state aid	-	14	14
Total state program revenues	-	3,963,426	3,963,426
Federal program revenues:			
PCS start-up grant	-	608,962	608,962
IDEA B cluster	-	53,125	53,125
Child Nutrition cluster	-	28,239	28,239
Total federal program revenues	-	690,326	690,326
Net assets released from restrictions – restrictions satisfied by payments	4,324,251	(4,324,251)	-
Total revenues and other support	8,458,123	857,509	9,315,632
Expenses			
11 Instructional	2,762,791	-	2,762,791
13 Curriculum development and instructional staff development	48,995	-	48,995
21 Instructional leadership	29,352	-	29,352
23 School leadership	584,535	-	584,535
31 Guidance, counseling, and evaluation services	6,208	-	6,208
33 Health services	43,739	-	43,739
35 Food services	148,594	-	148,594
36 Extracurricular activities	99,482	-	99,482
41 General administration	1,291,911	-	1,291,911
51 Plant maintenance and operations	663,448	-	663,448
53 Data processing services	149,538	-	149,538
61 Community services	54,955	-	54,955
71 Debt service	326,685	-	326,685
81 Fundraising	400,322	-	400,322
Total expenses	6,610,555	-	6,610,555
Change in net assets	1,847,568	857,509	2,705,077
Net deficit at beginning of year	(166,779)	-	(166,779)
Net assets at end of year	$ 1,680,789	$ 857,509	$ 2,538,298

Notes to the financial statements form an integral part of these statements.

Great Hearts America – Texas

Statements of Cash Flows

Exhibit A-3

Years Ended June 30, 2016 and 2015

	2016	2015
Cash Flows From Operating Activities		
Change in net assets	$ 3,795,607	$ 2,705,077
Adjustments to reconcile change in net assets to net cash provided by (used in) operating activities:		
Depreciation	270,907	28,454
Amortization of loan issuance cost	284,854	123,975
Changes in:		
Due from governmental agencies	(2,056,835)	(553,942)
Prepaid expenses	(289,756)	252,664
Lease deposits	-	(79,840)
Unconditional promises to give	(178,084)	(2,003,258)
Other current assets	39,217	(38,498)
Accounts payable and other liabilities and retainage payable	(1,222,506)	205,074
Due to related party	77,313	102,742
Accrued expenses	516,086	44,530
Deferred revenue	(502,759)	(976,629)
Net cash provided by (used in) operating activities	734,044	(189,651)
Cash Flows From Investing Activities		
Purchase of property and equipment	(2,724,718)	(7,506,691)
Purchase of land held for sale	-	(267,878)
Net cash used in investing activities	(2,724,718)	(7,774,569)
Cash Flows From Financing Activities		
Payments on loans and notes payable	-	(1,780,000)
Proceeds from loans and notes payable	4,248,695	8,280,222
Loan issuance costs	(489,493)	(408,829)
Net cash provided by financing activities	3,759,202	6,091,393
Net increase (decrease) in cash and cash equivalents	1,768,528	(1,872,827)
Cash and cash equivalents at beginning of year	319,056	2,191,883
Cash and cash equivalents at end of year	$ 2,087,584	$ 319,056
Supplemental Disclosures of Cash Flow Information		
Cash paid for interest	$ 617,748	$ 202,709
Proceeds from loan deposited in escrow	$ -	$ 1,800,000
Loans paid off through refinance	$ 11,944,930	$ -

Notes to the financial statements form an integral part of these statements.

1. Organization and Significant Accounting Policies

Reporting Entity, Operations, and Nature of Activities

Great Hearts America – Texas (the "Organization") is a not-for-profit 501(c)(3) corporation established in the state of Texas to operate public charter schools with open admissions policies in Texas. The Organization was originally established in 2002 for the purpose of providing education under the name of Sister Creek Center for Liberal Arts. A Restated Certificate of Formation with New Amendments was filed on February 17, 2012 to change the Organization's name to Great Hearts America – Texas and amend its purpose to develop each student's academic potential, personal character, and leadership qualities through an academically rigorous and content-rich educational program grounded in the classical liberal arts tradition and to strive to give every student the education he or she deserves and needs. The primary goal of the Organization is to graduate thoughtful leaders of character who will contribute to a more philosophical, humane, and just society. No assets were transferred in the reformation process.

The Organization is the charter holder for all Great Hearts academies operated in Texas. The Organization has a sole corporate member, Great Hearts America, an Arizona not-for-profit 501(c)(3) corporation, as permitted by the Texas Business Organizations Code. This nonprofit corporate structure is intended to maintain the integrity of the national Great Hearts academic and programmatic model, while also allowing for local input and control.

Pursuant to the bylaws of the Organization, the Board of Directors (the "Board") will be comprised of not less than three and not more than seven members. Each director will serve a one-year term or until his or her successor is appointed, and a director whose term has expired may be appointed to succeed him or herself. The Board is responsible for the adoption and implementation of policy for the Organization and for the management, operation, and accountability of the charter school in all locations. At June 30, 2016 and 2015, there are six and four directors, respectively.

In November 2012, the Texas State Board of Education ("TEA") approved the Organization's first charter authorizing the opening of at least two K-12 campuses in and around San Antonio, Texas. According to the terms of the charter, the charter shall be in effect from the date of execution through July 31, 2018, unless renewed or terminated. The charter may be renewed for an additional period of ten years. The Organization opened Great Hearts Academy – Monte Vista (North and South campuses) on August 18, 2014.

In June 2014, the TEA also approved an expansion amendment to the charter, allowing the Organization to open up to two additional campuses (Great Hearts Academy – Dallas and Great Hearts Academy – Irving) to serve families in those additional geographic territories effective July 1, 2015. The TEA also approved an amendment in June to increase the charter's maximum enrollment of the Organization from 1,965 to 3,930 effective July 1, 2015. In January 2015, TEA approved a nonexpansion amendment for Great Hearts to open a third campus in San Antonio (Great Hearts Academy – Northern Oaks), in place of the previously approved campus Great Hearts Academy – Dallas. As a result of these amendments, the Organization operates four campuses as of July 1, 2015: Great Hearts Academy – Monte Vista North; Great Hearts Academy – Monte Vista South; Great Hearts Academy – Northern Oaks; and Great Hearts Academy – Irving. The Organization does not conduct any other charter or noncharter activities.

