



Report of Independent Auditors and
Financial Statements with
OMB Circular A-133 Audit Reports and
Supplementary Information

**Palo Alto Institute for
Research and Education, Inc.**

September 30, 2012

MOSS ADAMS LLP

Certified Public Accountants | Business Consultants

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REPORT OF INDEPENDENT AUDITORS

To the Board of Directors
Palo Alto Institute for Research and Education, Inc.

We have audited the accompanying statement of financial position of Palo Alto Institute for Research and Education, Inc. (the "Organization"), as of September 30, 2012, and the related statements of activities, functional expenses, and cash flows for the year then ended. These financial statements are the responsibility of the Organization's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit also includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Organization's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, such financial statements referred to above present fairly, in all material respects, the financial position of the Organization as of September 30, 2012, and the changes in its net assets and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

In accordance with *Government Auditing Standards*, we have also issued our report dated December 13, 2012, on our consideration of the Organization's internal control over financial reporting and our tests of its compliance with certain provisions of laws, regulations, contracts, 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 the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our audit.

Our audit was conducted for the purpose of forming an opinion on the financial statements as a whole. The accompanying schedule of expenditure of federal awards is presented for purposes of additional analysis as required by U.S. Office of Management and Budget Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations* and is not a required part of the financial statements. Such information is the responsibility of management and was derived from and relates directly to the underlying accounting and other records used to prepare the financial statements. The information has been subjected to the auditing procedures applied in the audit of the financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the financial statements or to the financial statements themselves, and other additional procedures in accordance with auditing standards generally accepted in the United States of America. In our opinion, the accompanying schedule of expenditures of federal awards is fairly stated in all material respects in relation to the financial statements as a whole

Moss Adams LLP

San Francisco, California
December 14, 2012

FINANCIAL STATEMENTS

PALO ALTO INSTITUTE FOR RESEARCH AND EDUCATION, INC.
STATEMENT OF FINANCIAL POSITION
As of September 30, 2012

ASSETS	
CURRENT ASSETS:	
Cash and cash equivalents	\$ 1,289,837
Certificates of deposit	3,143,641
Accounts receivable	3,448,943
Prepaid expenses	172,566
Total current assets	<u>8,054,987</u>
CERTIFICATE OF DEPOSIT - long-term	44,876
EQUIPMENT, net	<u>604,486</u>
Total assets	<u>\$ 8,704,349</u>
LIABILITIES AND NET ASSETS	
CURRENT LIABILITIES:	
Accounts payable	\$ 521,337
Payroll payable	537,763
Accrued vacation	536,990
Other accrued liabilities	605,729
Deferred revenue	1,129,444
Total current liabilities	<u>3,331,263</u>
NET ASSETS:	
Unrestricted	
Board-designated	1,360,000
Undesignated	3,485,279
Total unrestricted	<u>4,845,279</u>
Temporarily restricted	<u>527,807</u>
Total net assets	<u>5,373,086</u>
Total liabilities and net assets	<u>\$ 8,704,349</u>

See accompanying notes.

PALO ALTO INSTITUTE FOR RESEARCH AND EDUCATION, INC.
STATEMENT OF ACTIVITIES
For the Year Ended September 30, 2012

	<u>Unrestricted</u>	<u>Temporarily Restricted</u>	<u>Total</u>
REVENUE AND OTHER SUPPORT:			
Federal award revenue	\$ 17,920,291	\$ -	\$ 17,920,291
Other program revenue	5,695,816	1,627,470	7,323,286
Interest income	14,144	837	14,981
Unrealized loss on certificates of deposit	(6,715)	-	(6,715)
Total revenue	<u>23,623,536</u>	<u>1,628,307</u>	<u>25,251,843</u>
NET ASSETS RELEASED FROM RESTRICTIONS:			
Satisfaction of program restrictions	<u>1,647,094</u>	<u>(1,647,094)</u>	<u>-</u>
Total revenue and other support	<u>25,270,630</u>	<u>(18,787)</u>	<u>25,251,843</u>
EXPENSES:			
Program expenses	18,609,098	-	18,609,098
Management and general expenses	5,954,491	-	5,954,491
Total expenses	<u>24,563,589</u>	<u>-</u>	<u>24,563,589</u>
Change in net assets	707,041	(18,787)	688,254
NET ASSETS, at beginning of year	<u>4,138,238</u>	<u>546,594</u>	<u>4,684,832</u>
NET ASSETS, at end of year	<u>\$ 4,845,279</u>	<u>\$ 527,807</u>	<u>\$ 5,373,086</u>

See accompanying notes.

