# SOUTH UNIVERSITY

## AUDIT OF COMPLIANCE FOR EACH MAJOR STATE PROJECT
## IN ACCORDANCE WITH
## CHAPTER 10.650, RULES OF THE AUDITOR GENERAL

**Year Ended June 30, 2014**

FOGLE & ASSOCIATES, LLC
Certified Public Accountants

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Fogle & Associates, LLC
Certified Public Accountants

# INDEPENDENT AUDITOR'S REPORT ON COMPLIANCE FOR EACH MAJOR STATE PROJECT AND ON INTERNAL CONTROL OVER COMPLIANCE IN ACCORDANCE WITH CHAPTER 10.650, RULES OF THE AUDITOR GENERAL

To the Board of Directors
South University

## Report on Compliance for Each Major State Project

We have audited South University's compliance with the types of compliance requirements described in the Department of Financial Services' *State Projects Compliance Supplement* that could have a direct and material effect on each of South University's major State projects for the year ended June 30, 2014. South University's major State projects are identified in the summary of auditor's results section of the accompanying schedule of findings and questioned costs.

### *Management's Responsibility*

Management is responsible for compliance with the requirements of laws, regulations, contracts, and grants applicable to its State projects.

### *Auditor's Responsibility*

Our responsibility is to express an opinion on compliance for each of South University's major State projects based on our audit of the types of compliance requirements referred to above.

We conducted our audit of compliance in accordance with auditing standards generally accepted in the United States of America; the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States; and Chapter 10.650, *Rules of the Auditor General*. Those standards and Chapter 10.650, *Rules of the Auditor General* require that we plan and perform the audit to obtain reasonable assurance about whether noncompliance with the types of compliance requirements referred to above that could have a direct and material effect on a major State project occurred. An audit includes examining, on a test basis, evidence about South University's compliance with those requirements and performing such other procedures as we considered necessary in the circumstances.



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We believe that our audit provides a reasonable basis for our opinion on compliance for each major State project. However, our audit does not provide a legal determination of South University's compliance.

***Opinion on Each Major State Project***

In our opinion, South University complied, in all material respects, with the requirements referred to above that could have a direct and material effect on each of its major State projects for the year ended June 30, 2014.

***Report on Internal Control Over Compliance***

Management of South University is responsible for establishing and maintaining effective internal control over compliance with the types of compliance requirements referred to above. In planning and performing our audit of compliance, we considered South University's internal control over compliance with the types of requirements that could have a direct and material effect on each major State project to determine the auditing procedures that are appropriate in the circumstances for the purpose of expressing an opinion on compliance for each major State project and to test and report on internal control over compliance in accordance with Chapter 10.650, *Rules of the Auditor General* but not for the purpose of expressing an opinion on the effectiveness of South University's internal control over compliance. Accordingly, we do not express an opinion on the effectiveness of South University's internal control over compliance.

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

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

The purpose of this report on internal control over compliance is solely to describe the scope of our testing of internal control over compliance and the results of that testing based on the requirements of Chapter 10.650, *Rules of the Auditor General*. Accordingly, this report is not suitable for any other purpose.

Fogle & Associates, LLC

February 9, 2015

**SOUTH UNIVERSITY**

**SCHEDULE OF FINDINGS AND QUESTIONED COSTS - STATE PROJECTS**

**Year Ended June 30, 2014**

## A. SUMMARY OF AUDITORS' RESULTS

1. The consolidated financial statements of South University, LLC and Subsidiaries were audited by another independent registered public accounting firm whose report dated November 3, 2014 expressed an unmodified opinion.

2. One material weakness disclosed during the audit of the consolidated financial statements of South University, LLC and Subsidiaries was reported by another independent registered public accounting firm in its "Report of Independent Auditors on Internal Control Over Financial Reporting Based on an Audit of Financial Statements Performed in Accordance With *Government Auditing Standards*" dated November 3, 2014.

3. The consolidated financial statements of South University, LLC and Subsidiaries were audited by another independent registered public accounting firm whose "Report of Independent Auditors on Compliance and Other Matters Based on an Audit of Financial Statements Performed in Accordance With *Government Auditing Standards*" dated November 3, 2014 identified no instances of noncompliance material to the financial statements and no findings related to the financial statements which would be required to be reported in accordance with *Government Auditing Standards.*

4. The independent auditor's report on compliance for each major State project for South University expresses an unmodified opinion.

5. The audit of the major state projects of South University disclosed no findings or questioned costs required to be disclosed under Chapter 10.650, *Rules of the Auditor General.*

6. The programs tested as major state projects included:

   Florida Department of Education Student Financial Assistance Programs:

   a. Florida Access to Better Learning and Education Grant - CSFA #48.017
   b. Florida Student Assistance Grant - CSFA #48.054

7. The dollar threshold for distinguishing between Type A and Type B projects was $300,000 for major State projects.

8. No management letter is required because there were no matters related to major State projects required to be reported in the management letter.

9. No Summary Schedule of Prior Audit Findings is required because there were no prior audit findings related to major State projects.

SOUTH UNIVERSITY

SCHEDULE OF FINDINGS AND QUESTIONED COSTS -
STATE PROJECTS

Year Ended June 30, 2014

## A. SUMMARY OF AUDITORS' RESULTS (continued)

10. No Corrective Action Plan is required because there were no findings required to be reported under Chapter 10.650, *Rules of the Auditor General.*

# Consolidated Financial Statements and Supplemental Information

South University, LLC and Subsidiaries
Fiscal Years Ended June 30, 2014 and 2013
With Report of Independent Auditors

South University, LLC and Subsidiaries

Consolidated Financial Statements
and Supplemental Information

Fiscal Years Ended June 30, 2014 and 2013

## Contents

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# Report of Independent Auditors

The Member and Board of Trustees of
South University, LLC and Subsidiaries

### *Report on the Financial Statements*

We have audited the accompanying consolidated financial statements of South University, LLC and Subsidiaries, which comprise the consolidated balance sheets as of June 30, 2014 and 2013, and the related consolidated statements of operations, members' equity, and cash flows for the years 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 conformity 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 financial statements that are free of material misstatement, whether due to fraud or error.

### *Auditor's Responsibility*

Our responsibility is to express an opinion on these consolidated financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States 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 consolidated financial statements are free of material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the 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 entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

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

***Opinion***

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of South University, LLC and Subsidiaries at June 30, 2014 and 2013, and the consolidated results of their operations and their cash flows for the years then ended in conformity with U.S. generally accepted accounting principles.

***Supplementary Information***

Our audits were conducted for the purpose of forming an opinion on the consolidated financial statements as a whole. The accompanying consolidating balance sheets, statements of operations, 90/10 ratios, and composite scores, and supplemental schedules of expenditures of state financial assistance are presented for purposes of additional analysis and are not a required part of the consolidated 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 consolidated financial statements. The information has been subjected to the auditing procedures applied in the audit of the consolidated financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the consolidated financial statements or to the consolidated financial statements themselves, and other additional procedures in accordance with auditing standards generally accepted in the United States. In our opinion, the information is fairly stated, in all material respects, in relation to the consolidated 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 November 3, 2014 on our consideration of South University, LLC and Subsidiaries' 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 South University, LLC and Subsidiaries' internal control over financial reporting and compliance.

Ernst + Young LLP

November 3, 2014

# South University, LLC and Subsidiaries
## Consolidated Balance Sheets
*(In thousands)*

| | June 30, 2014 | June 30, 2013 |
|---|---|---|
| **Assets** | | |
| **Current assets:** | | |
| Cash and cash equivalents | $ 19,971 | $ 17,525 |
| Restricted cash | 40,195 | 44,691 |
| Student accounts receivable, net of allowance of $30,115 and $36,296 | 71,184 | 64,635 |
| Notes, advances, and other receivables | 11,302 | 9,374 |
| Deferred income taxes | 4,948 | 13,539 |
| Other current assets | 2,445 | 2,217 |
| **Total current assets** | 150,045 | 151,981 |
| Property and equipment, net | 47,107 | 51,846 |
| Other long-term assets | 8,276 | 5,481 |
| Intangible assets, net | 3,374 | 4,377 |
| Goodwill | 44,902 | 44,902 |
| **Total assets** | $ 253,704 | $ 258,587 |
| | | |
| **Liabilities and member's equity** | | |
| **Current liabilities:** | | |
| Accounts payable | $ 3,792 | $ 3,010 |
| Accrued liabilities | 12,900 | 15,427 |
| Unearned tuition | 46,291 | 43,136 |
| Advance payments | 26,333 | 24,408 |
| **Total current liabilities** | 89,316 | 85,981 |
| Deferred income taxes | 10,432 | 6,807 |
| Deferred rent | 27,940 | 28,943 |
| **Member's equity:** | | |
| Net investment of EDMC (Note 2) | 6,492 | 20,342 |
| Accumulated earnings | 119,524 | 116,514 |
| **Total member's equity** | 126,016 | 136,856 |
| **Total liabilities and member's equity** | $ 253,704 | $ 258,587 |

The accompanying notes are an integral part of these consolidated financial statements.

South University, LLC and Subsidiaries
Consolidated Statements of Operations
*(In thousands)*

| | For the Fiscal Year ended June 30, | |
|---|---|---|
| | **2014** | **2013** |
| **Net revenues** | $ 389,039 | $ 398,396 |
| **Costs and expenses:** | | |
| Educational services | 212,672 | 210,801 |
| General and administrative | 131,578 | 136,356 |
| Depreciation and amortization | 15,777 | 17,140 |
| **Total costs and expenses** | 360,027 | 364,297 |
| **Income before income taxes** | 29,012 | 34,099 |
| Income tax expense | 26,002 | 12,374 |
| **Net income** | $ 3,010 | $ 21,725 |

The accompanying notes are an integral part of these consolidated financial statements.

South University, LLC and Subsidiaries
Consolidated Statements of Member's Equity
*(In thousands)*

| | Net Investment of EDMC | Accumulated Earnings | Total Member's Equity |
|---|---|---|---|
| **Balance, June 30, 2012** | $ 91,272 | $ 94,789 | $ 186,061 |
| Decrease in net investment of EDMC | (70,930) | — | (70,930) |
| Net income | — | 21,725 | 21,725 |
| **Balance, June 30, 2013** | 20,342 | 116,514 | 136,856 |
| Decrease in net investment of EDMC | (13,850) | — | (13,850) |
| Net income | — | 3,010 | 3,010 |
| **Balance, June 30, 2014** | $ 6,492 | $ 119,524 | $ 126,016 |

The accompanying notes are an integral part of these consolidated financial statements.

