

**PACIFIC LEGAL FOUNDATION
AND SUBSIDIARY**

**CONSOLIDATED FINANCIAL STATEMENTS
WITH INDEPENDENT AUDITOR'S REPORT**

**YEARS ENDED
DECEMBER 31, 2015 AND 2014**

INDEPENDENT AUDITOR'S REPORT

**Board of Trustees
Pacific Legal Foundation and Subsidiary
Sacramento, California**

We have audited the accompanying consolidated financial statements of Pacific Legal Foundation and Subsidiary (Organization), which comprise the consolidated statements of financial position as of December 31, 2015 and 2014, and the related consolidated statements of activities, functional expenses, 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 accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of consolidated financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express an opinion on these consolidated financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audits 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 consolidated financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the consolidated financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements.

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

Opinion

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of the Organization as of December 31, 2015 and 2014, and the changes in their net assets and their cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

A handwritten signature in cursive script that reads "Gilbert Associates, Inc." The signature is written in black ink and is positioned above the printed name of the firm.

GILBERT ASSOCIATES, INC.
Sacramento, California

June 17, 2016

PACIFIC LEGAL FOUNDATION AND SUBSIDIARY

CONSOLIDATED STATEMENTS OF FINANCIAL POSITION DECEMBER 31, 2015 AND 2014

	<u>2015</u>	<u>2014</u>
ASSETS:		
Cash and cash equivalents	\$ 2,445,950	\$ 3,499,367
Investments	36,713,198	34,084,860
Contributions and other receivables	1,935,294	3,734,752
Prepaid expenses and deposits	120,158	190,751
Other assets	59,710	48,429
Charitable remainder trust assets	1,314,624	1,656,779
Property and equipment, net	<u>3,979,518</u>	<u>3,605,567</u>
TOTAL ASSETS	<u>\$ 46,568,452</u>	<u>\$ 46,820,505</u>
LIABILITIES AND NET ASSETS		
LIABILITIES:		
Accounts payable	\$ 181,687	\$ 114,668
Payable to secondary beneficiary from charitable remainder trust	47,529	47,529
Accrued expenses and other liabilities	1,138,506	1,107,164
Capital lease obligations	60,306	16,690
Liability to beneficiaries	<u>884,800</u>	<u>969,159</u>
Total liabilities	<u>2,312,828</u>	<u>2,255,210</u>
NET ASSETS:		
Unrestricted:		
Undesignated	6,686,941	8,114,623
Board designated	33,301,790	30,523,119
Temporarily restricted	3,169,881	4,768,889
Permanently restricted	<u>1,097,012</u>	<u>1,158,664</u>
Total net assets	<u>44,255,624</u>	<u>44,565,295</u>
TOTAL LIABILITIES AND NET ASSETS	<u>\$ 46,568,452</u>	<u>\$ 46,820,505</u>

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

PACIFIC LEGAL FOUNDATION AND SUBSIDIARY

CONSOLIDATED STATEMENT OF ACTIVITIES YEAR ENDED DECEMBER 31, 2015

	<u>Unrestricted</u>	<u>Temporarily Restricted</u>	<u>Permanently Restricted</u>	<u>Total</u>
OPERATING REVENUES:				
Contributions	\$ 5,935,914	\$ 1,183,318		\$ 7,119,232
Grants	2,901,574			2,901,574
Court-awarded attorney fees	186,827			186,827
Other income	45,776			45,776
Net assets released from restrictions	2,513,980	(2,513,980)		
Total revenues	<u>11,584,071</u>	<u>(1,330,662)</u>		<u>10,253,409</u>
OPERATING EXPENSES:				
Program services:				
Legal activities	4,460,308			4,460,308
Public education	1,741,045			1,741,045
Total program services	<u>6,201,353</u>			<u>6,201,353</u>
Supporting services:				
Revenue development	2,318,525			2,318,525
General and administrative	959,354			959,354
Total expenses	<u>9,479,232</u>			<u>9,479,232</u>
NET OPERATING INCOME (LOSS)	2,104,839	(1,330,662)		774,177
OTHER LOSSES:				
Investment loss	(709,299)		\$ (61,652)	(770,951)
Change in value of split-interest agreements	(44,551)	(268,346)		(312,897)
INCREASE (DECREASE) IN NET ASSETS	1,350,989	(1,599,008)	(61,652)	(309,671)
NET ASSETS, Beginning of year	<u>38,637,742</u>	<u>4,768,889</u>	<u>1,158,664</u>	<u>44,565,295</u>
NET ASSETS, End of year	<u>\$ 39,988,731</u>	<u>\$ 3,169,881</u>	<u>\$ 1,097,012</u>	<u>\$ 44,255,624</u>