Basis of Accounting

The accompanying financial statements were prepared in conformity with accounting principles generally accepted in the United States of America ("U.S. GAAP"). The Financial Accounting Standards Board ("FASB") is the accepted standard setting body for establishing not-for-profit accounting and financial reporting principles. Accordingly, revenues are recognized when earned and expenses are recognized when they are incurred.

Support and revenue are reported as an increase in unrestricted net assets unless use of the related assets is limited by donor-imposed restrictions. Expenses are reported as decreases in unrestricted net assets. Gains and losses on investments and other assets or liabilities are reported as increases or decreases in unrestricted net assets unless their use is restricted by explicit donor stipulation or by law. Expirations of temporary restrictions on net assets (e.g., the donor stipulated purpose has been fulfilled and/or the stipulated time period has elapsed) are reported as reclassifications between the applicable classes of net assets.

Use of Estimates

The preparation of financial statements in conformity with U.S. GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Basis of Presentation

Net assets and revenues, expenses, gains, and losses are classified as unrestricted, temporarily restricted, and permanently restricted based upon the following criteria.

<u>Unrestricted Net Assets</u> – Unrestricted net assets consist of net assets that are not subject to donor-imposed stipulations. Unrestricted net assets result from operating revenues, unrestricted contributions, and unrestricted dividend and interest income. Unrestricted net assets may be designated for specific purposes by action of the Board. The Organization had unrestricted net assets of $1,721,027 and $1,680,789 at June 30, 2016 and 2015, respectively.

<u>Temporarily Restricted Net Assets</u> – Temporarily restricted net assets consist of assets that are subject to grantor or donor-imposed stipulations that require the passage of time or the occurrence of a specified event (actions by the Organization). When the donor restriction expires, the temporarily restricted net assets are reclassified to unrestricted net assets and reported in the statements of activities as net assets released from restrictions. The temporarily restricted description requires the Organization to use state funding for the benefit of educating students enrolled in the Organization's schools. Compliance with this requirement allows the Organization to use these funds for any allowable school purpose to further educate its students. The Organization had $4,612,878 and $857,509 of temporarily restricted net asset at June 30, 2016 and 2015, respectively.

Permanently Restricted Net Assets – Permanently restricted net assets consist of net assets required to be maintained in perpetuity with only the income to be used for the Organization's charter school activities due to grantor donor-imposed restrictions. The Organization had no permanently restricted net assets at June 30, 2016 and 2015.

Cash and Cash Equivalents

For financial statement purposes, the Organization considers all highly liquid investment instruments with an original maturity of three months or less to be cash and cash equivalents. The Organization maintains a balance at a bank in excess of the federally insured limits. The Organization has not experienced any losses in such accounts and management believes it is not exposed to any significant credit risk on cash deposits and investment holdings. At June 2016 and 2015, cash and cash equivalents are comprised of bank accounts with a balance of $2,087,584 and $319,056; respectively.

Due From Government Agencies

Due from government agencies is comprised of amounts due from state and due from pass-through grants from TEA. Due from state consists of underpayments for the foundation school program made to the School from TEA. Any of the government funding sources may, at their discretion, request reimbursement for expenses or return of funds, or both, as a result of any noncompliance with the terms of the grant or contract. The Organization has never experienced any losses due to nonpayment, none are expected, and therefore, an allowance for doubtful accounts has not been established.

Prepaid Items

Certain payments to vendors reflect costs applicable to future accounting periods and are recorded as prepaid items. The cost of prepaid items is recorded as an expense when consumed rather than when purchased.

Allowance for Doubtful Accounts

Management reviews accounts receivable (e.g., due from) and promises to give on a regular basis to determine if any receivable will potentially be uncollectible. Management uses its judgment, based on the best available facts and circumstances, and records a specific reserve for each receivable to reduce the receivable to the amount that is expected to be collected. Factors such as the third-party organization's ability to meet its financial obligations and historical experience are used to determine the amount which is likely to be collected. Management includes receivable balances that are determined to be uncollectible in its overall allowance for doubtful accounts. After all attempts to collect a receivable have failed, the receivable is written off against the allowance. The allowance for doubtful accounts totaled $0 as of June 30, 2016 and 2015.

Capital Assets

Capital assets, as defined by the Organization, are assets with individual cost of more than $5,000. Such assets are recorded at cost if purchased or fair value if donated. Depreciation is calculated on the straight-line method based on the following estimated useful lives of the respective assets.

Asset Classification	Estimated Useful Lives
Building and improvements	40 years
Furniture and equipment	3-10 years
Computers and software	3-5 years

Impairment of Long-Lived Assets

The Organization reviews the carrying value of property and equipment for impairment whenever events and circumstances indicate the carrying value of an asset may not be recoverable from the estimated future cash flows expected to result from its use and eventual disposition. In cases where undiscounted expected future cash flows are less than the carrying value, an impairment loss is recognized equal to an amount by which the carrying value exceeds the fair value of assets. The factors considered by management in performing this assessment include current operating results, trends and prospects, and the effects of obsolescence, demand, competition, and other economic factors. The Organization did not recognize an impairment loss during the years ended June 30, 2016 and 2015.

Land Held for Sale

Land held for sale represents land purchased by the Organization that it is actively pursuing a buyer for as of June 30, 2016 and 2015. The land was sold on July 19, 2016 (see Note 16).

Lease Deposits

The Organization paid deposits for the lease of building space. The amounts will be refunded or expensed at the end of the lease term.

Loan Issuance Costs

Loan issuance costs are amortized over the term of the respective financing agreements.

Revenue Recognition

Capitation received, including base capitation, entitlements, and special services, is recognized in the period services are provided. Revenues from TEA are earned based on reported attendance. Public and private grants received are recognized in the period received and when the terms of the grant are met.