# South University, LLC and Subsidiaries
# Consolidated Statements of Cash Flows
*(In thousands)*

| | For the Fiscal Year Ended June 30, | |
|---|---|---|
| **Cash flows from operating activities:** | **2014** | **2013** |
| Net income | $ 3,010 | $ 21,725 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation and amortization | 15,777 | 17,140 |
| Bad debt expense | 30,840 | 37,467 |
| Non-cash adjustments related to deferred rent | (1,577) | (1,167) |
| Deferred income taxes | 11,743 | 673 |
| Changes in assets and liabilities: | | |
| Restricted cash | 4,496 | 6,499 |
| Receivables | (42,070) | (49,618) |
| Reimbursements for tenant improvements | 433 | 5,345 |
| Other assets | 6 | 134 |
| Accounts payable | 701 | (178) |
| Accrued liabilities | (2,006) | 11,305 |
| Unearned tuition and advance payments | 5,080 | (4,889) |
| Total adjustments | 23,423 | 22,711 |
| **Net cash flows provided by operating activities** | 26,433 | 44,436 |
| | | |
| **Cash flows from investing activities:** | | |
| Expenditures for long-lived assets | (7,232) | (10,988) |
| Reimbursements for tenant improvements | (433) | (5,345) |
| **Net cash flows used in investing activities** | (7,665) | (16,333) |
| | | |
| **Cash flows from financing activities:** | | |
| Decrease in net investment of EDMC | (16,322) | (73,949) |
| **Net cash flows used in financing activities** | (16,322) | (73,949) |
| | | |
| **Net increase (decrease) in cash and cash equivalents** | 2,446 | (45,846) |
| **Cash and cash equivalents, beginning of year** | 17,525 | 63,371 |
| **Cash and cash equivalents, end of year** | $ 19,971 | $ 17,525 |

| | As of June 30, | |
|---|---|---|
| **Supplemental disclosure of cash flow information** | **2014** | **2013** |
| Capital expenditures in current liabilities | $ 1,003 | $ 1,105 |

The accompanying notes are an integral part of these consolidated financial statements.

## 1. OWNERSHIP, OPERATIONS, AND GOVERNANCE

South University, LLC and Subsidiaries ("South University" or the "University") is a nonsectarian, coeducational institution of higher education with campuses in the following cities:

- Savannah, Georgia
- West Palm Beach, Florida
- Montgomery, Alabama
- Tampa, Florida
- Columbia, South Carolina
- Richmond, Virginia
- Virginia Beach, Virginia
- Novi, Michigan
- Cleveland, Ohio
- High Point, North Carolina
- Austin, Texas

Additionally, the University's consolidated financial statements include campuses of the Art Institute in the following cities:

- Dallas, Texas
- Fort Worth, Texas
- Charlotte, North Carolina
- Raleigh-Durham, North Carolina

The University is a wholly-owned subsidiary of Education Management Corporation ("EDMC") and South University is accredited by the Commission on Colleges of the Southern Association of Colleges and Schools Commission on Colleges ("SACSCOC") to award Associate's, Bachelor's, Master's, and Doctoral degrees. Additionally, South University offers Associate's degree programs fully-online through South University-Savannah or through a flexible combination of both online and campus-based instruction.

On June 1, 2006, EDMC was acquired by a consortium of private equity investment funds led by Providence Equity Partners, Goldman Sachs Capital Partners and Leeds Equity Partners (collectively, the "Sponsors"). The acquisition was accomplished through the merger of an acquisition company into EDMC, with EDMC surviving the merger (the "Transaction"). The Transaction was accounted for as a purchase; however, the impact of the purchase accounting related to the Transaction was not allocated to the University's financial statements. The University's assets and liabilities, where applicable, continue to be recognized on a historical basis.

## 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

### Basis of Consolidation and Presentation (Including EDMC Debt Restructuring)

The accompanying consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States. All significant intercompany transactions and balances have been eliminated in consolidation. Unless otherwise specified, any reference to a "year" is to a fiscal year ended June 30.

EDMC has experienced deteriorating results from operations over the last several fiscal years, which coupled with the use of cash, created uncertainty as to EDMC's ability to continue as a going concern. EDMC has entered into the following agreements and taken the following actions to mitigate these risks:

- an amendment agreement dated September 5, 2014 (the "Amendment Agreement"), with the holders of in excess of 98% of the term loan facilities and 100% of the revolving credit facility (collectively, the "Consenting Lenders") pursuant to which, among other things, (i) the maturity on the revolving credit facility was extended from June 1, 2015 to July 2, 2015, (ii) the Consenting Lenders under the revolving credit facility agreed to accept payment of interest in kind rather than cash through June 30, 2015, (iii) the Consenting Lenders holding term loans agreed that no amortization payments will be payable through June 30, 2015 and to accept the payment of interest in kind rather than cash through June 30, 2015, (iv) EDMC became a guarantor and granted a lien on substantially all of its assets to secure the obligations under the agreement, (v) compliance with the financial covenants was waived through June 30, 2015, and (vi) the security agreement governing the credit facility was amended such that the collateral proceeds "waterfall" set forth therein now provides that obligations owing to any lenders that are not Consenting Lenders shall be paid only after satisfaction in full of obligations owing to Consenting Lenders and swap counterparties who have executed the RSA (as defined below);
- a supplemental indenture dated September 5, 2014 (the "Supplemental Indenture"), pursuant to which the Indenture governing the cash pay/PIK notes due 2018 (the "Cash Pay/PIK Notes") was amended (i) to require EDMC to offer all holders of the Cash Pay/PIK Notes the opportunity to receive the same consideration in the Debt Restructuring (as defined below) as holders of the Interim Notes (as defined below), (ii) to provide for (a) the release of EDMC's guarantee and (b) the termination of certain covenants and certain events of default, in each case upon the completion of the exchange of Cash Pay/PIK Notes and Interim Notes contemplated by the Debt Restructuring and (iii) to provide that if Education Management LLC is no longer subject to the reporting requirements of Section 13 or Section 15(d) of the Securities Exchange Act of 1934, it will not be required to file reports with the Securities and Exchange Commission but instead will be required to distribute annual, quarterly and current reports to the trustee under the Indenture and hold a conference call within 20 business days of furnishing required annual and quarterly reports;
- an exchange agreement dated September 5, 2014 (the "Exchange Agreement"), pursuant to which the holders of 86% of the outstanding Cash Pay/PIK Notes exchanged their Cash Pay/PIK Notes for a like principal amount of new Senior PIK Toggle Notes due 2018 (the "Interim Notes" and together with the Cash Pay/PIK Notes, the "Notes"), whose terms are substantially similar to those of the Cash Pay/PIK Notes, except that their interest is payable entirely in kind for the two interest periods ending September 30, 2014 and March 30, 2015;
- a new indenture dated September 5, 2014 (the "New Indenture"), pursuant to which the Interim Notes were issued; and
- a Restructuring Support Agreement dated September 4, 2014 (the "RSA"), pursuant to which the Consenting Lenders, holders of in excess of 65% of the outstanding Notes (the "Consenting Noteholders"), certain of EDMC's swap counter-parties and holders of in excess of 72% of EDMC's outstanding common stock (the "Consenting Shareholders") agreed to support a comprehensive debt restructuring ("Debt Restructuring") as described below.

Pursuant to the Debt Restructuring:

- $150 million of revolving loans under the existing revolving credit facility will be repaid in cash at par, with such amount available for re-borrowing under a new revolving credit facility;
- the remaining portion of EDMC's $1.5 billion of outstanding indebtedness, including the Interim Notes, will be exchanged for two first lien senior secured term loans due July 2, 2020 in the aggregate principal amount of $400 million, mandatorily convertible preferred stock, optionally convertible preferred stock and warrants for common stock; and
- EDMC's current shareholders will retain their outstanding common stock, which in aggregate will equal 4% of EDMC's outstanding common stock after giving effect to the conversion of all of the preferred stock described above and subject to further dilution by a management incentive plan (the "MIP") and warrants (including those described in the next sentence) to be awarded pursuant to the Debt Restructuring. In addition, current shareholders will receive warrants for 5% of EDMC's common stock (subject to dilution by the MIP).

In connection with the RSA, EDMC commenced an exchange offer for the outstanding Notes on October 1, 2014 pursuant to which the Notes would be exchanged for a combination of mandatory convertible preferred stock of EDMC and warrants to purchase common stock of EDMC. On October 29, 2014, EDMC announced an extension of the termination date of the exchange offer until November 24, 2014 due to a lawsuit filed by holders of approximately $20 million of the Notes seeking to enjoin EDMC from engaging in an intercompany sale transaction which EDMC has stated it plans to use in the event that less than 100% of holders of Notes participate in the exchange offer.

In addition to these actions, management has developed a plan to reduce cash outflows in fiscal 2015 in order to maintain sufficient liquidity to allow EDMC to meet its obligations as they become due. While no assurance can be given that management's plan will be fully implemented in fiscal 2015, based on the agreements executed and management's projected cash flows for fiscal 2015, management believes that cash flow from operations and available cash on hand, supplemented from time to time with borrowings under the revolving credit facility, will provide adequate funds for ongoing operations, required debt service and other obligations as they become due during the next twelve months.

The accompanying consolidated financial statements have been prepared on the assumption that EDMC and the University will continue to operate as a going concern and do not include any adjustments that might result from EDMC and the University not being able to continue as a going concern. Accordingly, assets and liabilities of the University are recorded on the basis that the University will be able to realize its assets and discharge its liabilities in the normal course of business.

**Use of Estimates**

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America ("GAAP") requires management to make estimates that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Management bases these estimates on assumptions that it believes to be reasonable under the circumstances. Actual results may differ from these estimates under different assumptions or conditions.

**Cash and Cash Equivalents and Restricted Cash**

The University considers all highly liquid instruments purchased with a maturity of three months or less to be cash equivalents. These investments are stated at cost, which approximates fair value.

The University holds funds from the United States government under various student aid grants and loan programs in separate bank accounts. The University also serves as trustee for the U.S.

Department of Education or respective lender, guaranty agency or student borrower, as applicable. The funds held in these bank accounts are not shown as cash or restricted cash on the consolidated balance sheet until the authorization and disbursement process has occurred. Once the authorization and disbursement process to the student has been completed, the funds are transferred to unrestricted cash accounts and become available for use in current operations, except as noted in footnote two to the table below. This transfer generally occurs for the period of the academic term for which such funds were authorized, with no term being more than 16 weeks in length.

Restricted cash was as follows at June 30 (in thousands):

| | 2014 | | 2013 | |
|---|---|---|---|---|
| Cash secured letters of credit [1] | $ | 37,900 | $ | 41,800 |
| Title IV funds in excess of charges applied [2] | | 2,295 | | 2,891 |
| **Total restricted cash** | $ | 40,195 | $ | 44,691 |

(1) Includes amounts related to two cash secured letter of credit facilities entered into by EDMC pursuant to which the lenders agreed to issue letters of credit to the U.S. Department of Education. Such cash is not available for any purpose other than to reimburse drawings under the letters of credit or to pay related fees and obligations. Refer to Note 3, "Governmental Regulations," for more information.