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

PACIFIC LEGAL FOUNDATION AND SUBSIDIARY

CONSOLIDATED STATEMENT OF ACTIVITIES YEAR ENDED DECEMBER 31, 2014

	<u>Unrestricted</u>	<u>Temporarily Restricted</u>	<u>Permanently Restricted</u>	<u>Total</u>
OPERATING REVENUES:				
Contributions	\$ 7,050,985	\$ 2,781,355		\$ 9,832,340
Grants	3,080,619			3,080,619
Court-awarded attorney fees	194,174			194,174
Other income	3,517			3,517
Net assets released from restrictions	708,700	(708,700)		
Total revenues	<u>11,037,995</u>	<u>2,072,655</u>		<u>13,110,650</u>
OPERATING EXPENSES:				
Program services:				
Legal activities	3,904,252			3,904,252
Public education	1,517,519			1,517,519
Total program services	<u>5,421,771</u>			<u>5,421,771</u>
Supporting services:				
Revenue development	1,842,686			1,842,686
General and administrative	1,035,141			1,035,141
Total expenses	<u>8,299,598</u>			<u>8,299,598</u>
NET OPERATING INCOME	2,738,397	2,072,655		4,811,052
OTHER INCOME:				
Investment income	1,361,722	96,322	\$ 50,583	1,508,627
Change in value of split-interest agreements		30,819		30,819
INCREASE IN NET ASSETS	4,100,119	2,199,796	50,583	6,350,498
NET ASSETS, Beginning of year	<u>34,537,623</u>	<u>2,569,093</u>	<u>1,108,081</u>	<u>38,214,797</u>
NET ASSETS, End of year	<u>\$ 38,637,742</u>	<u>\$ 4,768,889</u>	<u>\$ 1,158,664</u>	<u>\$ 44,565,295</u>

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

PACIFIC LEGAL FOUNDATION AND SUBSIDIARY

CONSOLIDATED STATEMENT OF FUNCTIONAL EXPENSES YEAR ENDED DECEMBER 31, 2015

	<u>Program Services</u>		Total <u>Program</u> <u>Services</u>	<u>Supporting Services</u>		<u>Total</u>
	<u>Legal</u> <u>Activities</u>	<u>Public</u> <u>Education</u>		<u>Revenue</u> <u>Development</u>	<u>General &</u> <u>Admin.</u>	
Salaries	\$ 3,056,224	\$ 1,136,942	\$ 4,193,166	\$ 838,463	\$ 380,460	\$ 5,412,089
Employee benefits and insurance	382,443	86,423	468,866	93,730	102,578	665,174
Payroll taxes	207,168	59,454	266,622	57,410	56,728	380,760
Total compensation	<u>3,645,835</u>	<u>1,282,819</u>	4,928,654	989,603	539,766	6,458,023
Communications		235,918	235,918	1,050,589		1,286,507
Depreciation	177,921	67,188	245,109	48,812	21,150	315,071
Rent	145,662	54,188	199,850	39,962	18,135	257,947
Professional services	8,840		8,840		127,896	136,736
Office expenses	4,579	1,290	5,869	23,740	95,740	125,349
Case costs	118,243		118,243			118,243
Travel	49,394	20,252	69,646	23,130	10,110	102,886
Telephone	57,788	21,498	79,286	15,689	7,194	102,169
Equipment rental	52,583	19,561	72,144	14,722	6,251	93,117
Insurance	49,189	18,575	67,764	13,495	5,847	87,106
Library and research	83,531		83,531			83,531
Miscellaneous expenses	66,743	19,756	86,499	98,783	127,265	312,547
Total expenses	<u>\$ 4,460,308</u>	<u>\$ 1,741,045</u>	<u>\$ 6,201,353</u>	<u>\$ 2,318,525</u>	<u>\$ 959,354</u>	<u>\$ 9,479,232</u>