PALO ALTO INSTITUTE FOR RESEARCH AND EDUCATION, INC.
STATEMENT OF FUNCTIONAL EXPENSES
For the Year Ended September 30, 2012

	<u>Program</u>	<u>Management and General</u>	<u>Total</u>
Personnel costs	\$ 12,197,269	\$ 3,668,755	\$ 15,866,024
Supplies	2,063,291	311,583	2,374,874
Subcontracts	2,361,198	-	2,361,198
Outside services	647,751	561,095	1,208,846
Comparative medicine	928,430	7,118	935,548
Computer maintenance & supplies	33,512	323,582	357,094
Travel	76,030	214,564	290,594
Maintenance and repairs	12,160	242,008	254,168
Depreciation	-	184,052	184,052
Professional fees	-	123,359	123,359
Subject payments	99,430	3,490	102,920
Meetings and conferences	29,157	65,336	94,493
Small equipment	26,080	40,019	66,099
VA services	61,211	3,036	64,247
Insurance	-	53,647	53,647
Office supplies	963	46,011	46,974
Postage and delivery	24,194	22,056	46,250
Dues and subscriptions	774	44,000	44,774
Printing and publication	14,456	26,414	40,870
Subject recruitment	24,521	1,022	25,543
Telecommunications	7,771	6,537	14,308
Books	900	4,881	5,781
Miscellaneous expense	-	1,907	1,907
Equipment lease	-	19	19
Totals	<u>\$ 18,609,098</u>	<u>\$ 5,954,491</u>	<u>\$ 24,563,589</u>

See accompanying notes.

PALO ALTO INSTITUTE FOR RESEARCH AND EDUCATION, INC.
STATEMENT OF CASH FLOWS
For the Year Ended September 30, 2012

CASH FLOWS FROM OPERATING ACTIVITIES:	
Change in net assets	\$ 688,254
Adjustments to reconcile change in net assets to net cash from operating activities:	
Depreciation	184,052
Unrealized loss on certificates of deposit	6,715
Decrease/(increase) in operating assets:	
Accounts receivable	(1,174,706)
Prepaid expenses	(46,074)
Increase/(decrease) in operating liabilities:	
Accounts payable	256,813
Payroll payable	(11,063)
Accrued vacation	(39,091)
Other accrued liabilities	33,159
Deferred revenue	379,899
Total adjustments	<u>(410,296)</u>
Net cash from operating activities	<u>277,958</u>
CASH FLOWS FROM INVESTING ACTIVITIES:	
Purchases of equipment	(90,356)
Purchases of certificate of deposits	(2,810,001)
Proceeds from sales of certificates of deposit	<u>2,909,847</u>
Net cash for investing activities	<u>9,490</u>
Net change in cash and cash equivalents	287,448
CASH AND CASH EQUIVALENTS, beginning of year	<u>1,002,389</u>
CASH AND CASH EQUIVALENTS, end of year	<u><u>\$ 1,289,837</u></u>

See accompanying notes.

PALO ALTO INSTITUTE FOR RESEARCH AND EDUCATION, INC.
NOTES TO FINANCIAL STATEMENTS

NOTE 1 – GENERAL DESCRIPTION OF ACTIVITIES AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Palo Alto Institute for Research and Education, Inc. (the “Organization”), was formed in 1988 as a research institute affiliated with the Department of Veterans Affairs Palo Alto Health Care System (“VA”) in Palo Alto, California, under the provisions of Public Law 100-322. The Organization works with sponsors and the VA in administering funds for conducting research to find new and improved ways to combat human disease and help people with disabilities.

Income is derived primarily from conducting investigative projects sponsored by public and private organizations. The Organization receives government grants and contracts as well as awards from private corporations and philanthropic foundations to pursue health research goals.

Basis of presentation – The accompanying financial statements have been prepared on the accrual basis of accounting in accordance with accounting principles generally accepted in the United States of America (“GAAP”).