Local Support Revenue

Contributions from donors are recorded at fair value when the Organization is in possession of or receives an unconditional promise to give. Contributions are recorded as unrestricted, temporarily restricted, or permanently restricted support based on the existence and/or nature of any donor restrictions. Support that is restricted by the donor is reported as an increase in temporarily restricted net assets in the reporting period in which the support is recognized. When a donor restriction expires, that is, when a stipulated time restriction passes or purpose restriction is accomplished, temporarily restricted net assets are reclassified to unrestricted net assets and reported in the statements of activities as net assets released from restrictions.

Unconditional promises to give, including contributions and pledges that are expected to be collected within one year, are recorded at their net realizable value. Unconditional promises to give that are expected to be collected in future years are recorded at the present value of estimated future cash flows based on the fair value option.

Conditional promises to give are not included as revenues in the financial statements until such time as the conditions are met.

Donated services are recognized only if the services received either create or enhance assets or require specialized skills, are provided by individuals possessing those skills, and would typically need to be purchased if not provided by donation. No material amount of donated services was received during the years ended June 30, 2016 and 2015.

In-kind contributions of goods and services are recorded at fair market value and recognized as revenue in the accounting period in which they are received. No in-kind contributions were received during the years ended June 30, 2016 and 2015.

State and Federal Program Revenues

The Organization considers all government grants and contracts as exchange transactions rather than contributions. The Organization recognizes revenue from fee-for-service transactions as services are rendered and, for grants, as eligible expenditures are incurred. Advances from government agencies are recorded as deferred revenue. Eligible expenditures incurred in excess of grant fund reimbursements are recorded as due from pass-through grants from TEA.

Deferred Revenue

Amounts received for conditional promises to give for which the condition has not been met are recorded as deferred revenue. When the condition is met, the revenue will be recognized.

Federal Income Tax

The Organization is a not-for-profit organization and is exempt from federal income taxes under Section 501(c)(3) of the Internal Revenue Code, except to the extent it has unrelated business activities. As such, no provision for federal income taxes has been made in the accompanying financial statements.

The Organization's policy is to record interest and penalty expense related to income taxes as interest and other expense, respectively. At June 30, 2016 and 2015, no interest or penalties have been or are required to be accrued.

Functional Allocation of Expenses

The costs of providing various programs and activities have been summarized on a functional basis in the statements of activities. Accordingly, certain costs have been allocated among the programs and supporting services benefited.

Related Party Transactions

During the audit period, the Organization received donated administrative services from GreatHearts – Arizona ("GHA-AZ"), a fiscal sponsor of Great Hearts America. The amount of services received is minimal and, therefore, is not reflected in the financial statements. GHA-AZ is an Arizona not-for-profit 501(c)(3) corporation that manages a network of 22 academically rigorous classical liberal arts academies (serving grades K-12) in the Phoenix, Arizona metropolitan area. The Organization and GHA-AZ are considered affiliates as of June 30, 2016 and 2015, since the Board of the Organization is comprised of key management personnel of GHA-AZ and Great Hearts America. The amount due to related parties at June 30, 2016 totaled $180,055 ($102,742 in 2015). These transactions represent expenditures incurred by GHA-AZ and Great Hearts America on behalf of Great Hearts Texas.

Contingencies

Certain conditions may exist as of the date the financial statements are issued, which may result in a loss to the Organization, but which will only be resolved when one or more future events occur or fail to occur. The Organization's management assesses such contingent liabilities, and such assessment inherently involves an exercise of judgment. In assessing loss contingencies related to legal proceedings that are pending against the Organization or unasserted claims that may result in such proceedings, the Organization's legal counsel evaluates the perceived merits of any legal proceedings or unasserted claims, as well as the perceived merits of the amount of relief sought or expected to be sought therein.

If the assessment of a contingency indicates it is probable that a material loss has been incurred and the amount of the liability can be estimated, then the estimated liability would be accrued in the Organization's financial statements. If the assessment indicates a potentially material loss contingency is not probable, but is reasonably possible, or is probable, but cannot be estimated, then the nature of the contingent liability, together with an estimate of the range of possible loss, if determinable and material, would be disclosed in the notes to the financial statements. Loss contingencies considered remote are generally not disclosed unless they involve guarantees, in which case the guarantees would be disclosed in the notes to financial statements.

Recent Accounting Pronouncements

Leases – In February 2016, FASB issued Accounting Standards Update ("ASU") No. 2016-02, *Leases*, which sets out the principles for the recognition, measurement, presentation, and disclosure of leases for both parties to a contract (i.e., lessees and lessors). The new standard requires lessees to apply a dual approach, classifying leases as either finance or operating leases based on the principle of whether or not the lease is effectively a financed purchase by the lessee. This classification will determine whether lease expense is recognized based on an effective interest method or on a straight-line basis over the term of the lease, respectively. A lessee is also required to record a right-of-use asset and a lease liability for all leases with a term of greater than 12 months, regardless of their classification. Leases with a term of 12 months or less will be accounted for similar to existing guidance for operating leases today. The new standard requires lessors to account for leases using an approach that is substantially equivalent to existing guidance for sales-type leases, direct financing leases, and operating leases. The ASU is expected to impact the Organization's financial statements, as the Organization has certain operating and land lease arrangements for which it is the lessee. The standard is effective on January 1, 2020, with early adoption permitted. The Organization is in the process of evaluating the impact of this new guidance.

__*Debt Issuance Costs*__ – In April 2015, FASB issued ASU No. 2015-03, *Interest – Imputation of Interest: Simplifying the Presentation of Debt Issuance Costs.* The amendments in this ASU require that debt issuance costs related to a recognized debt liability be presented in the balance sheet as a direct deduction from the carrying amount of that debt liability, consistent with debt discounts. The recognition and measurement guidance for debt issuance costs are not affected by the amendments in this ASU. The amendments are effective for financial statements issued for fiscal years beginning after December 15, 2015 and for interim periods within fiscal years beginning after December 15, 2016. Early adoption of the amendments is permitted for financial statements that have not been previously issued. Management does not expect the adoption of this pronouncement to have a material impact on the financial statements of the Organization.