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

PACIFIC LEGAL FOUNDATION AND SUBSIDIARY

CONSOLIDATED STATEMENT OF FUNCTIONAL EXPENSES YEAR ENDED DECEMBER 31, 2014

	Program Services			Supporting Services		
	<u>Legal Activities</u>	<u>Public Education</u>	<u>Total Program Services</u>	<u>Revenue Development</u>	<u>General & Admin.</u>	<u>Total</u>
Salaries	\$ 2,756,937	\$ 996,799	\$ 3,753,736	\$ 776,130	\$ 465,838	\$ 4,995,704
Employee benefits and insurance	347,984	65,210	413,194	104,942	142,181	660,317
Payroll taxes	189,759	50,950	240,709	58,933	63,112	362,754
Total compensation	<u>3,294,680</u>	<u>1,112,959</u>	<u>4,407,639</u>	<u>940,005</u>	<u>671,131</u>	<u>6,018,775</u>
Communications		280,260	280,260	701,589		981,849
Depreciation	91,408	33,050	124,458	25,733	15,445	165,636
Rent	37,088	13,410	50,498	10,441	6,267	67,206
Professional services	7,618		7,618	2,619	133,747	143,984
Office expenses	10,749	709	11,458	9,488	78,218	99,164
Case costs	94,806		94,806			94,806
Travel	37,237	15,548	52,785	34,945	14,929	102,659
Telephone	49,854	18,025	67,879	14,035	8,424	90,338
Equipment rental	49,026	17,726	66,752	13,802	8,284	88,838
Insurance	67,739	6,395	74,134	4,979	2,989	82,102
Library and research	71,340		71,340			71,340
Miscellaneous expenses	92,707	19,437	112,144	85,050	95,707	292,901
Total expenses	<u>\$ 3,904,252</u>	<u>\$ 1,517,519</u>	<u>\$ 5,421,771</u>	<u>\$ 1,842,686</u>	<u>\$ 1,035,141</u>	<u>\$ 8,299,598</u>

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

PACIFIC LEGAL FOUNDATION AND SUBSIDIARY

CONSOLIDATED STATEMENTS OF CASH FLOWS YEARS ENDED DECEMBER 31, 2015 AND 2014

	<u>2015</u>	<u>2014</u>
CASH FLOWS FROM OPERATING ACTIVITIES:		
Increase (decrease) in net assets	\$ (309,671)	\$ 6,350,498
Reconciliation to net cash provided by operating activities:		
Net realized and unrealized (gain) loss on investments	1,610,041	(667,153)
Donated investments	(15,000)	(1,068,658)
Depreciation	315,071	165,636
Changes in:		
Contributions and other receivables	1,799,458	(2,263,433)
Prepaid expenses and deposits	70,593	(62,092)
Other assets	(11,281)	9,917
Charitable remainder trust assets	342,155	(6,906)
Accounts payable	67,019	64,794
Accrued expenses and other liabilities	79,276	50,679
Deferred rent		(205,181)
Liability to beneficiaries	<u>(84,359)</u>	<u>354,674</u>
Net cash provided by operating activities	<u>3,863,302</u>	<u>2,722,775</u>
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchase of property and equipment	(628,716)	(3,545,549)
Purchase of investments	(22,744,639)	(18,934,383)
Proceeds from sale of investments	<u>18,473,326</u>	<u>21,817,941</u>
Net cash used by investing activities	<u>(4,900,029)</u>	<u>(661,991)</u>
CASH FLOWS FROM FINANCING ACTIVITIES:		
Principal payments on capital lease obligations	<u>(16,690)</u>	<u>(18,285)</u>
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	(1,053,417)	2,042,499
CASH AND CASH EQUIVALENTS, Beginning of year	<u>3,499,367</u>	<u>1,456,868</u>
CASH AND CASH EQUIVALENTS, End of year	<u>\$ 2,445,950</u>	<u>\$ 3,499,367</u>
NON-CASH TRANSACTIONS:		
Charitable remainder trust assets transferred to investments	<u>\$</u>	<u>\$ 476,862</u>
Net realized and unrealized loss in investments held for supplemental pension plan and related change in liability	<u>\$ (47,934)</u>	<u>\$ (4,427)</u>

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

PACIFIC LEGAL FOUNDATION AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS DECEMBER 31, 2015 AND 2014

1. ORGANIZATION

Pacific Legal Foundation (Foundation) is a nonprofit public benefit corporation operating on voluntary, tax-deductible donations from the private sector, or through court-awarded attorneys' fees. Contributors consist of individuals, businesses, associations, and foundations from across the United States. The Foundation's mission is to protect the individual and economic freedoms of Americans by representing the economic, social, and environmental interests of the public in court while emphasizing private property rights, freedom from excessive government regulation, free enterprise, balanced environmental policy, and non-wasteful, productive and fiscally sound government. The Foundation is headquartered in Sacramento, California, with additional locations in the states of Alaska, Florida, Hawaii, Washington, and in Washington D.C.