Use of estimates – The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect certain reported amounts and disclosures. Accordingly, actual results could differ from those estimates.

Net asset classifications – Net assets, revenues, expenses, gains, and losses are classified based on the existence or absence of donor-imposed restrictions. Accordingly, net assets of the Organization and changes therein are classified and reported as follows:

Unrestricted net assets – Include those assets over which the Board of Directors has discretionary control in carrying out the operations of the Organization.

Temporarily restricted net assets – Net assets subject to donor-imposed restrictions that will be met either by actions of the Organization and/or the passage of time. When donor-stipulated time restriction ends or purpose restriction is accomplished, temporarily restricted net assets are reclassified to unrestricted net assets and reported in the statement of activities as net assets released from restrictions.

Permanently restricted net assets – Net assets that are subject to donor-imposed restrictions that specify assets donated be invested to provide a permanent source of income. There were no permanently restricted net assets as of September 30, 2012.

For the fiscal year ended September 30, 2012, the Organization had only unrestricted and temporarily restricted net assets. Temporarily restricted net assets as of September 30, 2012, relate primarily to contributions for which the research funds have not yet been spent for the purpose designated by the donor.

Revenue recognition – The Organization administers several different types of research agreements, including those that are reciprocal and nonreciprocal (charitable) in nature. Reciprocal agreements are typically on a per-subject payment schedule. Grant revenue is recognized when earned, generally in proportion to the expense incurred. Advance payments from sponsors are classified as deferred revenue and recognized as revenue upon expenditure of allowable costs or completion of the various stages of the studies.

Nonreciprocal revenues or contributions are reported as increases in restricted net assets if they are given with a donor-imposed restriction. Expiration of donor-imposed restrictions (i.e., the donor-stipulated purpose has been satisfied) is reported as satisfaction of program restrictions. The Organization reports donations as unrestricted revenue when the donor does not restrict its use as well as when the donor’s restrictions are met in the same reporting period.

Advance payments from government grants are not included as support until all conditions are substantially met. As of September 30, 2012, the unearned balance of advance conditional contributions was \$1,129,444, which is reported in deferred revenue in the statement of financial position.

Other program revenue includes both grants and contracts from public and private sources. Revenue is recognized as unrestricted or temporarily restricted as specified by the donor, either when received, when costs are incurred or when milestones are reached based on the individual grant or contract provisions.

PALO ALTO INSTITUTE FOR RESEARCH AND EDUCATION, INC.
NOTES TO FINANCIAL STATEMENTS

Cash and cash equivalents – The Organization considers short-term, highly liquid investments to be cash equivalents provided that they are both readily convertible to cash and had an original maturity of three months or less when purchased.

Certificates of deposit – Certificates of deposits are carried at fair value. The Organization has both the ability and the intent to hold them to maturity. Fair value is determined by discounting the related cash flows based on current yields of similar instruments with comparable durations considering the credit-worthiness of the issuer.

Accounts receivable – Accounts receivable are stated at the amount management expects to collect from outstanding balances after reserves for discounts, bad debts, and allowances, taking into account past experience, contracts, history and other organizations' ability to meet their obligations. Management provides for probable uncollectible amounts through a charge to expense and an increase to a valuation allowance based on its assessment of the current status of individual accounts. Balances that are still outstanding after management has used reasonable collection efforts are written off through a charge to the valuation allowance and a reduction of accounts receivable. Management has deemed all accounts receivable collectible.

Equipment – Equipment is stated at cost. Depreciation is computed using the straight-line method over the assets' estimated useful lives ranging from three to seven years. The Organization has adopted a capitalization policy of capitalizing equipment purchases of \$5,000 or more.

Fair value of financial instruments – Unless otherwise indicated, the fair values of all reported assets and liabilities, which represent financial instruments, approximate their carrying values.

Accrued vacation – Accrued vacation represents vacation earned but not taken. The maximum vacation time that can be accrued is 240 hours. The accrued vacation balance as of September 30, 2012, was \$536,990.

Deferred revenue – The Organization receives advances for services to be performed in the future. The amounts are recorded as deferred revenue when received and are recognized as revenue when the services are provided.

Functional expenses allocation – All costs are charged directly to the appropriate functional expense category.