(2) U.S. Department of Education regulations require Title IV Program funds received by the University in excess of the charges applied to the relevant students at that time to be, with these students' permission, maintained and classified as restricted cash. In addition, some states have similar requirements. Such funds received for courses that have not yet begun are recorded as restricted cash due to legal restrictions on the use of the funds and as advance payments on the University's consolidated balance sheet. Funds transferred through electronic funds transfer programs are held in a separate cash account and released when certain conditions are satisfied. These restrictions have not significantly affected the University's ability to fund daily operations.

**Revenue Recognition**

The University's revenues are recorded net of student refunds and scholarships and consist primarily of tuition and fees, student housing fees, bookstore sales, restaurant sales in connection with culinary programs, workshop fees and sales of related study materials. The University derived approximately 94% and 95% of its net revenues from tuition and fees in the fiscal years ended June 30, 2014 and 2013, respectively.

The University bills tuition and housing revenues at the beginning of an academic term and recognizes the revenue on a pro rata basis over the term of instruction or occupancy. Some of the University's academic terms have starting and ending dates that differ from the University's fiscal quarters. Therefore, at the end of each fiscal year, the University has tuition from academic terms with respect to which the associated revenue has not yet been earned. Such amounts are recorded as unearned tuition as a current liability in the accompanying consolidated balance sheet. Advance payments are generally refundable and relate to payments received for future academic periods and are also recorded as a current liability in the accompanying consolidated balance sheet.

If a student withdraws from the University, a student's obligation for tuition and fees is limited depending on when a student withdraws during an academic term. Student refunds are regulated by the standards of the U.S. Department of Education, various state education authorities that regulate the University's schools, the Southern Association of Colleges and Schools Commission on Colleges (“SACSCOC”) and the University's institutional policies (collectively, “Refund Policies”). In the vast majority of situations, if a student withdrew from one of the University's schools after attending class for a portion of a term of instruction (ranging from approximately 40% to 70%), he or she would not be eligible for any reduction in tuition under the University's Refund Policies. Accordingly, the student would have to pay the University the balance of tuition and fees that has not been received already either in the form of financial aid or payments from the student. However, if a student withdraws from one of the University's schools prior to attending the full term of instruction (ranging from approximately 40%

to 70%), the University may reduce the amount of a student's obligation for tuition and fees based on a tiered approach under which, in general, the greater the portion of the academic term that has elapsed at the time the student withdraws, the greater the student's obligation is to the University for the tuition and fees related to that academic term. The University's reported net revenues are net of any reduction in the student's obligation to the University that results from any applicable Refund Policy.

Based on the application of its Refund Policies, the University may be entitled to incremental revenue on the day the student withdraws from one of its schools. Prior to fiscal 2014, the University recorded this incremental revenue, related student receivable and an estimate of the amount it did not expect to collect as bad debt expense during the fiscal quarter a student withdrew. Effective in fiscal 2014, the University reassesses collectability when a student withdraws from the institution (i.e., is no longer enrolled) and records this incremental revenue as it receives the related cash. This correction in policy had the effect of reducing net revenues and student receivables by $9.1 million and bad debt expense and the corresponding allowance for doubtful accounts by $8.1 million, which resulted in a decrease to earnings before taxes of $1.0 million in the fiscal year ended June 30, 2014. Prior year amounts were not corrected because the effects were not material.

**Student Receivables**

The University records student receivables at cost less an estimated allowance for doubtful accounts, which is determined on a quarterly basis based on the likelihood of collection considering students' enrollment status and historical payment experience. Historical collection experience is analyzed by disaggregating the student receivable balances based on predominant risk characteristics, such as whether the student is currently in-school, recently withdrew from school, or has not made a payment for a longer period of time. This level of disaggregation of student receivables results in individual pools of receivables which management believes appropriately differentiates credit risk in the portfolio and provides a reasonable basis to compute the estimate of loss. When certain criteria are met, which is generally when receivables age past the due date by more than four months, and internal collection measures have been taken without success, the accounts of former students are placed with a collection agency. Student accounts that have been placed with a collection agency are almost fully reserved and are written off after collection attempts have been unsuccessful.

During fiscal 2013, the University reduced the number of days since a student last paid after which accounts placed with a collection agency are written off. This change had no impact on the statement of operations or net student receivables as the applicable accounts were already fully reserved. Refer to Note 5, "Student Receivables," for more information.

**Leases**

The University leases certain classroom, dormitory, and office space as well as equipment under operating leases. Before entering into a lease, an analysis is performed to determine whether a lease should be classified as a capital or an operating lease.

Certain of the University's lease agreements include tenant improvement allowances. Once the lease agreement is signed, these tenant improvement allowances are recorded as other current assets with the offset to deferred rent liabilities on the consolidated balance sheet. Concurrent with the expenditures for lease improvements, the University records increases to leasehold improvement assets in property and equipment. Other current assets are reduced once the landlord reimburses the University. The deferred rent liabilities related to tenant improvements are amortized over the term of the lease as a reduction to rent expense upon possession of the lease space.

Most of the University's lease agreements contain escalation clauses under which, if fixed and determinable, rent expense is recognized on a straight-line basis over the lives of the leases, which generally range from three to 15 years with one or more renewal options. For leases with renewal options, the University records rent expense and amortizes the leasehold improvements on a straight-line basis over the original lease term, exclusive of the renewal period. When a renewal occurs, the University records rent expense over the new lease term.

**Property and Equipment**

Property and equipment is recorded at cost less accumulated depreciation. The University's property and equipment is depreciated over estimated useful lives ranging from three to 15 years using the straight-line method, depending on the asset. Leasehold improvements are amortized using the straight-line method over the shorter of the remaining lease term, exclusive of any renewal periods, or their estimated useful lives. Accelerated depreciation methods are generally used for income tax purposes. The University evaluates the recoverability of property and equipment whenever events or changes in circumstances indicate the carrying amount of such assets may not be fully recoverable. No impairments were recorded in fiscal 2014 and 2013.

**Goodwill and Intangible Assets**

The University was acquired by EDMC in fiscal 2004. As part of this business combination, goodwill was recorded, which consists of the cost in excess of the fair value of the identifiable net assets acquired. The University is required to perform a goodwill impairment test on an annual basis. No impairments have been recognized to date.

Intangible assets primarily consist of curriculum, which is recorded at cost. The University uses the straight-line method of amortization for these intangible assets over an estimated two-year useful life.

**Net Investment of EDMC**

The University participates in a cash management program operated by EDMC that allows EDMC to consolidate most cash from all its locations in order to maximize investment income. In addition, EDMC funds checks written on the University's disbursement bank account as they clear the disbursing bank. The difference between the cash provided to EDMC by the University and the day-to-day funding provided by EDMC to the University has been classified in member's equity as part of the net investment of EDMC in the balance sheets as there is no formal repayment schedule related to this amount. The net investment of EDMC balance also includes contributed capital.

**Costs and Expenses**

Educational services expense consists primarily of costs related to the development, delivery and administration of the University's education programs. Major cost components are faculty compensation, administrative salaries, facility occupancy costs, bad debt expense, costs of educational materials, information systems costs and support services provided by The Center as described in Note 7, "Related-Party Transactions."

General and administrative expense consists of marketing and student admissions expenses and certain central staff costs such as executive management, finance and accounting, legal, corporate development and other departments that do not provide direct services to the University's education programs.

Marketing costs, which are expensed as incurred and classified as general and administrative expense in the consolidated statements of operations, were $57.6 million and $54.6 million in the fiscal years ended June 30, 2014 and 2013, respectively.

**Contingencies**

The University accrues for contingent obligations when it is probable that a liability has been incurred and the amount is reasonably estimable. As facts concerning contingencies become known, management reassesses its position and makes appropriate adjustments to its consolidated financial statements.

**Income Taxes**

The University accounts for income taxes using the asset and liability method. Under this method, deferred tax assets and liabilities result from (i) temporary differences in the recognition of income and expense for financial and income tax reporting requirements, and (ii) differences between the recorded value of assets acquired in business combinations accounted for as purchases for financial reporting purposes and their corresponding tax bases. Deferred income tax assets are reduced by a valuation allowance if it is more-likely-than-not that some portion of the deferred income tax asset will not be realized.

The University is included in the federal consolidated tax return filed by EDMC. The University and EDMC do not have a formal tax-sharing agreement. The provision for income taxes (including the measurement of any necessary valuation allowance) in the accompanying statements of operations is calculated on a carve-out basis, giving recognition to the impact of filing in a consolidated group. The effective tax rate differs from the combined federal and state statutory rates primarily due to valuation allowances and expenses that are not deductible for tax purposes. State taxes are accrued and reported to the states where the University provides services.

**Fair Value**

The fair value of the University's cash and cash equivalents, restricted cash, student receivables, notes receivable, accounts payable and accrued expenses approximate their carrying values.

**Recent Accounting Pronouncements**

In May 2014, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") No. 2014-09, “Revenue from Contracts with Customers." The standard outlines a single comprehensive model for entities to use in accounting for revenue arising from contracts with customers and supersedes most current revenue recognition guidance. ASU 2014-09 is effective for fiscal years, and interim periods within those years, beginning after December 15, 2016, and early adoption is not permitted. The University is currently evaluating the impact that the standard will have on its financial condition, results of operations, and disclosures.

**Subsequent Events**

The University has evaluated subsequent events through November 3, 2014, the date through which these financial statements were available to be issued.

## 3. GOVERNMENTAL REGULATIONS

Most of the students at the University's schools rely, at least in part, on financial assistance to pay for the cost of their education. In the United States, the largest sources of such support are the federal student aid programs under Title IV of the Higher Education Act of 1965, as amended ("HEA"). Additional sources of funds include other federal grant programs, state grant and loan programs, private loan programs and institutional grants and scholarships. To provide students access to financial assistance resources available through Title IV programs, a school must be (i) authorized to offer its programs of instruction by the relevant agency of the states in which it is physically located and comply with applicable state requirements regarding fully-online programs, (ii) institutionally accredited by an agency recognized by the U.S. Department of Education, and (iii) certified as an eligible institution by the U.S. Department of Education. In addition, the University must ensure that Title IV program funds are properly accounted for and disbursed in the correct amounts to eligible students and remain in compliance generally with the Title IV program regulations. Most of the U.S. Department of Education's requirements, such as the financial responsibility standards and the 90/10 Rule, which are described in greater detail below, are applied on an institutional basis, with an institution defined as a main campus and its additional locations, if any.