PLF Building, LLC (LLC) is a wholly-owned subsidiary of the Foundation established to act as a title holding company.

2. SIGNIFICANT ACCOUNTING POLICIES

Principles of consolidation – The accompanying financial statements reflect the consolidation of the Foundation and the LLC (collectively, the Organization). Material transactions between entities have been eliminated in consolidation.

Basis of accounting and financial statement presentation – The consolidated financial statements are prepared on the accrual basis of accounting in conformity with professional standards applicable to not-for-profit entities. The Organization reports information regarding its financial position and activities according to three classes of net assets: unrestricted, temporarily restricted, and permanently restricted.

Revenue recognition – Contributions, grants, and promises to give are recognized in full when received or unconditionally promised, in accordance with professional standards. All contributions are considered available for unrestricted use unless specifically restricted by donors for future periods or specific purposes. Donor-restricted amounts are reported as increases in temporarily or permanently restricted net assets. Temporarily restricted net assets become unrestricted, and are reported in the *Consolidated Statement of Activities* as net assets released from restrictions, when the time restrictions expire or the contributions are used for the restricted purpose. Temporarily restricted contributions whose restrictions are met in the same reporting period are shown as unrestricted.

Court-awarded attorney fees are recorded when received.

Cash and cash equivalents – For financial statement purposes, the Organization considers all investments with a maturity at purchase of three months or less to be cash equivalents, unless held for long-term purposes.

The Organization minimizes credit risk associated with cash by periodically evaluating the credit quality of its primary financial institution. The balance at times may exceed federally insured limits. The Organization has not experienced any losses in such accounts and management believes the Organization is not exposed to any significant credit risk related to cash.

Investments are stated at fair value.

PACIFIC LEGAL FOUNDATION AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS DECEMBER 31, 2015 AND 2014

Property and equipment – Furniture, office equipment, library, and leasehold improvements are recorded at cost. The Organization capitalizes all expenditures of property and equipment in excess of \$250. Assets are depreciated using the straight-line method over estimated useful lives of three to thirty years.

Charitable remainder trust assets include the estimated fair value of irrevocable charitable trusts in which the Organization is both the trustee and secondary beneficiary, as well as the estimated fair value of the Organization's remainder interest in irrevocable trusts for which the Organization is the secondary beneficiary. The fair value of the Organization's remainder interest in irrevocable trusts is determined using investment returns consistent with the composition of the asset portfolios, life expectancies, and relevant discount rate. Irrevocable charitable trusts whose use is limited by the Organization due to time or donor-imposed restrictions increase temporarily restricted net assets.

Liability to beneficiaries represents the present value of the liability due to primary beneficiaries and other secondary beneficiaries of the irrevocable charitable remainder trusts and charitable gift annuities for which the Organization is both trustee and secondary beneficiary. On an annual basis, the Organization reviews the need to revalue the liability to make distributions to the designated beneficiaries based upon actuarial assumptions. The present value of the estimated future payments is calculated using discount rates ranging from 2.0% to 8.92% and applicable mortality tables. The current portion of the liability to beneficiaries at December 31, 2015 and 2014 was \$132,467 and \$142,017, respectively.

Functional expenses – The costs of providing the program and supporting services have been summarized on a functional basis in the *Consolidated Statement of Activities* and *Consolidated Statement of Functional Expenses*. Accordingly, certain costs have been allocated to program and supporting services in proportion to the estimated benefit received by each activity.

Income taxes – The Foundation is exempt from income taxes under Internal Revenue Code Section 501(c)(3), and is classified as a public charity within the meaning of Internal Revenue Code Section 509(a).

The Foundation has applied the accounting principles related to accounting for uncertainty in income taxes and has determined that there is no material impact on the consolidated financial statements. With some exceptions, the Foundation is no longer subject to U.S. federal and state income tax examinations by tax authorities for years prior to 2011.

Use of estimates – The preparation of consolidated financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect certain reported amounts and disclosures. Accordingly, actual results could differ from those estimates.