Income taxes – Palo Alto Institute for Research and Education, Inc. is a nonprofit corporation exempt from federal income tax under Internal Revenue Code section 501(c)(3) and state income tax under California Revenue and Taxation Code section 23701(d). The Organization qualifies for the charitable contribution deduction under IRC section 170(b)(1)(A)(iii) and has been classified as an Organization that is not a private foundation under section 509(a)(1). As of September 30, 2012, the Organization had no unrecognized tax benefits or uncertain tax positions requiring accrual. Therefore, no provision for income taxes has been provided in the financial statements. With few exceptions, the Organization is no longer subject to the United States federal or state local income tax examinations by tax authorities for fiscal years before 2007.

NOTE 2 – EQUIPMENT

Equipment is comprised of the following as of September 30, 2012:

Medical research assets	\$ 1,118,945
Administrative assets	593,187
Less accumulated depreciation	<u>(1,107,646)</u>
Equipment, net	<u><u>\$ 604,486</u></u>

Depreciation expense for the year ended September 30, 2012, was \$184,052.

PALO ALTO INSTITUTE FOR RESEARCH AND EDUCATION, INC.
NOTES TO FINANCIAL STATEMENTS

NOTE 3 – TEMPORARILY RESTRICTED NET ASSETS

Temporarily restricted net assets as of September 30, 2012, are available for the following purposes:

Research restricted donations	\$ 524,009
Educational activities	3,429
Private foundation grants, for research	369
Total	<u>\$ 527,807</u>

Net assets were released from donor restrictions during the year ended September 30, 2012, by incurring expenses to satisfy the purpose of the restriction, by the passage of time, or by the occurrence of other specific events as shown in the table below:

Research restricted donations	\$ 1,647,094
Total	<u>\$ 1,647,094</u>

NOTE 4 – RETIREMENT PLAN

The Organization’s retirement plan (under Internal Revenue Code section 401(k)) includes a defined contribution retirement plan (of the profit-sharing type) and a cash or deferred arrangement. All employees are eligible for the plan except for temporary employees. A temporary employee is one who is hired to work for twelve months or less. Eligible employees may elect to defer a percentage of their salary into the plan. After one year of service, the Organization matches participants’ contributions up to 5% of the individual participant’s compensation. Additionally, the Organization makes annual profit-sharing contributions of up to 5% of eligible employee compensation. Postdoctoral Fellows hired after January 1, 2008 are not eligible for the match or profit-sharing contributions. Contributions made to the plan by the Organization were \$616,104 for the year ended September 30, 2012. Plan assets are not reflected in the accompanying financial statements.

NOTE 5 – RELATED PARTY TRANSACTIONS

In 1988, the Organization was incorporated in the State of California in accordance with Title 38 of the United States Code Chapter 73 Subchapter VI-Research Corporations, as established by Public Law 100-322. The Organization provides a flexible funding mechanism for the conduct of approved research at the VA Palo Alto Health Care System (“VAPAHCS”). Furthermore, as stipulated by statute, the persons holding the positions of Director, Chief of Staff, Associate Chief of Staff for Research and Development and Associate Chief of Staff for Education of VAPAHCS shall be permanent board members of the Organization.

The majority of the Organization’s board of directors are employed or affiliated with the VA. The Organization reimburses the VA for various services. Expenses incurred for services received from the VA were approximately \$803,672 for the fiscal year; in addition, the Organization was indebted to the VA in the amount of \$16,250, which is included in accounts payable as of September 30, 2012.

Additionally, the Organization charges the VA for some personnel costs via the Intergovernmental Personnel Act (“IPA”) of 1970. Costs expended include salaries and wages, as well as payroll taxes and other benefit costs. Reimbursements for these costs were approximately \$2,092,943 for the year ended September 30, 2012. These costs were included in personnel costs on the statement of functional expenses. At September 30, 2012, the VA was indebted to the Organization in the amount of \$929,169. The VA provides office space and utilities to the Organization at no cost. The value of these services is approximately \$118,580, which has not been recorded in the financial statements by management.

NOTE 6 – CONCENTRATIONS

During the year ended September 30, 2012, the Organization received approximately 84% of its revenue from three sources. Grants from the U.S. Department of Health & Human Services National Institutes of Health accounted for 66%, U.S. Department of Defense 5%, and private foundations 13%. The Organization has long-term agreements with each of these agencies and does not anticipate a decrease in revenue from these sources.