__*Revenue*__ – In May 2014, FASB issued ASU No. 2014-09, *Revenue From Contracts With Customers*, requiring an entity to recognize the amount of revenue to which it expects to be entitled for the transfer of promised goods or services to customers. The updated standard will replace most existing revenue recognition guidance in U.S. GAAP when it becomes effective and permits the use of either a full retrospective or retrospective with cumulative effect transition method. In August 2015, FASB issued ASU No. 2015-14, which defers the effective date of ASU No. 2014-09 one year, making it effective for annual reporting periods beginning after December 15, 2018. The Organization has not yet selected a transition method and is currently evaluating the effects the standard will have on the financial statements.

Subsequent Events

The Organization has evaluated subsequent events through October 25, 2016, the date the financial statements were available to be issued (see Note 16).

Reclassification

Certain reclassifications have been made in the prior year's financial statements to conform to the current year's presentation.

2. Fair Value Measurements and Disclosures

The requirements of *Fair Value Measurements and Disclosures* of the Accounting Standards Codification ("ASC") apply to all financial instruments and all nonfinancial assets and nonfinancial liabilities that are being measured and reported on a fair value basis. Fair value is defined 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. *Fair Value Measurements and Disclosures* also establishes a fair value hierarchy that prioritizes the inputs used in valuation methodologies into the following three levels:

- Level 1 Inputs – Unadjusted quoted prices in active markets for identical assets or liabilities.

- Level 2 Inputs – Observable inputs other than Level 1 prices, such as quoted prices for similar assets or liabilities, or other inputs that can be corroborated by observable market data for substantially the full term of the assets or liabilities.

- Level 3 Inputs – Unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities. Level 3 assets and liabilities include financial instruments whose value is determined using pricing models, discounted cash flow methodologies, or other valuation techniques, as well as instruments for which the determination of fair value requires significant management judgment or estimation.

At June 30, 2016 and 2015, the Organization had no investments.

The fair value of the Organization's cash and cash equivalents, due from government agencies, prepaid expenses, and deposits approximates the carrying amounts of such instruments due to their short maturity. The fair value of the debt approximates the carrying amount because the rate and terms currently available to the Organization approximate the rate and terms on the existing debt.

3. Due From Government Agencies

Due from government agencies consists of the following:

	June 30, 2016	June 30, 2015
Due from state – settlement of current year underpayment	**$ 2,524,768**	$ 625,595
Due from pass-through grants from TEA:		
IDEA B	**107,418**	-
Title II, Part A	**41,588**	-
Title I	**12,938**	-
Child Nutrition cluster	-	4,282
Total due from government agencies	**$ 2,686,712**	$ 629,877

4. Promises to Give

On February 2, 2012, the Organization received a conditional promise to give of $1,000,000 payable in annual installments starting on January 1, 2013 through January 31, 2021. The Organization met the condition of opening a school in the San Antonio area during fiscal year 2015; thus, revenue discounted to the present value was recognized during the year ended June 30, 2015. The discount rate used to calculate the present value of long-term promises to give at June 30, 2016 is 1.63%.

On June 4, 2012, the Organization received a conditional promise to give of $2,000,000 payable in annual installments starting on July 1, 2013 through December 31, 2016. The Organization met the condition of opening a school in the San Antonio area during fiscal year 2015; thus, revenue discounted to the present value was recognized during the year ended June 30, 2015.

On June 25, 2014, the Organization received an unconditional promise to give of $500,000 payable in five $100,000 annual installments starting on December 31, 2014 through December 31, 2018. The discount rate used to calculate the present value of long-term promises to give at June 30, 2016 is 0.92%.

On April 30, 2015, the Organization received a conditional promise to give of $500,000 payable between 2015 and 2022. The Organization met the condition by finding a match from another funder during fiscal year 2015; thus, revenue discounted to the present value was recognized during the year ended June 30, 2015. The discount rate used to calculate the present value of long-term promises to give at June 30, 2016 is 2.07%.

On June 10, 2015, the Organization received an unconditional promise to give of $500,000 payable in 2 installments over 12 months. The contribution is restricted for use to offset the costs of low-income students who qualify for Free and Reduced Lunch Program, including out-of-school time education programs, uniforms, school supplies, and athletic fees in the San Antonio area.

On July 7, 2015, the Organization received an unconditional promise to give of $50,000 payable between 2016 and 2019. The discount rate used to calculate the present value of long-term promises to give at June 30, 2016 is 1.17%. The contribution is restricted.

On June 30, 2016, the Organization received an unconditional promise to give of $1,000,000. The full amount will be paid in fiscal year 2017; therefore, a discount rate was not applied. The contribution is restricted.

Unconditional promises to give consists of the following:

	June 30, 2016	June 30, 2015
Gross amounts due in:		
One year or less	$ 1,796,452	$ 783,000
One to five years	967,300	1,883,015
Total unconditional promises to give	2,763,752	2,666,015
Less discounts to net present value	(122,373)	(202,720)
Less allowance for doubtful accounts	-	-
Net unconditional promises to give	$ 2,641,379	$ 2,463,295

5. Property and Equipment

Property and equipment consist of the following:

	June 30, 2016	2015
Land and improvements	$ 2,404,878	$ 2,404,878
Building and improvements	8,329,104	3,300
Furniture and equipment	416,354	43,737
Computers and software	68,334	80,590
Construction in progress	550,033	6,511,480
	11,768,703	9,043,985
Less accumulated depreciation	308,895	37,988
Net property and equipment	$ 11,459,808	$ 9,005,997

Depreciation expense for the years ended June 30, 2016 and 2015 totaled $270,907 and $28,454, respectively.

6. Conditional Contributions

On September 5, 2014, the Organization received a conditional promise to give in the amount of $812,994. Payment was contingent upon the Organization meeting certain criteria specified by the donor. In fiscal year 2015, the Organization received a payment of $533,136 on this conditional promise to give; however, since the condition had not been met, this was recorded in deferred revenue. The condition was satisfied in August 2015 and the deferred revenue, along with the remaining payment of $278,858 which was received in fiscal year 2016, were recognized as revenue. There is no conditional promises to give at June 30, 2016.

7. Deferred Revenues

Deferred revenues consist of the following:

	June 30, 2016	2015
Conditional promises to give	$ -	$ 533,136
Deferred grant revenue	70,000	-
After school program deposits	34,612	74,235
Total deferred revenues	$ 104,612	$ 607,371

8. Notes Payable

On June 30, 2014, the Organization entered into a note agreement and received proceeds in the amount of $1,780,000. The note had an interest rate of 3.75% and was scheduled to mature on October 31, 2014.