Recent Accounting Pronouncement – During 2015, the Foundation adopted ASU No. 2015-07 – *Fair Value Measurement (Topic 820): Disclosures for Investments in Certain Entities That Calculate Net Asset Value per Share (or Its Equivalent)*. This guidance removes the requirement to categorize within the fair value hierarchy investments whose fair values are measured at Net Asset Value (NAV) (or its equivalent) under the practical expedient in the fair value measurement guidance.

PACIFIC LEGAL FOUNDATION AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS DECEMBER 31, 2015 AND 2014

Reclassifications – Certain 2014 amounts have been reclassified to conform with the 2015 presentation.

Subsequent events have been evaluated through June 17, 2016, the date the consolidated financial statements were issued. Management concluded that no material subsequent events have occurred since December 31, 2015 that require recognition or disclosure in the financial statements.

3. RECEIVABLES

Receivables consist of the following:

	<u>2015</u>	<u>2014</u>
Pledges receivable	\$ 638,650	\$ 284,550
Contributions receivable	<u>1,296,644</u>	<u>3,450,202</u>
Total	<u>\$ 1,935,294</u>	<u>\$ 3,734,752</u>

Pledges, contributions, and other receivables are due to be collected as follows:

	<u>2015</u>	<u>2014</u>
Within one year	\$ 1,410,294	\$ 3,632,252
In one to five years	<u>525,000</u>	<u>102,500</u>
Total	<u>\$ 1,935,294</u>	<u>\$ 3,734,752</u>

Contributions receivable includes the expected residual value of a charitable remainder trust asset totaling \$24,000 and \$752,301 at December 31, 2015 and 2014, respectively. Although the charitable remainder trust matured in 2011 the underlying trust is in the process of being settled, therefore, the expected value fluctuates with market conditions and other fees and expenses.

4. PROPERTY AND EQUIPMENT

Property and equipment consist of the following:

	<u>2015</u>	<u>2014</u>
Building and related property	\$ 3,500,000	\$ 3,500,000
Office furniture and equipment	485,406	445,779
Furniture	367,620	366,227
Leasehold improvements	987,900	380,613
Library	<u>24,239</u>	<u>24,239</u>
Total	5,365,165	4,716,858
Less accumulated depreciation and amortization	<u>(1,385,647)</u>	<u>(1,111,291)</u>
Property and equipment, net	<u>\$ 3,979,518</u>	<u>\$ 3,605,567</u>

PACIFIC LEGAL FOUNDATION AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS DECEMBER 31, 2015 AND 2014

5. INVESTMENTS

Investment income is reported net of broker fees and commissions of \$145,738 and \$137,000 in 2015 and 2014, respectively.

Investments consist of the following:

	<u>2015</u>	<u>2014</u>
Money market funds	\$ 3,735,845	\$ 714,499
Mutual funds (equity):		
Value	1,472,529	4,321,738
Growth	4,097,100	6,012,653
Blend	104,569	4,908,319
Foreign	3,648,883	3,328,632
Core	4,883,663	
Diversified emerging markets		1,715,180
Long-short		699,758
Multi-strategy		1,475,909
Merger fund		287,979
Energy infrastructure		162,319
Real estate		1,681,975
Commodities		139,186
Active income		296,303
Mutual funds (fixed income):		
High yield	1,449,460	1,438,703
Emerging markets	700,808	754,635
Short-term	691,500	3,445,162
Intermediate-term	215,575	66,132
World bond	422,545	545,702
Income fund	925,772	1,025,008
Other	29,855	57,891
Equity securities:		
Value	4,818	
Growth	394,897	
Core	3,195,279	
Foreign	1,100,168	
Real estate investment trusts	1,668,689	
Other real assets	934,567	
Hedge funds:		
Macro	752,182	
Event driven	1,137,020	
Equity	1,493,601	
Corporate bonds	1,837,430	225,478
Government bonds	1,816,443	772,644
Other		<u>9,055</u>
Total	<u>\$ 36,713,198</u>	<u>\$ 34,084,860</u>

PACIFIC LEGAL FOUNDATION AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS DECEMBER 31, 2015 AND 2014

Investment income (loss) consists of the following:

	<u>2015</u>	<u>2014</u>
Interest and dividends	\$ 839,090	\$ 841,474
Net realized and unrealized gain (loss)	<u>(1,610,041)</u>	<u>667,153</u>
Total	<u>\$ (770,951)</u>	<u>\$ 1,508,627</u>