PALO ALTO INSTITUTE FOR RESEARCH AND EDUCATION, INC.
NOTES TO FINANCIAL STATEMENTS

Major funding – As of September 30, 2012, the Organization has receivables from the U.S. Department of Health and Human Services National Institutes of Health of \$1,107,354, or 32% of total accounts receivable as of September 30, 2012; Stanford University of \$477,532, or 14% of total accounts receivable as of September 30, 2012; and the VA of \$929,169, or 27% of total accounts receivable as of September 30, 2012.

Major vendor – The Organization incurred expenses from one vendor for the year ended September 30, 2012, of \$2,821,018, or 15% of program expenses as of September 30, 2012.

NOTE 7 – COMMITMENTS AND CONTINGENCIES

The Organization has received federal grants for specific purposes that are subject to review and audit by the federal government. Although such audits could result in expenditure disallowances under grant terms, management believes the Organization is in substantial compliance with current laws and regulations and that any potential liability arising from compliance issues will not be material to the Organization’s financial position and results of operations as of and for the year ended September 30, 2012.

Board designated funds – The Organization’s Board has designated \$1,360,000 of unrestricted net assets, which are not to be spent without specific board approval.

NOTE 8 – FAIR VALUE MEASUREMENT

Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. The fair value hierarchy requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. The standard describes three levels of inputs that may be used to measure fair value:

- Level 1 Quoted prices in active markets for identical assets or liabilities

- Level 2 Observable inputs other than Level 1 prices, such as quoted prices for similar assets or liabilities; quoted prices in active markets that are not active; or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities

- Level 3 Unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities

Following is a description of the valuation methodologies used for instruments measured at fair value on a recurring basis and recognized in the accompanying statement of financial position, as well as the general classification of such instruments pursuant to the valuation hierarchy.

Where quoted market prices are available in an active market, investments are classified within Level 1 of the valuation hierarchy. Level 1 investments include highly liquid government bonds and exchange traded equities. If quoted market prices are not available, then fair values are estimated by using pricing models, quoted prices of investments with similar characteristics or discounted cash flows. Level 2 investments include most fixed income investments traded in a limited market and certificates of deposit. In certain cases where Level 1 or Level 2 inputs are not available, investments are classified within Level 3 of the hierarchy.

The following table presents the fair value measurements of assets recognized in the accompanying statement of financial position measured at fair value on a recurring basis and the level within the fair value hierarchy in which the fair value measurements fall at September 30, 2012:

<u>Description</u>	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>	<u>Total</u>
Certificates of deposit	\$ -	\$ 3,188,517	\$ -	\$ 3,188,517

PALO ALTO INSTITUTE FOR RESEARCH AND EDUCATION, INC.
NOTES TO FINANCIAL STATEMENTS

NOTE 9 – SUBSEQUENT EVENTS

Subsequent events are events or transactions that occur after the statement of financial position date but before financial statements are issued. The Organization recognizes in the financial statements the effects of all subsequent events that provide additional evidence about conditions that existed at the date of the statement of financial position, including the estimates inherent in the process of preparing the financial statements. The Organization's financial statements do not recognize subsequent events that provide evidence about conditions that did not exist at the date of the statement of financial position but arose after the statement of financial position date and before financial statements are available to be issued.

The Organization has evaluated subsequent events through December 14, 2012, which is the date the financial statements are available to be issued.

SUPPLEMENTARY INFORMATION

PALO ALTO INSTITUTE FOR RESEARCH AND EDUCATION, INC.
SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS
For the Year Ended September 30, 2012