On June 30, 2014, the Organization entered into a loan commitment agreement to borrow $1,800,000. The note had an interest rate of 6.5% and was scheduled to mature on October 31, 2014. On July 1, 2014, the lender funded the loan and deposited the loan proceeds into an escrow account for the Organization to purchase land.

The $1,780,000 and $1,800,000 notes payables described above were refinanced through the issuance of the long-term debt instruments described below:

> On October 28, 2014, the Organization entered into a long-term debt instrument of up to $10,000,000 in principal ("Jefferson Bank loan"). The loan bore an interest rate of 4.8% and was scheduled to mature on October 27, 2017.
>
> On October 28, 2014, the Organization also entered into two subordinated notes, each with principal immediately outstanding of $1,000,000 and annual interest of 3.75%. The entire unpaid principal amount of the subordinated notes, together with all accrued unpaid interest, were to be payable on October 27, 2017. One of these subordinated notes was not required to be paid back to the lender effective June 30, 2016 and is included in revenue.

The Jefferson Bank loan and the other $1,000,000 subordinated note were refinanced through the issuance of the long-term debt instruments described below:

> On June 30, 2016, the Organization entered into a long-term debt instrument of up to $16,768,800 in principal ("Mutual of Omaha loan"). The loan bears an interest rate of 3.98% and is scheduled to mature on June 29, 2021.
>
> On June 30, 2016, the Organization also entered into a subordinated note of $4,192,200. The subordinate loan bears an interest rate of 8% and is scheduled to mature on November 30, 2021.

Notes payable consist of the following:

	June 30, 2016	June 30, 2015
Promissory note payable to Jefferson Bank in the original maximum amount of $10,000,000, including interest at 4.80%; due October 2017; collateralized by property	$ -	$ 6,280,222
Subordinate notes payable in the original amount amount of $1,000,000 each, including interest at 3.75%; due October 2017; collateralized by property	-	2,000,000
Debt instrument payable to Mutual of Omaha in the maximum amount of $16,768,800, including interest at 3.98%; due June 2021; collateralized by property	8,336,717	-
Subordinate note payable in the original amount of $4,192,200, including interest at 8.00%; due November 2021; collateralized by property	4,192,200	-
	$ 12,528,917	$ 8,280,222

Aggregate maturities required at June 30, 2016 were as follows:

Year ending June 30,	
2017	$ -
2018	-
2019	-
2020	50,138
2021	8,395,759
Thereafter	4,083,020
	$ 12,528,917

Interest expense totaled $542,120 and $202,709 for the years ended June 30, 2016 and 2015, respectively.

9. Leases

The Organization leases building space pursuant to noncancellable operating lease agreements expiring through 2025.

One of the lease agreements requires the Organization to obtain a letter of credit that can be used in the event the Organization cannot pay the required lease payments. On March 2, 2015, a third-party nonprofit corporation entered into a letter of credit reimbursement agreement for the Organization to meet this requirement. The amount of the letter of credit was originally $359,680. The outstanding amount on the letter of credit as of June 30, 2016 is $0.

Future minimum lease payments under noncancellable operating leases as of June 30, 2016 were as follows:

Year ending June 30,	
2017	$ 936,023
2018	952,623
2019	1,026,770
2020	712,385
2021	738,974
Thereafter	3,121,149
Future minimum lease payments	**$ 7,487,924**

Rent expense totaled $1,134,444 for the year ended June 30, 2016 ($419,109 in 2015).

10. Commitments and Contingencies

The Organization receives a portion of its funding from federal and state programs that are governed by various rules and regulations of the grantors. The ultimate determination of amounts received under these programs is generally based upon allowable costs reported to the government. Until such audits have been completed and final settlement reached, there exists a contingency to refund any amount received in excess of allowable costs. Management is of the opinion that no material liability will result from such audits.

During the years ended June 30, 2016 and 2015, the Organization entered into contracts to perform construction on new schools. The construction commitment balance and retainage payable totaled $1,153,504 and $7,710, respectively, at June 30, 2016, and $1,779,890 and $528, 898, respectively, at June 30, 2015.

11. Temporarily Restricted Net Assets

Temporarily restricted net assets consist of assets that are subject to grantor or donor-imposed stipulations that require the passage of time or the occurrence of a specified event.

	June 30,	
	2016	2015
Foundation School Program – State of Texas	**$ 3,125,813**	$ 357,509
Donor restricted contributions	**1,487,065**	500,000
	$ 4,612,878	$ 857,509

Net assets are released from donor restriction by incurring expenses satisfying the purpose or time restrictions specified by donors as follows:

	June 30,	
	2016	2015
Foundation School Program – State of Texas	$ 12,127,987	$ 3,605,903
Other state aid	190,585	14
Public Charter School ("PCS") start-up grant	-	608,962
Child Nutrition cluster	331,324	56,247
IDEA B cluster	107,418	53,125
Title II, Part A	41,588	-
Title I, Part A	12,938	-
Other grants	62,934	-
	$ 12,874,774	$ 4,324,251

12. **Employee Benefit Plan**

401(k) Plan – The Organization previously had a 401(k) plan for the benefit of substantially all employees. The Organization's contributions to the plan were at the discretion of the Board and no contributions were ever made by the Organization. Effective July 1, 2014, the Organization no longer offered the 401(k) employees' profit sharing plan since it switched to the Teacher Retirement System of Texas ("TRS"), as described below.

Pension Plan Obligations

TRS Plan Description – The Organization participates in a cost-sharing multiple employer defined benefit pension plan that has a special funding situation. The plan is administered by TRS. TRS' defined benefit pension plan is established and administered in accordance with the Texas Constitution, Article XVI, Section 67 and Texas Government Code, Title 8, Subtitle C. The pension trust fund is a qualified pension trust under Section 401(a) of the Internal Revenue Code. The Texas Legislature establishes benefits and contribution rates within the guidelines of the Texas Constitution. The pension's Board of Trustees does not have the authority to establish or amend benefit terms. The TRS plan does not include a collective-bargaining agreement.