6. CHARITABLE REMAINDER TRUST ASSETS

Charitable remainder trust assets consist of the following:

	<u>2015</u>	<u>2014</u>
Assets held in charitable remainder trusts in which the Organization is both trustee and secondary beneficiary	\$ 572,209	\$ 656,123
Charitable remainder interests receivable from third parties	<u>742,415</u>	<u>1,000,656</u>
Total	<u>\$ 1,314,624</u>	<u>\$ 1,656,779</u>

7. FAIR VALUE MEASUREMENTS

Fair value is a market-based measurement, not an entity-specific measurement. For some assets and liabilities, observable market transactions or market information might be available. For other assets and liabilities, observable market transactions and market information might not be available. However, the objective of a fair value measurement in both cases is the same—to estimate the price at which an orderly transaction to sell the asset or to transfer the liability would take place between market participants at the measurement date under current market conditions (that is, an exit price at the measurement date from the perspective of a market participant that holds the asset or owes the liability). In order to increase consistency and comparability in fair value measurements, a fair value hierarchy that prioritizes observable and unobservable inputs is used to measure fair value into three broad levels, as follows:

Level 1 Inputs	Unadjusted quoted prices in active markets that are accessible at the measurement date for identical assets or liabilities.
Level 2 Inputs	Inputs other than quoted prices in active markets that are observable either directly or indirectly.
Level 3 Inputs	Unobservable inputs for the assets or liabilities.

When a price for an identical asset or liability is not observable, a reporting entity measures fair value using another valuation technique that maximizes the use of relevant observable inputs and minimizes the use of unobservable inputs. Because fair value is a market-based measurement, it is measured using the assumptions that market participants would use when pricing the asset or liability, including assumptions about risk. As a result, a reporting entity's intention to hold an asset or to settle or otherwise fulfill a liability is not relevant when measuring fair value.

PACIFIC LEGAL FOUNDATION AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS DECEMBER 31, 2015 AND 2014

The Organization's assets subject to fair value are classified as follows:

Year ending December 31, 2015:	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>
Investments	\$ 31,922,305	\$ 3,653,873	
Investments held in charitable remainder trusts in which the Foundation is both trustee and secondary beneficiary	572,209		
Charitable remainder interests receivable from third parties	<u> </u>	<u> </u>	\$ <u>742,415</u>
Total	<u>\$ 32,494,514</u>	<u>\$ 3,653,873</u>	<u>\$ 742,415</u>
Year ending December 31, 2014:	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>
Investments	\$ 33,077,683	\$ 1,007,177	
Investments held in charitable remainder trusts in which the Organization is both trustee and secondary beneficiary	656,123		
Charitable remainder interests receivable from third parties	<u> </u>	<u> </u>	\$ <u>1,000,656</u>
Total	<u>\$ 33,733,806</u>	<u>\$ 1,007,177</u>	<u>\$ 1,000,656</u>

The Organization's investments and investments held in charitable remainder trusts in which the Organization is both trustee and secondary beneficiary are classified within Level 1 of the fair value hierarchy because they are valued using quoted market prices, broker or dealer quotations, or alternative sources with reasonable levels of price transparency. The Organization's charitable remainder interests receivable from third parties are classified within Level 3 of the hierarchy because determination of the present value of future cash flows is based on little or no market data and requires management to develop their own assumptions. The Organization's investments are classified within Level 2 of the hierarchy because the value is calculated on the basis of pricing information obtained from various pricing sources and from inputs other than quoted prices in active markets.

Changes in the Level 3 assets consist of:

	<u>2015</u>	<u>2014</u>
January 1	\$ 1,000,656	\$ 1,000,570
Maturity of charitable remainder interests receivable		(21,719)
Purchases		
Unrealized gain (loss) in fair value	<u>(258,241)</u>	<u>21,805</u>
December 31	<u>\$ 742,415</u>	<u>\$ 1,000,656</u>

PACIFIC LEGAL FOUNDATION AND SUBSIDIARY

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The Foundation has an investment totaling \$1,137,020 in a multi-adviser hedge fund that is valued using the net asset value reported by the fund manager, which is used as a practical expedient to estimate the fair value. There are no outstanding capital calls on this investment and it is fully redeemable on a quarterly tender basis, subject to a 5% holdback for 12 months.

