

**LARSON &
RIDGE LLP**

Certified Public Accountants



Post Office Box 92021
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**DIRECT RELIEF INTERNATIONAL
(A NON-PROFIT CORPORATION)**

**Independent Auditor's Report
and
Accompanying Financial Statements**

December 31, 2003

**DIRECT RELIEF INTERNATIONAL
(A NON-PROFIT CORPORATION)**

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INDEPENDENT AUDITOR'S REPORT

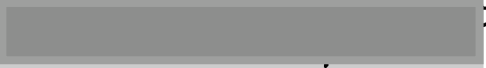
Board of Directors
Direct Relief International
Santa Barbara, California

We have audited the accompanying statements of financial position of Direct Relief International, a non-profit corporation, as of December 31, 2003 and the related statements of activities, changes in net assets, functional expenses and cash flows for the year then ended. These financial statements are the responsibility of Direct Relief International's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards in the United States of America. 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 includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes 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, the accompanying financial statements referred to above present fairly, in all material respects, the financial position of Direct Relief International at December 31, 2003 and the results of its operations for the year then ended, in conformity with generally accepted accounting principles in the United States of America.

April 6, 2004
Santa Barbara, California


Larson & Ridge LLP
Certified Public Accountants

**DIRECT RELIEF INTERNATIONAL
(A NON-PROFIT CORPORATION)
STATEMENT OF FINANCIAL POSITION
DECEMBER 31, 2003**

WITH COMPARATIVE TOTALS AS OF DECEMBER 31, 2002

	Unrestricted Funds	Temporarily Restricted Funds	Permanently Restricted Funds	Total All Funds December 31, 2003	Total All Funds December 31, 2002
Assets					
Current assets:					
Cash and cash equivalents	\$ 775,983	\$ 115,264	\$ -	\$ 891,247	\$ 823,179
Investments in marketable securities	3,776,714	19,750		3,796,464	2,991,948
Other investments	260,305			260,305	-
Contributions receivable	415,053	25,000		440,053	206,116
Inventories	17,157,224			17,157,224	12,571,138
Prepaid expenses	32,552			32,552	31,043
Total Current Assets	22,417,831	160,014	-	22,577,845	16,623,424
Property and equipment - net of accumulated depreciation of \$588,272	3,054,299			3,054,299	3,036,541
Contributions receivable from remainder unitrusts	41,173			41,173	40,684
Investment in real estate	530,000			530,000	530,000
Other assets	18,787			18,787	20,891
Total assets	\$ 26,062,090	\$ 160,014	\$ -	\$ 26,222,104	\$ 20,251,540
Liabilities and Net Assets					
Current liabilities:					
Accounts payable	\$ 45,571	\$ -	\$ -	\$ 45,571	\$ 35,576
Current portion of long-term debt	44,692			44,692	33,711
Other current liabilities	172,756			172,756	124,738
Total current liabilities	263,019	-	-	263,019	194,025
Long-term debt	1,581,777			1,581,777	1,631,398
Distribution payable - split interest agreements	-	36,793		36,793	37,146
Total liabilities	1,844,796	36,793	-	1,881,589	1,862,569
Net assets:					
Unrestricted net assets:					
Board designated endowment fund	4,844,568			4,844,568	3,854,414
Undesignated	19,372,726			19,372,726	14,473,876
Total unrestricted net assets	24,217,294	-	-	24,217,294	18,328,290
Temporarily restricted net assets		123,221		123,221	60,681
Total net assets	24,217,294	123,221	-	24,340,515	18,388,971
Total liabilities and net assets	\$ 26,062,090	\$ 160,014	\$ -	\$ 26,222,104	\$ 20,251,540

See notes to financial statements.