*Financial Responsibility Standards.* Education institutions participating in Title IV programs must satisfy a series of specific standards of financial responsibility. The U.S. Department of Education has adopted standards to determine an institution's financial responsibility to participate in Title IV programs. The regulations establish three ratios: (i) the equity ratio, intended to measure an institution's capital resources, ability to borrow and financial viability; (ii) the primary reserve ratio, intended to measure an institution's ability to support current operations from expendable resources; and (iii) the net income ratio, intended to measure an institution's profitability. Each ratio is calculated separately, based on the figures in the institution's most recent annual audited financial statements, and then weighted and combined to arrive at a single composite score. The composite score must be at least 1.5 in order for the institution to be deemed financially responsible without conditions or additional oversight. If an institution fails to meet any of these requirements, the U.S. Department of Education may set restrictions on the institution's eligibility to participate in Title IV programs. Institutions are evaluated for compliance with these requirements as part of the U.S. Department of Education's renewal of certification process and also annually as each institution submits its audited financial statements to the U.S. Department of Education. As of June 30, 2014 and 2013, the University satisfied the financial responsibility standards.

As of June 30, 2014, EDMC did not meet the required quantitative measures of financial responsibility on a consolidated basis due to the amount of indebtedness incurred and goodwill it recorded in connection with the Transaction. Accordingly, EDMC is required by the U.S. Department of Education to post a letter of credit and is subject to provisional certification and additional financial and cash monitoring of its disbursements of Title IV funds. The amount of this letter of credit was $302.2 million at June 30, 2014, which equals 15 percent of the total Title IV aid received by students attending EDMC's institutions during the fiscal year ended June 30, 2013.

*The "90/10 Rule."* Under a provision of the HEA commonly referred to as the "90/10 Rule," an institution will cease to be eligible to participate in Title IV programs if, on a cash accounting basis, more than 90% of its revenues for each of two consecutive fiscal years were derived from Title IV programs as calculated under the applicable regulations. If an institution loses its Title IV eligibility under the 90/10 Rule, it may not reapply for eligibility until the end of two fiscal years. Institutions that fail to satisfy the 90/10 Rule for one fiscal year are placed on provisional certification. The University was in compliance with the 90/10 Rule for the fiscal years ended June 30, 2014 and 2013.

## 4. PROPERTY AND EQUIPMENT

Property and equipment consisted of the following as of June 30 (in thousands):

| Asset Class | 2014 | 2013 |
|---|---|---|
| Leasehold improvements | $ 63,159 | $ 59,867 |
| Technology and other equipment | 19,289 | 25,058 |
| Furniture and equipment | 27,291 | 18,991 |
| Library books | 6,652 | 6,145 |
| Construction in progress | 1,161 | 3,636 |
| Total | 117,552 | 113,697 |
| Accumulated depreciation | (70,445) | (61,851) |
| **Property and equipment, net** | $ 47,107 | $ 51,846 |

The University's depreciation and amortization expense, which includes amortization of intangible assets, was $15.8 million and $17.1 million in the fiscal years ended June 30, 2014 and June 30, 2013, respectively. Included in depreciation expense was approximately $2.5 million and $3.0 million for the fiscal years ended June 30, 2014 and June 30, 2013, respectively, that has been allocated from EDMC for assets which are not recorded in the University's consolidated financial statements but are utilized by the University.

## 5. STUDENT RECEIVABLES

The University offers three types of financial arrangements to its students to assist with the obligation associated with tuition and fees, which helps students fund the difference between total tuition and fees and the amount covered by various sources of financial aid, including amounts awarded under Title IV programs, private loans and cash payments: due and payable amounts; a tuition payment plan; and lines of credit. Due and payable amounts are short-term extensions of credit for typically small balances which are repayable upon demand by the University. Tuition payment plans are short-term credit extensions for 12 months or less. Lines of credit are extensions of credit which include a monthly minimum payment amount and permit students to repay amounts borrowed over a period of up to 42 months after graduation. During fiscal 2013, the University extended the repayment period for financing made available to students from a maximum of 36 months beyond graduation to a maximum of 42 months beyond graduation. Student receivables include $8.2 million (net of $7.4 million allowance) and $5.4 million (net of $4.7 million allowance) at June 30, 2014 and 2013, respectively, recorded in other long-term assets on the accompanying consolidated balance sheets related to lines of credit to students for amounts due beyond one year.

The University monitors its student receivables based on enrollment status. Receivables from out-of-school students are reserved for at a higher rate than receivables from students that are in-school. Receivables from out-of-school students include balances in collections, which are reserved for at a higher rate than balances not in collections. The gross current and non-current student receivables by student status were as follows at June 30 (in thousands):

| | 2014 | 2013 |
|---|---|---|
| In-school | $ 77,972 | $ 69,598 |
| Out-of-school | 38,900 | 41,396 |
| **Gross student receivables** | $ 116,872 | $ 110,994 |

A roll forward of the University's total allowance for doubtful accounts from June 30, 2012 to June 30, 2014 is as follows (in thousands):

| | | |
|---|---|---|
| **Balance June 30, 2012** | $ | 51,998 |
| Bad debt expense | | 37,467 |
| Amounts written off | | (48,495) |
| **Balance June 30, 2013** | | 40,970 |
| Bad debt expense | | 30,840 |
| Amounts written off | | (34,263) |
| **Balance June 30, 2014** | $ | 37,547 |

The amounts set forth above are recorded within student receivables, net and other long-term assets on the consolidated balance sheets. Recoveries of amounts previously written off were not significant in any period presented. Refer to Note 2, "Summary of Significant Accounting Policies," for more information.

## 6. ACCRUED LIABILITIES

Accrued liabilities consisted of the following as of June 30 (in thousands):

| | 2014 | 2013 |
|---|---|---|
| Employee compensation | $ 4,236 | $ 4,033 |
| Student support services | 1,619 | 3,424 |
| Capital expenditures | 294 | 729 |
| Taxes | 372 | 322 |
| Student refunds | 91 | 211 |
| Other (*) | 6,288 | 6,708 |
| **Total accrued liabilities** | $ 12,900 | $ 15,427 |

(*) Includes outstanding liability for which there is an offsetting insurance receivable included in notes, advances and other receivables on the accompanying consolidated balance sheet at June 30, 2014 and 2013.

## 7. RELATED-PARTY TRANSACTIONS

### Coordinating and Support Services

The University receives coordinating and support services from EDMC, such as legal, insurance, and information technology-related services. EDMC allocates costs to the University based upon certain factors including the University's revenues and student enrollment, which estimate the amount that the University would pay an unaffiliated entity for these services. In addition, during fiscal 2014, EDMC created "The Center," which provides support services to all of its campuses through the centralization and automation of certain non-student facing activities, including financial aid packaging, the qualification and transfer of prospective students to school admissions teams, student billing services, certain registrar services, support call center services for students and employees, and remote student advising services. The Center allocates costs to each campus based primarily on the level of transaction volume.

Total costs allocated by The Center and EDMC to the University were approximately $40.4 million and $35.7 million, which are included in general and administrative expense and educational services expense in the consolidated statements of operations in the fiscal years ended June 30, 2014 and 2013, respectively.

### Cash Management

Refer to Note 2, "Summary of Significant Accounting Policies," under "Net Investment of EDMC" for information regarding the University's cash management program.

**Employee Scholarships**

The University records revenues and expenses related to its internal tuition grant policy on a gross basis. The University received $3.3 million and $3.0 million in fiscal 2014 and 2013, respectively, relating to employees of other EDMC wholly-owned entities attending the University. In addition, the University paid $1.0 million and $0.8 million in fiscal 2014 and 2013, respectively, to other EDMC wholly-owned entities relating to its employees attending another EDMC wholly-owned institution.

**Leases**

South University, LLC, a wholly-owned subsidiary of EDMC, leased facilities under a long-term arrangement from two separate entities owned by John T. South, one of EDMC's executive officers. Total rental payments under these arrangements approximated $0.5 million in fiscal 2013. The facilities were sold to an unrelated third party in September 2012. Mr. South paid the University $0.8 million in connection with the closing of the sale of the properties due to the University's renegotiation of the leases prior to the sale.

The University's Tampa campus shares its physical location with the Art Institute of Tampa, which is also wholly-owned by EDMC. Certain building costs, primarily rent expense, are allocated by EDMC between South University of Tampa and the Art Institute of Tampa. Total rent expense for this shared location was $2.4 million in each of the fiscal years ended June 30, 2014 and 2013. Included in this amount was approximately $1.0 million that was allocated to South University of Tampa in each of the fiscal years ended June 30, 2014 and 2013 and is included in the accompanying consolidated statements of operations within educational services expense.

EDMC guarantees all of the University's lease agreements, under which EDMC assumes all obligations, liabilities, and duties of the University in the event of default. The guarantees are in place through the full terms of the leases, including any extensions or renewals. Refer to Note 9, "Commitments and Contingencies," for the University's remaining lease obligations.

**8. INCOME TAXES**

The provision for income taxes includes current and deferred taxes, as reflected below for the fiscal year ended June 30 (in thousands):

| Current taxes: | **2014** | **2013** |
|---|---|---|
| Federal | $ 13,142 | $ 10,181 |
| State | 1,117 | 1,520 |
| Total current tax provision | 14,259 | 11,701 |
| Deferred tax expense | 11,743 | 673 |
| **Income tax expense** | $ 26,002 | $ 12,374 |

As a result of the EDMC consolidated group being in a historical cumulative loss position, it was concluded that the group may not fully recognize the benefit of its deferred tax assets. As such, valuation allowances were recorded against certain federal and state deferred tax assets of the EDMC consolidated group. The deferred tax assets presented in the accompanying consolidated balance sheets reflect the impact of the recording of such valuation allowances against the University's deferred tax assets.

Deferred income taxes are presented in the consolidated balance sheets for all significant temporary differences between tax and financial reporting, which consist primarily of the allowance for doubtful accounts on student receivables, intangible assets, deferred rent, start-up costs and property and equipment. Net deferred income tax assets and liabilities consisted of the following at June 30 (in thousands):

| | 2014 | 2013 |
|---|---|---|
| Gross current deferred tax assets | $ 15,283 | $ 14,927 |
| Valuation allowance | (10,335) | (1,388) |
| **Total current deferred tax assets** | $ 4,948 | $ 13,539 |
| | | |
| Total noncurrent deferred tax assets | $ 8,587 | $ 7,555 |
| Valuation allowance | (4,964) | (177) |
| Total noncurrent deferred tax assets | 3,623 | 7,378 |
| Noncurrent deferred tax liabilities | 14,055 | 14,185 |
| **Total net noncurrent deferred tax liabilities** | $ 10,432 | $ 6,807 |

At June 30, 2014, the University had a North Carolina net operating loss carryforward of approximately $3.6 million available to offset future taxable income and a related deferred tax asset of $0.1 million. This carry forward expires in fiscal 2029. The University expects to fully utilize the net operating loss within the carryforward period.