Federal Grantor/Pass-Through Grantor/Program or Cluster Title	Federal CFDA Number (*)	Pass-Through Entity Identifying Number	Federal Expenditures
<i>Research and Development Cluster</i>			
U.S. Department of Defense:			
Basic and Applied Scientific Research	12.300		\$ 287,222
Military Medical Research and Development	12.420		933,844
Subtotal Direct Programs			<u>1,221,066</u>
Pass-through programs from:			
HM Jackson Foundation - Military Medical Research and Development		W91Y7Z-11-C-0033	643,279
University of Southern California - Military Medical Research and Development	12.420	W81XWH-10-2-0076	4,368
Smith-Kettlewell Eye Research Institute - Military Medical Research and Development	12.420	W81XWH-11-2-0066	10,502
Craig Hospital - Military Medical Research and Development	12.420	W81XWH-11-1-0635	22,926
Stanford University - Military Medical Research and Development	12.420	W81XWH-10-2-0178	42,445
Veterans Medical Research Foundation - Military Medical Research and Development	12.420	W81XWH-10-2-0104	35,020
Subtotal pass-through programs			<u>758,540</u>
Total U.S. Department of Defense			<u>1,979,606</u>
National Science Foundation:			
Engineering Grants	47.041	ECCS-0901292	78,789
Total National Science Foundation			<u>78,789</u>
U.S. Department of Education			
Pass-through programs from:			
Rehabilitation Institute of Chicago - National Institute on Disability and Rehabilitation Research	84.133	H133G090093	10,479
AFB Tech - National Institute on Disability and Rehabilitation Research	84.133	H133G090026	8,184
Total U.S. Department of Education			<u>18,663</u>
U.S. Department of Health and Human Services:			
Research and Training in Complementary and Alternative Medicine	93.213		432,802
National Center on Sleep Disorders Research	93.233		294,104
Mental Health Research Grants	93.242		2,107,577
Alcohol Research Programs	93.273		858,383
Drug Abuse and Addiction Research Programs	93.279		123,614
Minority Health and Health Disparities Research	93.307		85,054
Trans-NIH Research Support	93.310		648,259
Nursing Research	93.361		6,227
Cancer Cause and Prevention Research	93.393		265,841
Cancer Biology Research	93.396		202,358
Trans-NIH Recovery Act Research Support - ARRA	93.701		233,363
Cardiovascular Diseases Research	93.837		712,869
Lung Diseases Research	93.838		351,138
Blood Diseases and Resources Research	93.839		383,919
Arthritis, Musculoskeletal and Skin Diseases Research	93.846		887,502
Diabetes, Digestive, and Kidney Diseases Extramural Research	93.847		346,672
Extramural Research Programs in the Neurosciences and Neurological Disorders	93.853		1,223,047
Allergy, Immunology and Transplantation Research	93.855		2,588,574
Biomedical Research and Research Training	93.859		228,520
Aging Research	93.866		857,381
Subtotal Direct Programs			<u>12,837,204</u>

See notes to schedule of expenditures of federal awards

PALO ALTO INSTITUTE FOR RESEARCH AND EDUCATION, INC.
SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS
For the Year Ended September 30, 2012

Federal Grantor/Pass-Through Grantor/Program or Cluster Title	Federal CFDA Number (*)	Pass-Through Entity Identifying Number	Federal Expenditures
Pass-through programs from:			
Stanford University - National Library of Medicine Contract - ARRA		HHSN276201000027C	17,808
Stanford University - National Heart, Lung and Blood Institute Contract		HHSN26820101134C	37,476
UCSF - Center for Disease Control-National Health & Nutrition Examination Survey		200-2011-38445	15,341
Brandeis University - Drug Abuse and Addiction Research Programs	93.279	R01 DA030150	19,583
University of Michigan - Nursing Research	93.361	R01 NR012011	13,762
University of Michigan - Cancer Control	93.399	U54 CA136429	5,805
Stanford University - Trans-NIH Recovery Act Research Support - ARRA	93.701	Various	423,443
University of Texas - Strategic Health IT Advanced Research Projects (SHARP) - ARRA	93.728	90TR0004-01	99,288
Stanford University - Cardiovascular Diseases Research	93.837	P50 HL083800	117,503
Vanderbilt University - Cardiovascular Diseases Research	93.837	P01 HL058000	172,068
Stanford University - Lung Diseases Research	93.838	P01 HL108797	261,960
UCSF - Diabetes, Digestive, and Kidney Diseases Extramural Research	93.847	R01 DK080123	65,246
NCIRE - Diabetes, Digestive, and Kidney Diseases Extramural Research	93.847	R01 DK069406	160,074
Brigham & Women's - Extramural Research Programs in the Neurosciences & Neurological Disorders	93.853	R01 NS030843	45,681
University of Iowa - Extramural Research Programs in the Neurosciences & Neurological Disorders	93.853	R01 NS072432	68,468
UCSF - Extramural Research Programs in the Neurosciences & Neurological Disorders	93.853	Various	165,045
Emory University - Allergy, Immunology and Transplantation Research	93.855	U19 AI057266	347,513
Mayo Clinic - Allergy, Immunology and Transplantation Research	93.855	U01 AI089859	38,697
University of Colorado - Allergy, Immunology and Transplantation Research	93.855	U19 AI050864	46,760
UCSF - Allergy, Immunology and Transplantation Research	93.855	R01 AI073737	13,150
Stanford University - Microbiology and Infectious Diseases Research	93.856	U19 AI057229	261,232
University of Kentucky Research Foundation - Microbiology and Infectious Diseases Research	93.865	R01 HD064993	17,700
Mayo Clinic Jacksonville - Aging Research	93.866	R01 AG006656	47,099
Johns Hopkins University - Aging Research	93.866	R01 AG031348	88,032
Stanford - Aging Research	93.866	P01 AG036695	420,106
Subtotal pass-through programs			<u>2,968,840</u>
Total U.S. Department of Health and Human Services			<u>15,806,044</u>
Total Research and Development Cluster and Expenditures of Federal Awards			<u>\$ 17,883,102</u>