**DIRECT RELIEF INTERNATIONAL
(A NON-PROFIT CORPORATION)
STATEMENT OF ACTIVITIES
FOR THE YEAR ENDED DECEMBER 31, 2003**

WITH COMPARATIVE TOTALS FOR THE YEAR ENDED DECEMBER 31, 2002

	<u>Unrestricted</u>	<u>Temporarily Restricted</u>	<u>Permanently Restricted</u>	<u>Total All Funds December 31, 2003</u>	<u>Total All Funds December 31, 2002</u>
Public support and revenue					
Public support:					
Contributions:					
In cash and securities	\$ 2,235,229	\$ 157,768	\$ -	\$ 2,392,997	\$ 1,957,586
In-kind - pharmaceutical and medical supplies	98,211,195			98,211,195	62,246,517
In-kind - nonmedical				-	-
Contributed freight	392,427			392,427	355,109
Freight subsidy	121,746			121,746	106,673
Volunteer services	44,736			44,736	42,168
Combined federal campaign contributions	65,225			65,225	58,886
Grants	611,130	86,000		697,130	269,800
Fundraising events	217,895			217,895	434,868
Net assets released from restriction	178,527	(178,527)		-	-
Total public support	<u>102,078,110</u>	<u>65,241</u>	<u>-</u>	<u>102,143,351</u>	<u>65,471,607</u>
Revenue:					
Investment income	68,075	1,592		69,667	121,236
Gain (loss) on sale of investments	87,691	172		87,863	(41,909)
Change in value - split interest agreements	490	(3,873)		(3,383)	85,741
Unrealized gain (loss) on investments	679,759	(592)		679,167	(94,424)
Other income (loss)	67,772			67,772	64,113
Total revenue	<u>903,787</u>	<u>(2,701)</u>	<u>-</u>	<u>901,086</u>	<u>134,757</u>
Total public support and revenue	102,981,897	62,540	-	103,044,437	65,606,364
Expenses					
Program services:					
Medical supplies and related expenses	96,107,583			96,107,583	69,990,225
Supporting services:					
Fundraising	541,317			541,317	381,820
Administration	443,993			443,993	433,315
Total supporting services	<u>985,311</u>	<u>-</u>	<u>-</u>	<u>985,311</u>	<u>815,135</u>
Total expenses	<u>97,092,893</u>	<u>-</u>	<u>-</u>	<u>97,092,893</u>	<u>70,805,360</u>
Increase (decrease) in net assets	<u>\$ 5,889,004</u>	<u>\$ 62,540</u>	<u>\$ -</u>	<u>\$ 5,951,544</u>	<u>\$ (5,198,996)</u>

See notes to financial statements.

**DIRECT RELIEF INTERNATIONAL
(A NON-PROFIT CORPORATION)
STATEMENTS OF CHANGES IN NET ASSETS
FOR THE YEAR ENDED DECEMBER 31, 2003**

WITH COMPARATIVE TOTALS FOR THE YEAR ENDED DECEMBER 31, 2002

	<u>Unrestricted</u>	<u>Temporarily Restricted</u>	<u>Permanently Restricted</u>	<u>Total</u>
Balance at December 31, 2001	23,472,395	115,572	-	23,587,967
Decrease in net assets for the year ended December 31, 2002	<u>(5,144,105)</u>	<u>(54,891)</u>		<u>(5,198,996)</u>
Balance at December 31, 2002	18,328,290	60,681	-	18,388,971
Increase in net assets for the year ended December 31, 2003	5,889,004	62,540		5,951,544
Balance at December 31, 2003	<u>\$ 24,217,294</u>	<u>\$ 123,221</u>	<u>\$ -</u>	<u>\$ 24,340,515</u>

See notes to financial statements.

DIRECT RELIEF INTERNATIONAL
(A NON-PROFIT CORPORATION)
STATEMENT OF FUNCTIONAL EXPENSES
FOR THE YEAR ENDED DECEMBER 31, 2003