## 9. COMMITMENTS AND CONTINGENCIES

### Qui Tam Matters

Washington v. Education Management Corporation. On May 3, 2011, a *qui tam* action captioned *United States of America, and the States of California, Florida, Illinois, Indiana, Massachusetts, Minnesota, Montana, New Jersey, New Mexico, New York and Tennessee, and the District of Columbia, each ex rel. Lynntoya Washington and Michael T. Mahoney v. Education Management Corporation, et al.* ("Washington") filed under the federal False Claims Act in April 2007 was unsealed due to the U.S. Department of Justice's decision to intervene in the case. Five of the states listed on the case caption joined the case based on *qui tam* actions filed under their respective False Claims Acts. The Court granted EDMC's motion to dismiss the District of Columbia from the case and denied the Commonwealth of Kentucky's motion to intervene in the case under its consumer protection laws.

The case, which is pending in federal district court in the Western District of Pennsylvania, relates to whether EDMC's compensation plans for admission representatives violated the HEA and U.S. Department of Education regulations prohibiting an institution participating in Title IV programs from providing any commission, bonus or other incentive payment based directly or indirectly on success in securing enrollments to any person or entity engaged in any student recruitment or admissions activity during the period of July 1, 2003 through June 30, 2011. The complaint was initially filed by a former admissions representative at The Art Institute of Pittsburgh Online Division and a former director of training at EDMC Online Higher Education and asserts the regulators are entitled to recover treble the amount of actual damages allegedly sustained by the federal government as a result of the alleged activity, plus civil monetary penalties. The complaint does not specify the amount of damages sought but claims that EDMC and/or students attending EDMC's schools received over $11 billion in funds from participation in Title IV programs and state financial aid programs during the period of alleged wrongdoing.

On May 11, 2012, the Court ruled on EDMC's motion to dismiss the case for failure to state a claim upon which relief can be granted, dismissing the claims that the design of EDMC's compensation plan for admissions representatives, which included both quantitative and qualitative factors, violated the incentive compensation rule and allowing common law claims and the allegations that the plan as implemented violated the rule to continue to discovery. On May 8, 2014, the Court denied EDMC's motion for summary judgment based on a statistical analysis of the salary adjustments for admissions representatives under the compensation plan. EDMC believes the case to be without merit and intends to vigorously defend itself. From time to time, EDMC engages in settlement discussions with respect to this case. At this time, EDMC is unable to estimate the amount of any reasonably possible loss related to this matter because of the status of current settlement negotiations and the fact that EDMC is only willing to settle the case if a settlement can be negotiated in an amount that EDMC believes is reasonable. There can be no assurance that the settlement conversations will lead to a settlement acceptable to all parties and approved by all parties. There can also be no assurance that any settlement will be within amounts currently accrued or be covered by insurance or not be material to EDMC.

In July 2014, our excess insurer filed a declaratory judgment action in federal district court in the Western District of Pennsylvania seeking a ruling that it has no liability to provide coverage to us in connection with the Washington and other qui tam litigation matters. Because of the many questions of fact and law that may arise, the outcome of this legal proceeding is uncertain at this point.

Sobek v. Education Management Corporation. On March 13, 2012, a *qui tam* action captioned *United States of America, ex rel. Jason Sobek v. Education Management Corporation, et al*. filed under the federal False Claims Act on January 28, 2010 was unsealed after the U.S. Department of Justice declined to intervene in the case. The case, which is pending in the federal district court in the Western District of Pennsylvania, alleges that the defendants violated the U.S. Department of Education's regulation prohibiting institutions from making substantial misrepresentations to prospective students, did not adequately track student academic progress and violated the U.S. Department of Education's prohibition on the payment of incentive compensation to admissions representatives. The complaint was filed by a former project associate director of admissions at EDMC Online Higher Education who worked for South University and asserts the relator is entitled to recover treble the amount of actual damages allegedly sustained by the federal government as a result of the alleged activity, plus civil monetary penalties. The complaint does not specify the amount of damages sought but claims that EDMC's institutions were ineligible to participate in Title IV programs during the period of alleged wrongdoing.

In August 2013, the parties to the action, along with the U.S. Department of Justice, participated in a private mediation in which the relator and defendants reached an agreement in principle regarding the financial terms of a potential settlement. The agreement between the parties remains subject to approval by the U.S. Department of Justice. Significant terms remain to be negotiated, and there is no certainty that a final agreement will be reached. The settlement amount agreed to by the parties under the terms of the agreement in principle would be paid by EDMC's insurer and EDMC would pay an immaterial amount of attorneys' fees incurred by the relator. The ultimate dismissal of the action, should a final settlement be reached, is subject to the Court's approval.

In the course of settlement discussions regarding the *Sobek* matter, the U.S. Department of Justice informed EDMC that it is the subject of an investigation related to a claim under the federal false claims act by the U.S. Attorney's Office for the Middle District of Tennessee. Additionally, in March 2014 the U.S. Department of Justice informed EDMC that it is the subject of an investigation related to a claim under the federal false claims act by the U.S. Attorney's Office for the Western District of Pennsylvania. EDMC plans to cooperate with the U.S. Department of Justice with regard to these matters. However, EDMC cannot predict the eventual scope, duration or outcome of the investigations at this time nor can it estimate any amount of a reasonably possible loss related to these investigations because of their status.

**Shareholder Derivative Lawsuits**

On May 21, 2012, a shareholder derivative class action captioned *Oklahoma Law Enforcement Retirement System v. Todd S. Nelson, et al.* was filed against the directors of EDMC in state court located in Pittsburgh, PA. EDMC is named as a nominal defendant in the case. The complaint alleges that the defendants violated their fiduciary obligations to EDMC's shareholders due to EDMC's violation of the

U.S. Department of Education's prohibition on paying incentive compensation to admissions representatives, engaging in improper recruiting tactics in violation of Title IV of the HEA and accrediting agency standards, improper classification of job placement data for graduates of its schools and failure to satisfy the U.S. Department of Education's financial responsibility standards. EDMC previously received two demand letters from the plaintiff which were investigated by a Special Litigation Committee of the EDMC Board of Directors and found to be without merit.

EDMC and the director defendants filed a motion to dismiss the case with prejudice on August 13, 2012. In response, the plaintiffs filed an amended complaint making substantially the same allegations as the initial complaint on September 27, 2012. EDMC and the director defendants filed a motion to dismiss the amended complaint on October 17, 2012. On July 16, 2013, the Court dismissed the claims that EDMC engaged in improper recruiting tactics and mismanaged EDMC's financial well-being with prejudice and found that the Special Litigation Committee could conduct a supplemental investigation of the plaintiff's claims related to incentive compensation paid to admissions representatives and graduate placement statistics. The Special Litigation Committee filed supplemental reports on October 15, 2013, January 9, 2014 and February 28, 2014, finding no support for the incentive compensation and graduate placement statistic claims. The Court held a hearing on the defendants' supplemental motion to dismiss the case on January 29, 2014 and granted the plaintiff's request for limited discovery on June 11, 2014.

On August 3, 2012, a shareholder derivative class action captioned *Stephen Bushansky v. Todd S. Nelson, et al.* was filed against certain of the directors of EDMC in federal district court in the Western District of Pennsylvania. EDMC is named as a nominal defendant in the case. The complaint alleges that the defendants violated their fiduciary obligations to EDMC's shareholders due to EDMC's use of improper recruiting, enrollment admission and financial aid practices and violation of the U.S. Department of Education's prohibition on the payment of incentive compensation to admissions representatives. EDMC previously received a demand letter from the plaintiff which was investigated by a Special Litigation Committee of the EDMC Board of Directors and found to be without merit. EDMC believes that the claims set forth in the complaint are without merit and intends to vigorously defend itself. EDMC and the named director defendants filed a motion to stay the litigation pending the resolution of the *Oklahoma Law Enforcement Retirement System* shareholder derivative case or, alternatively, dismiss the case on October 19, 2012. On August 5, 2013, the Court granted EDMC's motion to stay the case in light of the ruling on the defendants' motion to dismiss the *Oklahoma Law Enforcement Retirement System* case.

Because of the many questions of fact and law that may arise, the outcome of these legal proceedings is uncertain at this point. Based on the information presently available, EDMC cannot reasonably estimate a range of loss for these actions and, accordingly, has not accrued any liability associated with these actions.

**Securities Class Action**

On September 19, 2014, a securities class action complaint captioned *Robb v. Education Management Corporation*, et. al was filed against EDMC and certain of its executive officers. The complaint alleges violations of Sections 10(b) and 20(a) of the Exchange Act of 1934 and rule 10b-5 promulgated thereunder due to allegedly materially false and misleading statements made by EDMC during the period of August 8, 2012 through September 16, 2014 in connection with EDMC's filings with the SEC, press releases and other statements and documents. Because of the many questions of fact and law that may arise, the outcome of this legal proceeding is uncertain at this point. Based on the information available to us at present, we cannot reasonably estimate a range of loss for this action and, accordingly, we have not accrued any liability associated with this action.

**OIG Subpoena**

On May 24, 2013, EDMC received a subpoena from the Office of Inspector General of the U.S. Department of Education requesting policies and procedures related to Argosy University's attendance, withdrawal and return to Title IV policies during the period of July 1, 2010 through December 31, 2011 and detailed information on a number of students who enrolled in Argosy University's Bachelor's of Psychology degree program. EDMC plans to cooperate with the Office of Inspector General in connection with its investigation. However, EDMC cannot predict the eventual scope, duration or outcome of the investigation at this time nor can it estimate any amount of a reasonably possible loss related to the investigation because of its status.

**State Attorneys General Investigations**

EDMC received inquiries from 13 states in January 2014 and an additional state in March 2014 regarding EDMC’s business practices. The Attorney General of the Commonwealth of Pennsylvania informed EDMC that it will serve as the point of contact for the inquiries related to EDMC. The inquiries focus on EDMC's practices relating to the recruitment of students, graduate placement statistics, graduate certification and licensing results, and student lending activities, among other matters. Several other companies in the proprietary education industry have disclosed that they received similar inquiries. EDMC has cooperated with the states involved and, from time to time, engaged in preliminary discussions designed to lead to a settlement of the investigation. However, EDMC is unable to estimate the amount of any reasonably possible loss related to this matter or the eventual scope, duration or outcome of the investigation due to the nature and status of the preliminary discussions.