(*) CFDA numbers that are not available were intentionally left blank

PALO ALTO INSTITUTE FOR RESEARCH AND EDUCATION, INC.
NOTES TO SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS
For the Year Ended September 30, 2012

NOTE 1 – BASIS OF PRESENTATION

The accompanying schedule of expenditures of federal awards (the “Schedule”) includes the federal grant activity of Palo Alto Institute for Research and Education, Inc. (the “Organization”), under programs of the federal government for the year ended September 30, 2012. The information in this schedule is presented in accordance with the requirements of the Office of Management and Budget (“OMB”) Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*. Because the schedule presents only a selected portion of the operations of Palo Alto Institute for Research and Education, Inc., it is not intended to and does not present the financial position, changes in net assets, or cash flows of Palo Alto Institute for Research and Education, Inc.

NOTE 2 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Expenditures reported on the Schedule are reported on the accrual basis of accounting. Such expenditures are recognized following the cost principles contained in OMB Circular A-122, *Cost Principles for Non-profit Organizations*, wherein certain types of expenditures are not allowable or are limited as to reimbursement. Pass-through entity identifying numbers are presented where available.

NOTE 3 – SUBRECIPIENTS

Certain funds are passed through to subrecipient organizations by the Organization. Expenditures incurred by the subrecipients, and reimbursed by the Organization, are included in the Schedule of Expenditures of Federal Awards. Of the federal expenditures presented in the Schedule of Expenditures of Federal Awards, the Organization provided federal awards to subrecipients as follows:

<u>Program Title</u>	<u>Federal CFDA Number</u>	<u>Amount Provided</u>
Military Medical Research and Development	12.420	\$ 170,152
Research and Training in Complementary and Alternative Medicine	93.213	20,375
National Center on Sleep Disorders Research	93.233	31,655
Mental Health Research Grants	93.242	931,728
Alcohol Research Programs	93.273	22,326
Lung Diseases Research	93.838	19,777
Blood Diseases and Resources Research	93.839	8,221
Extramural Research Programs in the Neurosciences and Neurological Disorders	93.853	253,519
Allergy, Immunology and Transplantation Research	93.855	648,392
Aging Research	93.866	347
		<u>\$ 2,106,492</u>

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*

To the Board of Directors
 Palo Alto Institute for Research and Education, Inc.

We have audited the financial statements of the Palo Alto Institute for Research and Education, Inc. (the "Organization") as of and for the year ended September 30, 2012, and have issued our report thereon dated December 7, 2012. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

INTERNAL CONTROL OVER FINANCIAL REPORTING

Management of the Organization is responsible for establishing and maintaining effective internal control over financial reporting. In planning and performing our audit, we considered the Organization's internal control over financial reporting as a basis for designing our auditing procedures for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Organization's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of the Organization's internal control over financial reporting.

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 in internal control* is a deficiency, or combination of deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of the organization's financial statements will not be prevented, or detected and corrected, on a timely basis.

Our consideration of the internal control over financial reporting 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 financial reporting that might be deficiencies, significant deficiencies or material weaknesses. We did not identify any deficiencies in internal control over financial reporting that we consider to be material weaknesses, as defined previously.