All employees of public, state-supported educational institutions in Texas who are employed for one-half or more of the standard work load and who are not exempted from membership under Texas Government Code, Title 8, Section 822.002 are covered by TRS.

The TRS plan differs from single employer plans in the following ways:

1. Charters are legally separate entities from the state and each other.

2. Assets contributed by one charter or independent school district ("ISD") may be used for the benefit of an employee of another charter or ISD.

3. The unfunded obligations get passed along to other charters or ISDs.

4. There is not a withdrawal penalty for leaving the TRS system.

Pension Plan Fiduciary Net Position

At August 31, 2015, TRS total plan assets were $149,780,061,824; accumulated benefit obligation was $163,887,375,172; and the plan was 78.43% unfunded.

Detailed information about TRS' fiduciary net position is available in a separately issued Comprehensive Annual Financial Report ("CAFR") that includes financial statements and required supplementary information. That report may be obtained on the Internet at http://www.trs.state.tx.us/about/documents/cafr.pdf#CAFR; by writing to TRS at 1000 Red River Street, Austin, TX, 78701-2698; or by calling (512) 542-6592.

Contributions

Contribution requirements are established or amended pursuant to Article 16, Section 67 of the Texas Constitution, which requires the Texas legislature to establish a member contribution rate of not less than 6% of the member's annual compensation and a state contribution rate of not less than 6% and not more than 10% of the aggregate annual compensation paid to members of TRS during the fiscal year. Texas Government Code, Section 821.006 prohibits benefit improvements, if as a result of the particular action, the time required to amortize TRS' unfunded actuarial liabilities would be increased to a period that exceeds 31 years, or, if the amortization period already exceeds 31 years, the period would be increased by such action.

Employee contribution rates are set in state statute, Texas Government Code, Section 825.402. Senate Bill 1458 of the 83rd Texas Legislature amended Texas Government Code, Section 825.402 for member contributions and established employee contribution rates for fiscal years 2014 through 2017. It also added a 1.5% contribution for employers not paying Old Age Survivor and Disability Insurance ("OASDI") on certain employees effective for fiscal year 2015 as discussed in Note 1 of the TRS 2014 CAFR. The 83rd Texas Legislature, General Appropriations Act ("GAA") established the employer contribution rates for fiscal years 2014 and 2015. The 84th Texas Legislature, GAA established the employer contribution rates for fiscal years 2016 and 2017.

Contributors to the plan include members, the Organization, and the state of Texas as the only nonemployer contributing entity ("NECE"). The state is the employer for senior colleges, medical schools, and state agencies, including TRS. In each respective role, the state contributes to the plan in accordance with state statutes and the GAA.

As the NECE for public education and junior colleges, the state of Texas contributes to TRS an amount equal to the current employer contribution rate times the aggregate annual compensation of all participating members of the pension trust fund during that fiscal year reduced by the amounts described below which are paid by the Organization. The Organization is required to pay the employer contribution rate in the following instances:

- On the portion of the member's salary that exceeds the statutory minimum for members entitled to the statutory minimum under Section 21.402 of the Texas Education Code ("TEC").
- During a new member's first 90 days of employment.
- When any part or all of an employee's salary is paid by federal funding sources, a privately sponsored source, from noneducational and general, or local funds.
- When the employing district is a public junior college or junior college district, the district shall contribute to TRS an amount equal to 50% of the state contribution rate for certain instructional or administrative employees; and 100% of the state contribution rate for all other employees.

In addition to the Organization employer contributions listed below, when employing a retiree of TRS, the Organization shall pay both the member contribution and the state contribution as an employment after retirement surcharge. The Organization's contribution to TRS does not represent more than 5% of the total contributions to the TRS plan. There have been no changes that would affect the comparison of employer contributions from year to year.

	2016	2015
Member (employees)	**7.2%**	6.7%
NECE	**6.8%**	6.8%
Employers	**6.8%**	6.8%
Employer contributions	**$ 112,590**	$ 51,959
Member contributions	**$ 568,394**	$ 182,918
Non-OASDI contributions	**$ 119,618**	$ 39,126

13. Health Insurance

During the years ended June 30, 2016 and 2015, employees of the Organization were covered by a health insurance plan. The Organization contributed $316-$893 per employee, per month ($283-$857 per employee, per month for 2015) depending on the employees' health insurance plan rate. Employees, at their option, authorized payroll withholdings to pay contributions or premiums for dependents. All premiums were paid to licensed insurers.

14. Economic Dependency

During the year ended June 30, 2016, the Organization received approximately 60% of its contributions from three revenue sources (87% from three revenue sources in 2015). With schools operational, the Organization earns the majority of its funding from various federal, state, and local entities. Changes in state funding levels for charter schools in Texas could have a significant impact on the Organization's future revenues.

15. State Compliance Matters

Budgetary Matters
In accordance with the TEA Special Supplement to the Financial Accountability System Resource Guide Charter Schools, if the original and final budgeted amounts vary by more than 10% of the original budgeted amounts, a written statement discussing the causes of the variances is required.

The Board approved one budget amendment in June 2016. This amendment was necessary to more accurately reflect the budget and actual expense transactions in accordance with the Texas requirements.

The final budgeted amounts varied by more than 10% of the original budgeted amounts as follows:

- State program revenue increased by $2,319,513 as a result of higher than anticipated Average Daily Attendance and per student allotment; greater than anticipated allotments for Special Education, Compensatory Education, Bilingual and New Instructional Facility funding, and Tier II funding.

- Federal program revenue increased by $55,380 as the result of a decrease in the National School Lunch Program because of lower participation and an increase from being awarded additional funds for IDEA B, Title I Part A, and Title II Part A.

- Function 13 – decrease of $128,263 due to outside professional development being limited due to cash flow limitations.

- Function 21 – decrease of $411,980 for reclassification of personnel expenses.

- Function 23 – increase of $382,899 for reclassification of personnel cost.

- Function 36 – increase of $83,100 for personnel cost and related benefits of the athletic coach position originally included in Function 11, instructional budget.