In October 2010, Argosy University received a subpoena from the Florida Attorney General's office seeking a wide range of documents related to EDMC's institutions, including the nine institutions located in Florida, from January 2, 2006 to the present. The Florida Attorney General has announced that it is investigating potential misrepresentations in recruitment, financial aid and other areas. EDMC is cooperating with the investigation, but has also filed a suit to quash or limit the subpoena and to protect information sought that constitutes proprietary or trade secret information. EDMC cannot predict the eventual scope, duration or outcome of the investigation at this time.

**Other Matters**

EDMC is a defendant in certain other legal proceedings arising out of the conduct of its business. Additionally, EDMC is subject to compliance reviews by various state and federal agencies which provide student financial aid programs, with respect to which noncompliance may result in liability for educational benefits paid as well as fines and other corrective action. In the opinion of management, based upon an investigation of these matters and discussion with legal counsel, the ultimate outcome of such other legal proceedings and compliance reviews, individually and in the aggregate, is not expected to have a material adverse effect on EDMC's consolidated financial position, results of operations or liquidity. At June 30, 2014, the University was not subject to any legal proceedings that are expected to have a material adverse effect on its consolidated financial position, results of operation or liquidity.

**Lease Commitments**

The University leases its facilities under various operating leases, some of which are with related parties (see Note 7, "Related-Party Transactions"), that expire on various dates through 2029. Rent expense under these leases was approximately $24.2 million and $22.2 million in the fiscal years ended June 30, 2014 and 2013, respectively.

The annual minimum future cash commitments for the fiscal years ending June 30 under the University's noncancelable, long-term operating leases are as follows at June 30, 2014 (in thousands):

| | |
|---|---|
| Fiscal Year: | |
| 2015 | $ 17,544 |
| 2016 | 16,465 |
| 2017 | 16,728 |
| 2018 | 17,112 |
| 2019 | 17,485 |
| Thereafter | 94,400 |

**Surety Bonds**

At June 30, 2014, the University has provided $9.7 million of surety bonds primarily to state regulatory agencies through three different surety providers.

**10. EMPLOYEE BENEFIT PLANS**

At June 30, 2014, EDMC sponsors a 401(k) plan that covers substantially all employees under which EDMC matches employee contributions to the retirement plan dollar for dollar up to 6%. All participants in the plan vest in EDMC's matching contributions immediately. The University's expense relating to this plan was $3.5 million and $3.4 million in the fiscal years ended June 30, 2014 and 2013, respectively, which is presented in educational services expense in the consolidated statements of operations. Effective September 20, 2014, EDMC suspended its matching program indefinitely.

# Supplemental Information

# South University, LLC and Subsidiaries

## Consolidating Balance Sheet *(Dollars in thousands)*

## June 30, 2014

| | South University -Savannah | South University -Tampa | South University-West Palm Beach | South University-Montgomery | South University-Richmond | South University-Columbia | South University Virginia Beach | South University-Novi | South University - Austin | South University - Cleveland | South University - Highpoint | The Art Institute of Dallas | The Art Institute of Fort Worth | The Art Institute of Charlotte | The Art Institute of Raleigh - Durham | Reclass-ifications & Eliminations | South University, LLC and Subsidiaries |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Cash and cash equivalents | $ 1,750 | $ 113 | $ 1,127 | $ 1,549 | $ 33 | $ 166 | $ 1,732 | $ 9 | $ 2,379 | $ 4,398 | $ 3,727 | $ 1,054 | $ 1,341 | $ 72 | $ 521 | $ — | $ 19,971 |
| Restricted cash | 26,863 | — | 4,092 | 3 | 400 | 3,534 | 1,000 | 4,000 | — | — | — | 116 | 32 | 105 | 50 | — | 40,195 |
| Total cash | 28,613 | 113 | 5,219 | 1,552 | 433 | 3,700 | 2,732 | 4,009 | 2,379 | 4,398 | 3,727 | 1,170 | 1,373 | 177 | 571 | — | 60,166 |
| Receivables: | | | | | | | | | | | | | | | | | |
| Trade | 30,246 | 7,086 | 5,811 | 5,354 | 6,685 | 10,173 | 6,124 | 4,844 | 1,537 | 2,455 | 2,183 | 4,250 | 944 | 9,304 | 4,303 | — | 101,299 |
| Allowance for doubtful accounts | (10,894) | (884) | (230) | (1,367) | (1,368) | (1,567) | (851) | (624) | (252) | (505) | (340) | (2,427) | (471) | (5,846) | (2,489) | — | (30,115) |
| Notes, advances, and other receivables | 10,822 | 269 | 9 | 3 | 3 | 64 | 7 | 3 | — | 40 | 4 | 1 | 44 | 22 | 11 | — | 11,302 |
| Deferred income taxes | 1,680 | 164 | 100 | 277 | 233 | 389 | 154 | 107 | 43 | 78 | 78 | 373 | 80 | 747 | 445 | — | 4,948 |
| Other current assets | 244 | 135 | 155 | 103 | 113 | 773 | 233 | 165 | 29 | 123 | 100 | 132 | 32 | 50 | 58 | — | 2,445 |
| **Total current assets** | 60,711 | 6,883 | 11,064 | 5,922 | 6,099 | 13,532 | 8,399 | 8,504 | 3,736 | 6,589 | 5,752 | 3,499 | 2,002 | 4,454 | 2,899 | — | 150,045 |
| Property and equipment, net | 2,207 | 1,012 | 5,864 | 1,963 | 4,312 | 3,103 | 2,250 | 3,219 | 1,167 | 3,807 | 3,524 | 6,130 | 1,171 | 2,000 | 5,378 | — | 47,107 |
| Investment in subsidiaries | 77,555 | — | — | — | — | — | — | — | — | — | — | — | — | — | — | (77,555) | — |
| Deferred income taxes | — | 110 | 233 | 265 | 222 | 338 | 30 | 23 | — | 6 | 340 | 483 | 159 | 184 | 102 | (2,495) | — |
| Other long-term assets | 919 | 303 | 15 | 721 | 1,006 | 1,285 | 448 | 436 | 66 | 164 | 98 | 426 | 90 | 1,433 | 866 | — | 8,276 |
| Intangible assets, net of amortization | 3,144 | — | 111 | 74 | — | 45 | — | — | — | — | — | — | — | — | — | — | 3,374 |
| Goodwill | 44,295 | — | — | — | — | — | — | — | — | — | — | — | — | 607 | — | — | 44,902 |
| **Total assets** | $ 188,831 | $ 8,308 | $ 17,287 | $ 8,945 | $ 11,639 | $ 18,303 | $ 11,127 | $ 12,182 | $ 4,969 | $ 10,566 | $ 9,714 | $ 10,538 | $ 3,422 | $ 8,678 | $ 9,245 | $ (80,050) | $ 253,704 |
| **Current liabilities:** | | | | | | | | | | | | | | | | | |
| Accounts payable | $ 2,125 | $ 184 | $ 123 | $ 86 | $ 117 | $ 220 | $ 216 | $ 197 | $ 30 | $ 120 | $ 119 | $ 26 | $ 19 | $ 172 | $ 38 | $ — | $ 3,792 |
| Accrued liabilities | 9,975 | 218 | 218 | 194 | 197 | 175 | 89 | 196 | 200 | 155 | 233 | 368 | 113 | 344 | 225 | — | 12,900 |
| Unearned tuition | 13,169 | 4,726 | 4,963 | 2,593 | 3,373 | 7,276 | 3,827 | 2,663 | 947 | 1,360 | 1,394 | — | — | — | — | — | 46,291 |
| Advance payments | 23,476 | 171 | 565 | 44 | 51 | 202 | 389 | 67 | 21 | 44 | 14 | 539 | 215 | 242 | 293 | — | 26,333 |
| **Total current liabilities** | 48,745 | 5,299 | 5,869 | 2,917 | 3,738 | 7,873 | 4,521 | 3,123 | 1,198 | 1,679 | 1,760 | 933 | 347 | 758 | 556 | — | 89,316 |
| Deferred income taxes | 12,897 | — | — | — | — | — | — | — | 30 | — | — | — | — | — | — | (2,495) | 10,432 |
| Deferred rent | 1,173 | 67 | 4,563 | 1,873 | 2,574 | 1,967 | 1,278 | 2,238 | 23 | 2,519 | 2,217 | 3,687 | 641 | 820 | 2,300 | — | 27,940 |
| **Member's equity:** | | | | | | | | | | | | | | | | | |
| Net investment of EDMC | 52,398 | (3,538) | (17,711) | (7,374) | 5,793 | (33,240) | 5,905 | 13,163 | 13,375 | 13,403 | 9,797 | (38,785) | 2,906 | (6,618) | 4,961 | (7,943) | 6,492 |
| Accumulated earnings (deficit) | 73,618 | 6,480 | 24,566 | 11,529 | (466) | 41,703 | (577) | (6,342) | (9,657) | (7,035) | (4,060) | 44,703 | (472) | 13,718 | 1,428 | (69,612) | 119,524 |
| **Total member's equity** | 126,016 | 2,942 | 6,855 | 4,155 | 5,327 | 8,463 | 5,328 | 6,821 | 3,718 | 6,368 | 5,737 | 5,918 | 2,434 | 7,100 | 6,389 | (77,555) | 126,016 |
| **Total liabilities and member's equity** | $ 188,831 | $ 8,308 | $ 17,287 | $ 8,945 | $ 11,639 | $ 18,303 | $ 11,127 | $ 12,182 | $ 4,969 | $ 10,566 | $ 9,714 | $ 10,538 | $ 3,422 | $ 8,678 | $ 9,245 | $ (80,050) | $ 253,704 |