WITH COMPARATIVE TOTALS FOR THE YEAR ENDED DECEMBER 31, 2002

	Program Services		Supporting Services		Total Program and Supporting Services	
	Domestic	International	Administration	Fundraising	December 31, 2003	2002
Contributed services		\$ 44,736	\$ -	\$ -	\$ 44,736	\$ 42,168
Salaries	41,178	765,299	245,600	218,999	1,271,076	1,118,108
Payroll taxes	3,274	60,851	19,553	17,602	101,280	87,417
Employee benefits	7,017	130,409	28,226	17,181	182,833	162,928
Total Salaries and Related Expenses	51,469	1,001,295	293,379	253,782	1,599,925	1,410,620
Pharmaceuticals, medical equipment and supplies distributed	1,652,605	91,974,819	-	-	93,627,424	67,883,685
Accounting and legal	19	1,031	19,286	121	20,457	18,089
Advertising	11	618	586	2,012	3,227	5,856
Bank charges and brokerage fees	3	162	6,996		7,161	16,777
Building expenses					-	648
Contract services	421	23,412	3,257	12,304	39,394	106,293
Contributed freight expense	-	392,427			392,427	355,109
Development education	49	2,706		3,440	6,195	9,862
Dues and subscriptions	151	8,385	3,959	160	12,655	6,845
Duplicating and printing	125	6,954	1,675	93,918	102,672	84,139
Equipment parts and refurbishment	229	12,738			12,967	10,952
Freight and processing charges	6,303	350,810			357,113	233,887
Grants and stipends	2,285	98,622			100,907	57,280
Hospitality	25	1,402	4,854	4,214	10,495	6,450
Insurance	425	23,669	527	431	25,052	23,594
Interest	1,549	86,183	1,997	1,588	91,317	117,413
Miscellaneous	8	466	900		1,374	924
Office supplies	172	9,561	8,250	3,242	21,225	15,676
Packing supplies	151	8,386			8,537	3,170
Postage and mailing services	55	3,042	1,046	13,249	17,392	17,243
Procurement	28,725	186,369			215,094	159,771
Program evaluation					-	14,287
Public relations			49,716		49,716	7,888
Publications					-	1,343
Repairs and maintenance	192	10,676	6,837	7,295	25,000	18,669
Seminars	3	157	2,760	710	3,630	5,820
Special events				134,427	134,427	57,032
Taxes, licenses and fees	46	2,543	15,016	40	17,645	16,750
Travel and auto expenses	599	33,362	11,797	3,536	49,294	17,053
Utilities and telephone	575	32,013	3,007	1,208	36,803	33,965
Warehouse operations	193	10,765			10,958	3,086
Total Expenses Before Depreciation	1,746,388	94,282,573	435,845	535,677	97,000,483	70,720,174
Depreciation and amortization	1,388	77,234	8,148	5,640	92,410	85,186
Total Functional Expenses	\$ 1,747,776	\$ 94,359,807	\$ 443,993	\$ 541,317	\$ 97,092,893	\$ 70,805,360

See notes to financial statements.

**DIRECT RELIEF INTERNATIONAL
(A NON-PROFIT CORPORATION)
STATEMENTS OF CASH FLOWS
FOR THE YEAR ENDED DECEMBER 31, 2003**

WITH COMPARATIVE TOTALS FOR THE YEAR ENDED DECEMBER 31, 2002

	Total All Funds December 31, 2003	Total All Funds December 31, 2002
Cash flows from operating activities:		
Increase (decrease) in net assets	\$ 5,951,544	\$ (5,198,996)
Adjustments to reconcile changes in net assets to net cash provided by operating activities		
(Increase)/Decrease in inventory	(4,586,086)	5,526,894
Depreciation and amortization	92,410	85,185
Realized (gain) loss on sale of investments	(87,863)	(47,021)
Unrealized (gain) loss on investments	(679,167)	94,424
Change in value of estate receivable	(490)	(683)
Changes in operating assets and liabilities:		
Contributions receivable	(233,936)	(91,322)
Prepaid expenses	(1,509)	94,679
Other assets	-	-
Accounts payable	9,995	(29,174)
Accrued expenses	17,413	21,999
Other liabilities	30,605	62,047
Net cash provided by operating activities	512,916	518,032
Cash flows from investing activities:		
Purchases of property and equipment	(108,065)	(51,558)
Proceeds from sales and maturities of investments	745,613	1,729,114
Purchases of investments	(1,043,404)	(3,475,047)
Investment in split interest agreements	(352)	(2,631)
Contributions receivable from remainder unitrusts	-	767,764
Sale of real estate	-	301,753
Net cash used by investing activities	(406,208)	(730,605)
Cash flows from financing activities:		
Reduction of capital lease obligation	-	(1,408)
Increase in line-of-credit	-	(13)
Principal reduction on first trust deed	(38,640)	(29,050)
Net cash used by financing activities	(38,640)	(30,471)
Net increase/(decrease) in cash and cash equivalents	68,068	(243,044)
Cash and cash equivalents - beginning of year	823,179	1,066,223
Cash and cash equivalents - end of year	\$ 891,247	\$ 823,179

See notes to financial statements

Note 1: Summary of Significant Accounting Policies

Organization

Direct Relief International (the Organization), a California non-profit public benefit corporation, provides pharmaceuticals, medical supplies, equipment and services to medically less developed areas around the world as well as medical assistance to victims of natural and man-made disasters.

Financial Statement Presentation

In 1995, the Organization adopted Statement of Financial Accounting Standards (SFAS) No.117, "Financial Statements of Not-for-Profit Organizations". SFAS No. 117 requires the Organization to report information regarding its financial position and activities according to three classes of net assets: unrestricted net assets, temporarily restricted net assets and permanently restricted net assets. In addition, the Organization is required to present a statement of cash flows.

Contributions

The Organization also adopted SFAS No. 116, "Accounting for Contributions Received and Contributions Made" in 1995. In accordance with SFAS No. 116, contributions received are recorded as unrestricted, temporarily restricted or permanently restricted support depending on the existence or nature of any donor restrictions.