- Function 41 – decrease of $696,000 due to reclassification of budgeted expense related to software and copier lease to Function 53 – data processing services, decrease of personnel cost for positions which were vacated and remained unfilled for periods throughout the year and limitations on travel during the first two quarters of the year due to cash flow limitations.

- Function 51 – increased $376,753 due to several categories of expense occurring during the year that were not planned for during the budget cycle – decision to hire two internal maintenance professionals during the year, additional supplies for maintenance and repair at the Irving and Northern Oaks campuses, recordation of Irving lease on a straight-line basis, increase in maintenance and repair services and travel expenses of facilities management.

- Function 53 – increased $82,000 due to software and copier lease expenses originally budgeted to Function 41, general administration, moved to this function.

- Function 71 – increased $396,820 due to additional interest payment made due to debt refinancing, write-off of bond amortization related to refinanced debt, and unbudgeted interest payments on subordinate debt.

In accordance with the TEA Special Supplement to the Financial Accountability System Resource Guide Charter Schools, variances between the final budgeted amounts and the actual amounts that exceed 10% of the final budget amount also require a written statement discussing the cause of the variance.

The actual expenses did not vary by more than 10% from the final amended budget.

16. Subsequent Events

In May of 2016, the Organization entered into a sale agreement for 1.69 undeveloped acres of the 17 acres of the Great Hearts Academy – Northern Oaks campus for a total price of $ 375,000. At the time of the sale agreement, the entire sale amount was placed into escrow and, on May 11, 2016, $100,000 was released to the Organization to be held as earnest money. The sale was completed on July 19, 2016 at which time the remaining amount due less charges and legal fees was deposited into the Organization's operating account. The total remaining amount received at the time of closing was $245,000.

Other Supplemental Information

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Great Hearts America – Texas

Schedules of Expenses

Years Ended June 30, 2016 and 2015

		2016	2015
Expenses			
6100	Payroll costs	$ 9,689,520	$ 3,450,563
6200	Professional and contracted services	3,132,525	1,194,703
6300	Supplies and materials	2,187,683	1,063,376
6400	Other operating costs	737,191	575,229
6500	Debt service costs	826,974	326,684
	Total expenses	$ 16,573,893	$ 6,610,555

Great Hearts America – Texas

Schedule of Capital Assets

June 30, 2016

Asset Classification		Ownership Interest Local	State	Federal
Property and Equipment				
1510	Land and improvements	$ -	$ 2,404,878	$ -
1520	Building and improvements	-	8,329,104	-
1530	Furniture and equipment	-	416,354	-
1532	Computers and software	-	56,078	12,256
1580	Construction in progress	-	550,033	-
		$ -	$ 11,756,447	$ 12,256

Great Hearts America – Texas

Budgetary Comparison Schedule

Year Ended June 30, 2016

	Budgeted Amounts			Variance With Final Budget Positive
	Original	Final	Actual	(Negative)
Revenues and Other Support				
5700 Local support	$ 5,321,113	$ 5,173,676	$ 4,997,413	$ (176,263)
5800 State program revenues	13,084,793	15,404,306	15,086,876	(317,430)
5900 Federal program revenues	228,960	284,340	285,211	871
Total revenues and other support	18,634,866	20,862,322	20,369,500	(492,822)
Expenses				
11 Instructional	8,674,163	8,634,852	8,285,584	349,268
13 Curriculum development and instructional staff development	141,925	13,662	14,240	(578)
21 Instructional leadership	411,980	-	-	-
23 School leadership	780,777	1,163,676	1,146,428	17,248
31 Guidance, counseling, and evaluation services	58,170	54,925	50,760	4,165
33 Health services	180,772	180,774	165,648	15,126
35 Food services	360,948	390,948	414,010	(23,062)
36 Extracurricular activities	189,403	272,503	280,646	(8,143)
41 General administration	2,745,161	2,049,161	1,979,141	70,020
51 Plant maintenance and operations	2,080,697	2,457,450	2,237,988	219,462
53 Data processing services	177,220	259,220	279,580	(20,360)
61 Community services	274,699	275,100	258,861	16,239
71 Debt service	453,180	850,000	826,975	23,025
81 Fundraising	548,134	579,537	634,032	(54,495)
Total expenses	17,077,229	17,181,808	16,573,893	607,915
Change in net assets	1,557,637	3,680,514	3,795,607	115,093
Net assets at beginning of year	2,538,298	2,538,298	2,538,298	-
Net assets at end of year	$ 4,095,935	$ 6,218,812	$ 6,333,905	$ 115,093

Compliance Section

PS&Co.

PS&Co.

Padgett Stratemann

Independent Auditor's Report on Internal Control Over Financial Reporting and on Compliance and Other Matters Based on an Audit of Financial Statements Performed in Accordance With *Government Auditing Standards*

To the Board of Directors
Great Hearts America – Texas
San Antonio, Texas

We have audited, in accordance with the auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States, the financial statements of Great Hearts America – Texas (the "Organization") which comprise the statement of financial position as of June 30, 2016, the related statements of activities and cash flows for the year then ended, and the related notes to financial statements, and have issued our report thereon dated October 25, 2016.

Internal Control Over Financial Reporting

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

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

Our consideration of internal control was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies. Given these limitations, during our audit we did not identify any deficiencies in internal control that we consider to be material weaknesses. We did identify certain deficiencies in internal control described in the accompanying Schedule of Findings and Questioned Costs as items 2016-002 and 2016-003 that we consider to be significant deficiencies.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the Organization's financial statements are free from material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit and, accordingly, we do not express such an opinion. The results of our tests disclosed an instance of noncompliance or other matters that is required to be reported under *Government Auditing Standards* and described in the accompany Schedule of Findings and Questioned Costs as item 2016-001.

The Organization's Responses to the Findings

The Organization's responses to the findings identified in our audit are described in the accompanying Schedule of Findings and Questioned Costs and Corrective Action Plan. The Organization's responses were not subjected to the auditing procedures applied in the audit of the financial statements and, accordingly, we express no opinion on them.

Purpose of This Report

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

Padgett, Stratemann + Co., L.L.P.