8. LEASE OBLIGATIONS

The Organization leases certain equipment and office space under long-term operating lease agreements, which expire at various dates through 2018. During 2014, the Foundation exercised its option to purchase their leased office building and terminate the rental agreement. Rental expense for 2015 and 2014 was \$299,306 and \$151,310, respectively. Future minimum lease payments are as follows:

Fiscal year ending December 31:

2016	\$	123,652
2017		75,673
2018		59,551
2019		<u>7,688</u>
Total	\$	<u>266,564</u>

9. LINE OF CREDIT

The Organization has a \$1,000,000 revolving line of credit agreement with Wells Fargo Bank that expired on February 1, 2015 and was not renewed. The interest on the line of credit was variable and was equal to the greater of the Bank's prime rate or 5%. There was no outstanding balance as of December 31, 2014.

10. NET ASSETS

Temporarily restricted net assets are available for the following purposes:

	<u>2015</u>	<u>2014</u>
<u>Time Restriction:</u>		
Charitable remainder trusts	\$ 953,765	\$ 1,232,233
Litigation	1,538,650	2,684,550
General operations	24,000	752,301
<u>Purpose Restriction:</u>		
Litigation	432,074	
Liberty Clinic	211,893	49,805
Building renovation		50,000
Other	<u>9,499</u>	<u> </u>
Total	<u>\$ 3,169,881</u>	<u>\$ 4,768,889</u>

PACIFIC LEGAL FOUNDATION AND SUBSIDIARY

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The Organization's endowments include both donor-restricted endowment funds and funds designated by the Board of Trustees to function as endowments. As required by GAAP, net assets associated with endowment funds, including funds designated by the Board of Trustees to function as endowments, are classified and reported based on the existence or absence of donor-imposed restrictions.

The Organization classifies as permanently restricted net assets (a) the original value of gifts donated to the permanent endowment, (b) accumulated unrealized appreciation and depreciation of endowment investments if directed by the donor gift instrument, (c) the original value of subsequent gifts to the permanent endowments, and (d) accumulations to the permanent endowment made in accordance with the direction of the applicable donor gift instrument at the time the accumulation is added to the fund. Permanently restricted net assets as of December 31, 2015 and 2014, consist of one endowment fund, and are to be invested in perpetuity with gains and losses. Interest and dividends are to be used for operating or other purposes as designated by the Board of Trustees.

Board endowments of \$33,301,790 and \$30,523,119 at December 31, 2015 and 2014, respectively, have been designated to provide annual income that is predictable and reliable to assure the ability of the Organization to meet long-term professional obligations inherent in the nature of its litigation services.

The endowment investment policy, approved by the Board of Trustees, emphasizes preservation of capital as its primary objective and growth and income as secondary objectives. Changes in endowment net assets are as follows:

	Board Designated Unrestricted	Permanently Restricted
Year ending December 31, 2015:		
Endowment net assets, beginning of year	\$ 30,523,119	\$ 1,158,664
Investment loss	(710,245)	(61,652)
Contributions	3,615,011	
Endowment funds used for operations		
Endowment expenditures	<u>(126,095)</u>	<u> </u>
Endowment net assets, end of year	<u>\$ 33,301,790</u>	<u>\$ 1,097,012</u>
	Board Designated Unrestricted	Permanently Restricted
Year ending December 31, 2014:		
Endowment net assets, beginning of year	\$ 32,724,733	\$ 1,108,081
Investment income	1,335,295	50,583
Contributions	1,634,236	
Endowment funds used for operations	(5,046,780)	
Endowment expenditures	<u>(124,365)</u>	<u> </u>
Endowment net assets, end of year	<u>\$ 30,523,119</u>	<u>\$ 1,158,664</u>

PACIFIC LEGAL FOUNDATION AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS DECEMBER 31, 2015 AND 2014

11. PENSION PLANS

The Organization has established a defined contribution supplemental pension plan for certain executive employees. The Organization annually accrues a fixed percentage of the covered executive employees' annual compensation. Pension expense for this plan was \$23,040 and \$21,800 for 2015 and 2014, respectively.

The Organization has a defined contribution pension plan under Internal Revenue Code Section 403(b). Employees are eligible to participate upon date of hire and are eligible to receive employer contributions after completing six months of service. On a discretionary basis, the Organization may make nonelective contributions. Plan expense was \$189,033 and \$166,430 for 2015 and 2014, respectively.