In 2003, the Organization received \$92,252 in restricted donations for domestic and international programs which had not been spent by December 31, 2003. These amounts have been classified as temporarily restricted net assets.

Promises To Give (Pledges)

Contributions are recognized when the donor makes a promise to give to the Organization that is, in substance, unconditional. Contributions that are restricted by the donor are reported as increases in unrestricted net assets if the restrictions expire in the fiscal year in which the contributions are recognized. All other donor-restricted contributions are reported as increases in temporarily restricted net assets depending on the nature of the restrictions. When a restriction expires, temporarily restricted net assets are reclassified to unrestricted net assets. The Organization uses the allowance method to determine uncollectible unconditional promises receivable.

Estimates

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

Inventory and In-kind Medical Contributions Received

Contributions of pharmaceutical and medical supplies are recorded at estimated wholesale value on the date received, based on published wholesale price indexes for pharmaceuticals and medical supplies. Contributions of medical equipment are recorded at estimated wholesale value based upon wholesale price guides or, when necessary, judgmentally determined.

Property and Equipment

Property and equipment are recorded at cost and depreciated using the straight-line method over their useful lives of five to forty years.

Investments

In 1996, the Organization adopted SFAS No. 124, "Accounting for Certain Investments Held by Not-for-Profit Organizations". Under SFAS No. 124, investments in marketable securities with readily determinable fair values and all investments in debt securities are reported at their fair values in the statement of financial position. Unrealized gains and losses are included in the change in net assets.

Income Taxes

The Organization is a not-for-profit organization that is exempt from income taxes under Section 501(c)(3) of the Internal Revenue Code.

Valuation of Future Interests

The Organization serves as trustee of a unitrust, of which it is the charitable beneficiary. The Organization is also the beneficiary of several charitable gift annuities. The future interests in the trust and in the gift annuities are recorded as assets and valued at fair market value on the date of each gift. Investments in the trust and in the gift annuities are adjusted to market value at the end of each year. The present value of the total estimated future distributions to the donors on the date of each gift is recorded as a liability.

Cash and Cash Equivalents

For purposes of the statement of cash flows, the Organization considers all highly liquid investments with an initial maturity of three months or less to be cash equivalents.

Note 2: Supplemental Cash Flow Disclosures

The Organization paid interest of \$91,317 and \$117,413 for the years ended December 31, 2003 and 2002, respectively.

Note 3: Investments

The Organization has adopted SFAS No. 124, "Accounting for Certain Investments Held by Not-for-Profit Organizations". This statement requires that nonprofit organizations record investments at fair market value in the statements of financial position. Investment holdings as of December 31, 2003 and 2002 are composed of the following:

	Cost		Market	
	2003	2002	2003	2002
Mutual funds	\$ 3,222,081	\$ 3,098,197	\$ 3,793,964	\$ 2,990,479
Government bonds	2,500	1,500	2,500	1,469
Total marketable securities	<u>\$ 3,224,581</u>	<u>\$ 3,099,697</u>	<u>\$ 3,796,464</u>	<u>\$ 2,991,948</u>

The Organization also holds a limited partnership interest in a hedge fund of funds. The interest was purchased for \$250,000 and has a value of \$260,305 as of December 31, 2003.

Note 4: Fair Value Of Financial Instruments

The Organization has a number of financial instruments, none of which are held for trading purposes. The Organization estimates that the fair value of all financial instruments at December 31, 2003 and 2002 does not differ materially from the aggregate carrying values of its financial instruments recorded in the accompanying statement of financial position. The estimated fair value amounts have been determined by the Organization using available market information and appropriate valuation methodologies. Considerable judgment is necessarily required in interpreting market data to develop estimates of fair value, and, accordingly, the estimates are not necessarily indicative of the amounts that the Organization could realize in a current market exchange.

Note 5: Property and Equipment

Property and equipment consist of the following at:

	December 31, 2003	December 31, 2002
Office and Warehouse	\$ 1,797,630	\$ 1,746,457
Land	1,363,950	1,363,950
Warehouse equipment	99,883	95,690
Computer equipment	91,262	81,436
Office equipment	65,959	65,959
Furniture & fixtures	65,164	65,164
Delivery equipment	61,653	20,361
Computer software	54,062	52,482
Bio-med equipment	43,008	43,008
Total	<u>3,642,571</u>	<u>3,534,507</u>
Less: Accumulated Depreciation	<u>-588,272</u>	<u>-497,966</u>
Net Property and Equipment	<u>\$ 3,054,299</u>	<u>\$ 3,036,541</u>

Note 6: Split Interest Agreements

The Organization held interests in the following agreements:

Agreement 1: The Organization holds a 25% interest in a charitable remainder unitrust established in 1991. The trust has a 20 year life and is composed of assets valued at \$415,023. The Organization's interest as of December 31, 2003 is valued at \$31,375, calculated by using an 8% discount rate over the remaining fifteen year term of the trust.