# South University, LLC and Subsidiaries

## Consolidating Balance Sheet *(Dollars in thousands)*

## June 30, 2013

| | South University -Savannah | South University -Tampa | South University- West Palm Beach | South University- Montgomery | South University- Richmond | South University- Columbia | South University Virginia Beach | South University- Novi | South University - Austin | South University - Cleveland | South University - Highpoint | The Art Institute of Dallas | The Art Institute of Fort Worth | The Art Institute of Charlotte | The Art Institute of Raleigh - Durham | Reclass- ifications & Eliminations | South University, LLC and Subsidiaries |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Cash and cash equivalents | $ 243 | $ 19 | $ 1,572 | $ 8 | $ 1 | $ 1 | $ 3,791 | $ 1 | $ 2,288 | $ 4,690 | $ 3,893 | $ 1,042 | $ 10 | $ 8 | $ (42) | $ — | $ 17,525 |
| Restricted cash | 27,334 | 200 | 3,334 | 1,901 | 2,100 | 3,520 | 1,000 | 4,000 | — | — | — | 66 | 1,021 | 201 | 14 | — | 44,691 |
| Total cash | 27,577 | 219 | 4,906 | 1,909 | 2,101 | 3,521 | 4,791 | 4,001 | 2,288 | 4,690 | 3,893 | 1,108 | 1,031 | 209 | (28) | — | 62,216 |
| Receivables: | | | | | | | | | | | | | | | | | |
| Trade | 34,252 | 6,973 | 6,493 | 5,982 | 5,815 | 10,383 | 5,657 | 3,251 | 1,290 | 1,522 | 1,188 | 4,328 | 1,136 | 8,122 | 4,539 | — | 100,931 |
| Allowance for doubtful accounts | (17,965) | (1,012) | (743) | (1,368) | (773) | (1,545) | (785) | (411) | (203) | (206) | (130) | (2,753) | (518) | (5,414) | (2,470) | — | (36,296) |
| Notes, advances, and other receivables | 9,222 | 12 | 8 | 6 | 5 | 37 | 7 | 1 | — | — | 8 | (11) | 73 | (28) | 34 | — | 9,374 |
| Deferred income taxes | 6,407 | 430 | 346 | 570 | 321 | 608 | 324 | 186 | 78 | 90 | 67 | 1,005 | 198 | 1,914 | 995 | — | 13,539 |
| Other current assets | 239 | 132 | 143 | 114 | 157 | 218 | 284 | 102 | 35 | 75 | 93 | 467 | 48 | 57 | 53 | — | 2,217 |
| **Total current assets** | 59,732 | 6,754 | 11,153 | 7,213 | 7,626 | 13,222 | 10,278 | 7,130 | 3,488 | 6,171 | 5,119 | 4,144 | 1,968 | 4,860 | 3,123 | — | 151,981 |
| Property and equipment, net | 2,425 | 1,571 | 6,638 | 2,347 | 5,161 | 4,224 | 2,565 | 2,763 | 1,488 | 4,153 | 3,717 | 5,822 | 1,419 | 2,305 | 5,248 | — | 51,846 |
| Investment in subsidiaries | 85,155 | — | — | — | — | — | — | — | — | — | — | — | — | — | — | (85,155) | — |
| Deferred income taxes | — | 254 | 387 | 494 | 566 | 353 | — | 93 | — | — | 626 | 1,439 | 432 | 629 | 54 | (5,327) | — |
| Other long-term assets | 733 | 36 | 41 | 671 | 816 | 851 | 71 | 227 | 42 | 87 | 23 | 372 | 70 | 858 | 583 | — | 5,481 |
| Intangible assets, net of amortization | 4,101 | — | 133 | 89 | — | 54 | — | — | — | — | — | — | — | — | — | — | 4,377 |
| Goodwill | 44,295 | — | — | — | — | — | — | — | — | — | — | — | — | 607 | — | — | 44,902 |
| **Total assets** | $ 196,441 | $ 8,615 | $ 18,352 | $ 10,814 | $ 14,169 | $ 18,704 | $ 12,914 | $ 10,213 | $ 5,018 | $ 10,411 | $ 9,485 | $ 11,777 | $ 3,889 | $ 9,259 | $ 9,008 | $ (90,482) | $ 258,587 |
| **Current liabilities:** | | | | | | | | | | | | | | | | | |
| Accounts payable | $ 1,310 | $ 91 | $ 123 | $ 94 | $ 151 | $ 304 | $ 272 | $ 101 | $ 63 | $ 72 | $ 150 | $ 53 | $ 27 | $ 129 | $ 70 | $ — | $ 3,010 |
| Accrued liabilities | 12,020 | 227 | 205 | 152 | 106 | 128 | 146 | 145 | 183 | 127 | 132 | 1,195 | 98 | 323 | 241 | (1) | 15,427 |
| Unearned tuition | 12,143 | 4,361 | 5,015 | 3,050 | 2,991 | 7,630 | 3,259 | 2,010 | 820 | 1,029 | 828 | — | — | — | — | — | 43,136 |
| Advance payments | 21,370 | 176 | 106 | 70 | 32 | 126 | 359 | 56 | 12 | 5 | 9 | 1,201 | 305 | 324 | 257 | — | 24,408 |
| **Total current liabilities** | 46,843 | 4,855 | 5,449 | 3,366 | 3,280 | 8,188 | 4,036 | 2,312 | 1,078 | 1,233 | 1,119 | 2,449 | 430 | 776 | 568 | (1) | 85,981 |
| Deferred income taxes | 11,616 | — | — | — | — | — | 117 | — | 232 | 169 | — | — | — | — | — | (5,327) | 6,807 |
| Deferred rent | 1,126 | 103 | 4,856 | 2,015 | 2,911 | 1,466 | 1,429 | 2,416 | 83 | 2,674 | 2,305 | 3,795 | 717 | 823 | 2,224 | — | 28,943 |
| **Member's equity:** | | | | | | | | | | | | | | | | | |
| Net investment of EDMC | 66,248 | (1,229) | (13,922) | (6,685) | 7,800 | (27,553) | 8,685 | 11,449 | 10,443 | 11,000 | 8,162 | (39,885) | 2,879 | (7,072) | 4,024 | (14,002) | 20,342 |
| Accumulated earnings (deficit) | 70,608 | 4,886 | 21,969 | 12,118 | 178 | 36,603 | (1,353) | (5,964) | (6,818) | (4,665) | (2,101) | 45,418 | (137) | 14,732 | 2,192 | (71,152) | 116,514 |
| **Total member's equity** | 136,856 | 3,657 | 8,047 | 5,433 | 7,978 | 9,050 | 7,332 | 5,485 | 3,625 | 6,335 | 6,061 | 5,533 | 2,742 | 7,660 | 6,216 | (85,154) | 136,856 |
| **Total liabilities and member's equity** | $ 196,441 | $ 8,615 | $ 18,352 | $ 10,814 | $ 14,169 | $ 18,704 | $ 12,914 | $ 10,213 | $ 5,018 | $ 10,411 | $ 9,485 | $ 11,777 | $ 3,889 | $ 9,259 | $ 9,008 | $ (90,482) | $ 258,587 |

# South University, LLC and Subsidiaries

## Consolidating Statement of Operations *(Dollars in thousands)*

## For the Fiscal Year Ended June 30, 2014

| | South University-Savannah | South University-Tampa | South University-West Palm Beach | South University-Montgomery | South University-Richmond | South University-Columbia | South University-Virginia Beach | South University-Novi | South University - Austin | South University - Cleveland | South University - Highpoint | The Art Institute of Dallas | The Art Institute of Fort Worth | The Art Institute of Charlotte | The Art Institute of Raleigh - Durham | Reclassifications & Eliminations | South University, LLC and Subsidiaries |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **Net revenues** | $ 157,505 | $ 20,928 | $ 22,843 | $ 12,504 | $ 13,673 | $ 34,467 | $ 15,495 | $ 10,250 | $ 3,299 | $ 5,397 | $ 4,786 | $ 30,246 | $ 7,632 | $ 31,688 | $ 18,326 | $ — | $ 389,039 |
| **Costs and expenses:** | | | | | | | | | | | | | | | | | |
| Educational services | 74,456 | 10,765 | 11,370 | 8,009 | 9,246 | 15,967 | 8,452 | 6,222 | 4,181 | 5,005 | 4,514 | 17,321 | 4,046 | 20,162 | 12,956 | — | 212,672 |
| General and administrative | 64,174 | 5,785 | 5,485 | 3,670 | 3,313 | 6,953 | 4,712 | 3,541 | 2,780 | 3,176 | 2,265 | 10,132 | 2,828 | 8,555 | 4,209 | — | 131,578 |
| Depreciation and amortization | 4,868 | 774 | 1,217 | 533 | 998 | 1,488 | 581 | 533 | 630 | 574 | 455 | 1,068 | 381 | 772 | 905 | — | 15,777 |
| **Total costs and expenses** | 143,498 | 17,324 | 18,072 | 12,212 | 13,557 | 24,408 | 13,745 | 10,296 | 7,591 | 8,755 | 7,234 | 28,521 | 7,255 | 29,489 | 18,070 | — | 360,027 |
| Earnings in investment in subsidiaries | (1,540) | — | — | — | — | — | — | — | — | — | — | — | — | — | — | 1,540 | — |
| **Income (loss) before income taxes** | 12,467 | 3,604 | 4,771 | 292 | 116 | 10,059 | 1,750 | (46) | (4,292) | (3,358) | (2,448) | 1,725 | 377 | 2,199 | 256 | 1,540 | 29,012 |
| Income tax expense (benefit) | 9,457 | 2,010 | 2,174 | 881 | 760 | 4,959 | 974 | 332 | (1,453) | (988) | (489) | 2,440 | 712 | 3,213 | 1,020 | — | 26,002 |
| **Net income (loss)** | $ 3,010 | $ 1,594 | $ 2,597 | $ (589) | $ (644) | $ 5,100 | $ 776 | $ (378) | $ (2,839) | $ (2,370) | $ (1,959) | $ (715) | $ (335) | $ (1,014) | $ (764) | $ 1,540 | $ 3,010 |
| University "90/10" Ratio | | | | | | | | | | | | | | | | | |
| Numerator | | | | | | | | | | | | | | | | | $ 282,663 |
| Denominator | | | | | | | | | | | | | | | | | $ 352,520 |
| Rate | | | | | | | | | | | | | | | | | 80.2% |
| **Composite Score** | 3.0 | 2.4 | 2.1 | 2.5 | 1.9 | 2.9 | 2.9 | 2.3 | 1.8 | 1.8 | 1.8 | 2.0 | 2.9 | 3.0 | 2.0 | | 2.3 |