San Antonio, Texas
October 25, 2016

I – Summary of Auditor's Results

Financial Statements

Type of auditor's report issued:	Unmodified			
Internal control over financial reporting:				
Material weakness(es) identified?		Yes	X	No
Significant deficiency(ies) identified that are not considered to be material weakness(es)?	X	Yes		None Reported
Noncompliance material to financial statements noted?		Yes	X	No

II – Financial Statement Finding

Finding 2016-001: Procurement
Type of Finding: Compliance

Criteria: The TEA Special Supplement to the Financial Accountability System Resource Guide Charter School Update 5.0 requires purchases be made using a process that provides the best value for the charter school in accordance with TEC 44.031-44.901.

Condition: The Organization currently is utilizing a vendor to purchase textbooks that was not properly procured in the prior year yet the Organization continued to use the vendor in the current year.

Context: The vendor was not properly procured in the prior year and the Organization did not subsequently go through the procurement process in the current year to resolve the compliance exception.

Cause and Effect: Fiscal year 2015 was the Organization's first year of Texas charter school operations and, as a result, the Organization did not have current policies to address competitive procurement. In fiscal year 2016, the procurement policies were developed and implemented for new vendors, however, the Organization did not ensure vendors it continued to use from the prior year were procured in accordance with the criteria described above or the newly implemented policies.

Recommendation: We recommend the Organization perform the proper procurement procedures to ensure compliance with the criteria described above.

Views of Responsible Officials: See Corrective Action Plan.

Finding 2016-002: Temporarily Restricted Net Assets
Type of Finding: Significant Deficiency

Criteria: Contributions received with donor-imposed restrictions are required to be recorded as temporarily restricted net assets and once the restriction has been met, those amounts are released from restrictions and reclassified to unrestricted net asset.

Condition: In fiscal year 2016, the Organization did not have a formal process in place to accurately track the expenses of the restricted contributions being released from restriction.

Context: We noted several instances where the release from restriction was not properly identified.

Cause and Effect: Due to lack of a formal process in this area, no amount of release from restrictions could be inaccurately presented.

Recommendation: We recommend the Organization implement formal policies and procedures to track the temporarily restricted contributions to ensure the amounts are properly classified as released from restrictions when the donor restrictions have been met.

Views of Responsible Officials: See Corrective Action Plan.

Finding 2016-003: Segregation of Duties
Type of Finding: Significant Deficiency

Criteria: Segregation of duties is a key financial reporting concept that ensures adequate oversight and review exists to reduce the risk of error and fraud in the financial statements.

Condition: A small number of people have the primary responsibility for performing most of the accounting and financial reporting duties. As a result, some aspects of internal controls that rely upon adequate segregation of duties are missing.

Context: During the year, the Organization experienced turnover in the accounting/finance department.

Cause and Effect: Segregation of duties can help reduce the risk of error and fraud; however, these controls were missing due to the recent turnover in the accounting/finance department.

Recommendation: We recommend the Organization consider additional alternative procedures to the current internal control system and evaluate possibilities to strengthen the system, particularly as the Organization continues to grow.

Views of Responsible Officials: See Corrective Action Plan.

Great Hearts America – Texas

Summary Schedule of Prior Audit Findings

Year Ended June 30, 2016

Finding 2015-001: Construction Payables

Prior Year Finding: At June 30, 2015, the Organization did not record the retainage payable of approximately $529,000 and did not record the June construction invoices of approximately $818,000.

Status: This finding has been corrected in the current year.

Finding 2015-002: Local Procurement Policies and Procedures

Prior Year Finding: The Organization's current policies do not address competitive procurement.

Status: This finding has been corrected in the current year.

Finding 2015-003: Procurement and Suspension and Debarment
Federal Program: 2013-2014 PCS Start-Up Grants

Prior Year Finding: The Organization did not fully follow the procurement guidelines and also did not check for suspension and debarment for three vendors paid $522,674 with the PCS start-up grant funds. However, the vendors used were not suspended or debarred.

Status: The Organization did not receive this grant in the current year. Current year procurement testing disclosed issues which are included in finding 2016-001. No transactions occurred in the current year that required the Organization to perform the suspension and debarment verification. Our inquiry of management indicated policies and procedures have been updated to include the suspension and debarment verification on future transactions.

Finding 2015-004: Cash Management and Financial Reporting
Federal Program: 2013-2014 PCS Start-Up Grants

Prior Year Finding: The Organization requested advance funds from TEA and did not make the disbursement of funds within three days.

Status: The Organization did not receive this grant in the current year. Due to current year turnover in the accounting/finance department, drawdown requests in general for federal grants of the Organization were not timely submitted.

Great Hearts America – Texas

Corrective Action Plan

Year Ended June 30, 2016

Finding 2016-001: Procurement

Views of Responsible Officials and Planned Corrective Action: Management agrees with the finding. During the year, the Organization developed new procurement procedures and implemented those for vendors which were new during the 2015-2016 fiscal year. The procedures will be adhered to for all vendors, as required, if not previously vetted through the process.

Responsible Person: Deborah Zimmerman

Implementation Date: Immediately

Finding 2016-002: Temporarily Restricted Net Assets

Views of Responsible Officials and Planned Corrective Action: Management agrees with the finding. The Organization has implemented a process by which a "project" code is used to identify the amounts released from restriction. The procedures manual will be updated to reflect this procedural change.

Responsible Person: Deborah Zimmerman

Implementation Date: Immediately

Finding 2016-003: Segregation of Duties

Views of Responsible Officials and Planned Corrective Action: Management agrees with the finding. During fiscal year 2015-2016, the Organization experienced turnover in the finance area. During much of the year, temporary help was utilized to continue the routine processing. In April 2016, a full-time permanent Accounts Payable/Payroll position was filled; in May of 2016, a Senior Accountant was hired; and in August 2016, a full-time Human Resources Manager was hired. There is still one remaining position budgeted for the Finance/Human Resources team, which is budgeted for and needs to be filled. With all positions filled, the VP of Finance and Administration will be enabled to perform more oversight of the activities, instead of performing the actual activities; thus, providing for a more sound system of internal control and better segregation of duties.

Responsible Person: Deborah Zimmerman

Implementation Date: Final hire to be made by December 31, 2016