COMPLIANCE AND OTHER MATTERS

As part of obtaining reasonable assurance about whether the Organization's 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*.

This report is intended solely for the information and use of the Board of Directors, management, others within the entity, federal awarding agencies, and pass-through entities and is not intended to be, and should not be, used by anyone other than these specified parties.

Moss Adams LLP

San Francisco, California
 December 14 2012



**REPORT OF INDEPENDENT AUDITORS ON COMPLIANCE WITH REQUIREMENTS
THAT COULD HAVE A DIRECT AND MATERIAL EFFECT ON EACH MAJOR PROGRAM
AND ON INTERNAL CONTROL OVER COMPLIANCE IN ACCORDANCE WITH
OMB CIRCULAR A-133**

To the Board of Directors
Palo Alto Institute for Research and Education, Inc.

COMPLIANCE

We have audited Palo Alto Institute for Research and Education, Inc.'s (the "Organization") compliance with the types of compliance requirements described in the *OMB Circular A-133 Compliance Supplement* that could have a direct and material effect on each of the Organization's major federal program for the year ended September 30, 2012. The Organization's major federal program is identified in the summary of auditor's results section of the accompanying schedule of findings and questioned costs. Compliance with the requirements of laws, regulations, contracts and grants applicable to its major federal program is the responsibility of the Organization's management. Our responsibility is to express an opinion on the Organization's compliance based on our audit.

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 OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*. Those standards and OMB Circular A-133 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 federal program occurred. An audit includes examining, on a test basis, evidence about the Organization's compliance with those requirements and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion. Our audit does not provide a legal determination on the Organization's with those requirements.

In our opinion, the Organization complied, in all material respects, with the compliance requirements referred to above that could have a direct and material effect on its major federal program for the year ended September 30, 2012.

INTERNAL CONTROL OVER COMPLIANCE

Management of the Organization is responsible for establishing and maintaining effective internal control over compliance with requirements of laws, regulations, contracts and grants applicable to federal programs. In planning and performing our audit, we considered the Organization's internal control over compliance with requirements that could have a direct and material effect on a major federal program in order to determine our auditing procedures for the purpose of expressing our opinion on compliance and to test and report on internal control over compliance in accordance with OMB Circular A-133, but not for the purpose of expressing an opinion on the effectiveness of internal control over compliance. Accordingly, we do not express an opinion on the effectiveness of the Organization'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 federal program 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 a material noncompliance with a type of compliance requirement of a federal program will not be prevented, or detected and corrected, on a timely basis.

MOSS ADAMS_{LLP}

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 that might be deficiencies, significant deficiencies or material weaknesses. We did not identify any deficiencies in internal control over compliance that we consider to be material weaknesses, as defined above.

This report is intended solely for the information and use of management, the Board of Directors, others within the entity, federal awarding agencies, and pass-through entities and is not intended to be, and should not be, used by anyone other than these specified parties.

Moss Adams LLP

San Francisco, California
December 14, 2012

PALO ALTO INSTITUTE FOR RESEARCH AND EDUCATION, INC.
SCHEDULE OF FINDINGS AND QUESTIONED COSTS
For the Year Ended September 30, 2012

PART I — SUMMARY OF AUDITOR'S RESULTS

Financial Statements

Type of auditor's report issued: Unqualified

Internal control over financial reporting:

- Material weakness(es) identified? yes no
- Significant deficiency identified? yes none reported
- Noncompliance material to financial statements noted? yes no

Federal Awards

Internal control over major programs:

- Material weakness(es) identified? yes no
- Significant deficiency identified? yes none reported

Type of auditor's report issued on compliance for major programs: Unqualified

Any audit findings disclosed that are required to be reported in accordance with:

- Section 510(a) of OMB Circular A-133? yes no

Identification of major programs:

CFDA Number Name of Federal Program

Various Research and Development Cluster

Dollar threshold used to distinguish between Type A and Type B programs: \$536,493

- Auditee qualified as low-risk auditee? yes no

PART II — FINANCIAL STATEMENT FINDINGS SECTION

No matters were reported.

PART III — FEDERAL AWARD FINDINGS AND QUESTIONED COSTS SECTION

No matters were reported.