# South University, LLC and Subsidiaries
## Consolidating Statement of Operations *(Dollars in thousands)*
## For the Fiscal Year Ended June 30, 2013

| | South University-Savannah | South University-Tampa | South University-West Palm Beach | South University-Montgomery | South University-Richmond | South University-Columbia | South University-Virginia Beach | South University-Novi | South University - Austin | South University - Cleveland | South University - Highpoint | The Art Institute of Dallas | The Art Institute of Fort Worth | The Art Institute of Charlotte | The Art Institute of Raleigh - Durham | Reclassifications & Eliminations | South University, LLC and Subsidiaries |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **Net revenues** | $ 171,009 | $ 20,104 | $ 22,302 | $ 14,412 | $ 13,134 | $ 36,226 | $ 13,193 | $ 6,382 | $ 2,677 | $ 2,552 | $ 1,265 | $ 35,110 | $ 8,834 | $ 31,335 | $ 19,861 | $ — | $ 398,396 |
| **Costs and expenses:** | | | | | | | | | | | | | | | | | |
| Educational services | 85,276 | 10,095 | 10,911 | 7,923 | 7,526 | 15,239 | 6,487 | 4,356 | 3,743 | 3,369 | 2,204 | 19,111 | 3,915 | 18,108 | 12,538 | — | 210,801 |
| General and administrative | 65,918 | 5,772 | 5,123 | 3,610 | 4,328 | 6,775 | 5,269 | 3,320 | 2,721 | 2,907 | 1,992 | 11,216 | 3,497 | 8,585 | 5,323 | — | 136,356 |
| Depreciation and amortization | 5,761 | 828 | 946 | 589 | 685 | 1,743 | 564 | 494 | 550 | 479 | 251 | 1,597 | 402 | 1,355 | 896 | — | 17,140 |
| **Total costs and expenses** | 156,955 | 16,695 | 16,980 | 12,122 | 12,539 | 23,757 | 12,320 | 8,170 | 7,014 | 6,755 | 4,447 | 31,924 | 7,814 | 28,048 | 18,757 | — | 364,297 |
| Earnings in investment in subsidiaries | 12,784 | — | — | — | — | — | — | — | — | — | — | — | — | — | — | (12,784) | — |
| **Income (loss) before income taxes** | 26,838 | 3,409 | 5,322 | 2,290 | 595 | 12,469 | 873 | (1,788) | (4,337) | (4,203) | (3,182) | 3,186 | 1,020 | 3,287 | 1,104 | (12,784) | 34,099 |
| Income tax expense (benefit) | 5,113 | 1,186 | 1,826 | 837 | 159 | 4,756 | 286 | (646) | (1,548) | (1,405) | (1,279) | 1,130 | 395 | 1,141 | 423 | — | 12,374 |
| **Net income (loss)** | $ 21,725 | $ 2,223 | $ 3,496 | $ 1,453 | $ 436 | $ 7,713 | $ 587 | $ (1,142) | $ (2,789) | $ (2,798) | $ (1,903) | $ 2,056 | $ 625 | $ 2,146 | $ 681 | $ (12,784) | $ 21,725 |
| | | | | | | | | | | | | | | | | | |
| University "90/10" Ratio | | | | | | | | | | | | | | | | | |
| Numerator | | | | | | | | | | | | | | | | | $ 286,572 |
| Denominator | | | | | | | | | | | | | | | | | $ 355,314 |
| Rate | | | | | | | | | | | | | | | | | 80.7% |
| | | | | | | | | | | | | | | | | | |
| **Composite Score** | 3.0 | 2.7 | 2.4 | 3.0 | 2.9 | 2.9 | 3.0 | 1.8 | 1.8 | 1.8 | 1.8 | 2.0 | 3.0 | 3.0 | 2.3 | | 2.5 |

# South University, LLC and Subsidiaries
## Supplemental Schedule of Expenditures of State Financial Assistance
## For the Fiscal Year Ended June 30, 2014

| | CSFA No. | Grant No. | Expenditures | Transfers to Subrecipients |
|---|---|---|---|---|
| **FLORIDA DEPARTMENT OF EDUCATION** | | | | |
| Direct Projects: | | | | |
| Florida Student Assistance Grant | 48.054 | N/A | $ 348,550 | $ — |
| Florida Access to Better Learning and Education Grant | | N/A | 556,795 | — |
| Florida Children and Spouses of Deceased or Disabled Veterans and Service Members Scholarship | 48.055 | N/A | 4,986 | — |
| Florida Bright Futures Scholarship | 48.059 | N/A | 92,460 | — |
| TOTAL DIRECT PROJECTS | | | $ 1,002,791 | $ — |
| Indirect Projects: | | | $ — | $ — |
| Passed Through: | | | $ — | $ — |
| TOTAL FLORIDA DEPARTMENT OF EDUCATION | | | $ 1,002,791 | $ — |
| TOTAL EXPENDITURES OF STATE FINANCIAL ASSISTANCE | | | $ 1,002,791 | $ — |

## NOTE TO SCHEDULE OF EXPENDITURES OF STATE FINANCIAL ASSISTANCE

**BASIS OF PRESENTATION**

The information in this schedule is prepared on the accrual basis of accounting and is presented in accordance with Chapter 69I-5, Rules of the Florida Department of Financial Services, Florida Administrative Code, *Schedule of Expenditures of State Financial Assistance.*

# South University, LLC and Subsidiaries

Supplemental Schedule of Expenditures of State Financial Assistance
For the Fiscal Year Ended June 30, 2013

| | CSFA No. | Grant No. | Expenditures | | Transfers to Subrecipients | |
|---|---|---|---|---|---|---|
| **FLORIDA DEPARTMENT OF EDUCATION** | | | | | | |
| Direct Projects: | | | | | | |
| Florida Student Assistance Grant | 48.054 | N/A | $ | 317,900 | $ | — |
| Florida Access to Better Learning and Education Grant | — | N/A | | 515,517 | | — |
| Florida Children and Spouses of Deceased or Disabled Veterans and Service Members Scholarship | 48.055 | N/A | | 4,974 | | — |
| Florida Bright Futures Scholarship | 48.059 | N/A | | 93,031 | | — |
| TOTAL DIRECT PROJECTS | | | $ | 931,422 | $ | — |
| Indirect Projects: | | | $ | — | $ | — |
| Passed Through: | | | $ | — | $ | — |
| TOTAL FLORIDA DEPARTMENT OF EDUCATION | | | $ | 931,422 | $ | — |
| TOTAL EXPENDITURES OF STATE FINANCIAL ASSISTANCE | | | $ | 931,422 | $ | — |

## NOTE TO SCHEDULE OF EXPENDITURES OF STATE FINANCIAL ASSISTANCE

**BASIS OF PRESENTATION**

The information in this schedule is prepared on the accrual basis of accounting and is presented in accordance with Chapter 69I-5, Rules of the Florida Department of Financial Services, Florida Administrative Code, *Schedule of Expenditures of State Financial Assistance.*

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# Report of Independent Auditors 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*

The Member and Board of Trustees of
South University, LLC and Subsidiaries

We have audited, in accordance with auditing standards generally accepted in the United States 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 South University, LLC and Subsidiaries, which comprise the consolidated balance sheets as of June 30, 2014 and 2013, and the related consolidated statements of operations, member's equity and cash flows for the years then ended, and the related notes to the financial statements, and have issued our report thereon dated November 3, 2014.

**Internal Control Over Financial Reporting**

In planning and performing our audits of the financial statements, we considered South University, LLC and Subsidiaries' 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 South University, LLC and Subsidiaries' internal control. Accordingly, we do not express an opinion on the effectiveness of South University, LLC and Subsidiaries' internal control.

Our consideration of internal control was for the limited purpose described in the preceding paragraph and was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies and therefore, material weaknesses or significant deficiencies may exist that were not identified. However, as described in the accompanying Schedule of Findings and Responses, we identified a deficiency in internal control that we consider to be a material weakness.

A *deficiency in internal control* exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct misstatements on a timely basis. A *material weakness* is a deficiency, or combination of deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis. We consider the deficiency described in the accompanying Schedule of Findings and Responses to be a material weakness.

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 to those charged with governance.

**Compliance and Other Matters**

As part of obtaining reasonable assurance about whether South University, LLC and Subsidiaries' financial statements are free of 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 no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*.

**South University, LLC and Subsidiaries' Response to Findings**

South University, LLC and Subsidiaries' response to the findings identified in our audit is described in the accompanying Schedule of Findings and Responses. South University, LLC and Subsidiaries' response was not subjected to the auditing procedures applied in the audit of the financial statements and, accordingly, we express no opinion on it.

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

Ernst + Young LLP

November 3, 2014

# South University, LLC and Subsidiaries
## Schedule of Findings and Responses
### Year Ended June 30, 2014

| | |
|---|---|
| Criteria: | South University, LLC and Subsidiaries' (the "University") financial statements are prepared in accordance with U.S. generally accepted accounting principles ("GAAP"). |
| Condition: | The University did not maintain effective controls to ensure the proper selection of its revenue recognition policy. Personnel with the appropriate level of accounting knowledge, experience and training commensurate with the financial reporting requirements did not analyze certain accounting issues at the level of detail required to ensure proper application of GAAP in certain circumstances. Specifically, the process for analyzing the collectibility criterion for revenue recognition was not designed to assess collectibility, on a student-by-student basis, throughout the period revenue was recognized by the University. |
| Cause: | The University's lack of adequate internal controls over the selection of the revenue recognition policy did not appropriately reflect revenue recorded upon a student's withdrawal from University during a term of instruction. |
| Effect: | The lack of adequately designed controls over the proper selection of its revenue recognition policy could result in errors within the University's financial statements that could be material. |
| Recommendation: | We recommend that the University implement controls over the selection of the revenue recognition policy to appropriately assess collectibility, on a student-by-student basis, throughout the period revenue was recognized by the University. |
| Views of responsible officials planned corrective actions: | Management is committed to remediating the control deficiency that constitutes the material weakness by implementing changes to its internal control over financial reporting. Management is responsible for implementing changes and improvements in the internal control over financial reporting and for remediating the control deficiency that gave rise to the material weakness.<br><br>Management plans to achieve this primarily through instituting additional controls within the revenue recognition process. Management also plans to undertake additional review processes to ensure the related significant accounting policies are implemented and applied properly on a consistent basis throughout the University. Management believes these measures will remediate the control deficiency. However, to date, management has not completed the corrective actions that it believes are necessary. As management continues to evaluate and work to remediate the control deficiency that gave rise to the material weakness, it may determine to take additional measures to address the control deficiency. |

South University, LLC and Subsidiaries
Schedule of Findings and Responses
Year Ended June 30, 2013

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| Criteria: | The South University, LLC and Subsidiaries' (the "University") consolidated financial statements are prepared in accordance with U.S. generally accepted accounting principles. The account balances included within the consolidated financial statements are recorded as part of the University's financial statement close process. |
| Condition: | As a result of our audit procedures, which are based on prescribed materiality thresholds, we identified balance sheet reclassification adjustments that aggregated to approximately $8.3 million on an absolute basis primarily resulting from one transaction. These adjustments resulted in an increase to current assets and current liabilities with no impact to members' equity on the consolidated balance sheet. This deficiency was remediated by June 30, 2014 |
| Cause: | The University's internal controls over the financial statement close process did not timely identify these balance sheet reclassifications. |
| Effect: | The deficiencies identified in internal control over the financial statement close process could result in unidentified balance sheet reclassifications within the consolidated financial statements that could be more than inconsequential. |
| Recommendation: | We recommend that the University enhance the controls over the financial statement close process to identify all reclassifying adjustments to the consolidated balance sheet. |
| Views of responsible officials planned corrective actions: | Management believes it has an adequate internal control structure in place to identify and properly record transactions affecting the consolidated statements of operations, members' equity and cash flows of the University and its composite score, which was not impacted by these balance sheet reclassifying adjustments. In fiscal 2014, the University has added a new internal control to more thoroughly identify and properly record transactions affecting only the consolidated balance sheet. This deficiency was remediated by June 30, 2014. |