Agreement 2: The Organization holds a 12.5% interest in a charitable remainder trust established in 1980. The trust terminates upon the death of the income beneficiary. The Organization's interest as of December 31, 2003 is valued at \$9,798, calculated by using an 8% discount rate over the estimated life expectancy (seventeen years) of the income beneficiary.

Agreement 3: The Organization is the sole beneficiary of several gift annuities established in 1993 and 1994. The annuities are held in trust. The assets of the trust are valued at \$23,059 (fair market value) as of December 31, 2003. A corresponding liability of \$15,948 is calculated by discounting at 6% the present value of estimated future distributions to the annuitants.

Agreement 4: The Organization is the sole beneficiary of a charitable remainder unitrust created in 1980. The terms of the trust require annual distributions of 5% of the corpus of the trust for the lifetime of the grantor and a successor beneficiary. As of December 31, 2003, the trust had assets valued at \$43,850 with a corresponding liability of \$20,845.

The Organization is trustee for Agreements 3 and 4; the assets are held in separate accounts and are not commingled with other Organization assets. The remaining Agreements are held in trust by third parties.

Note 7: Debt

The Organization's long-term debt consists of the following at:

	December 31, 2003	December 31, 2002
Mortgage note payable, requiring monthly payments of \$ 7,604 including interest at 5.50%, maturing on October 1, 2007	\$ 1,158,358	\$ 1,185,090
Mortgage note payable, requiring monthly payments of \$ 3,222 including interest at 4.50%, maturing on November 1, 2007	468,111	480,019
Total long-term debt	1,626,469	1,665,109
Less: current portion	46,200	33,711
Long-term portion	<u>\$ 1,580,269</u>	<u>\$ 1,631,398</u>

The mortgage notes are secured by the Organization's warehouse facility. The following is a summary of principal maturities of long-term debt during the next five years:

2004	\$ 46,200
2005	48,618
2006	51,164
2007	<u>1,480,487</u>
Total	<u>\$ 1,626,469</u>

Note 8: Quasi-endowment fund

In 1998, the Organization established a board designated endowment fund. The purpose of the fund was to provide a reserve for future operations. The endowment's resources came from board designated unrestricted gifts and donations in excess of operational needs.

For the year ended December 31, 2003, the Organization directed contributions in the amount of \$84,009 to the Endowment Fund while investment and other income for the Endowment Fund was \$836,675. Total net assets of the Endowment are \$4,844,568 as of December 31, 2003.

Note 9: Contributed Freight

Contributed freight of \$392,427 and \$355,109 for the years ended December 31, 2003 and 2002, respectively, represents estimated shipping expenses incurred by other organizations on behalf of Direct Relief International in the shipment of medical supplies to foreign countries.

Note 10: Contributed Services

The Organization records the estimated value of volunteer services that are an integral part of its operations. The estimated value of volunteer services is as follows:

	December 31, 2003	December 31, 2002
Warehouse operations	\$ 11,190	\$ 2,480
Medical volunteers	33,546	27,164
Other professional		12,524
Total Contributed Services	<u>\$ 44,736</u>	<u>\$ 42,168</u>

In addition to the above, the Organization received 6,780 hours of volunteer services of a non-professional, non-technical nature.

Note 11: Pension Expense

The Organization has an employee participation pension plan. Employee contributions to the plan are matched by the Organization, up to a maximum of 5% of the employee's annual gross salary. The annuity costs associated with the plan for the years 2003 and 2002 were \$27,842 and \$36,968

respectively. All employees working at least 1,000 hours per year with one year of service or more are eligible for matching contributions.

Note 12: Non-Qualified Deferred Compensation Agreement

The Organization is party to a non-qualified deferred compensation agreement with the surviving spouse of a co-founder of the Organization. Under the terms of the agreement, beginning January 1, 1971, the Organization is obligated to make monthly payments in acknowledgement of his 23 years of service. The retirement agreement expense for both 2003 and 2002 is \$ 9,920.

Note 13: Concentrations of Credit Risk

Financial instruments that potentially subject the Organization to concentrations of credit risk consist principally of bank and brokerage deposits. The Organization places its temporary cash investments with financial institutions and securities brokers. For the years ending December 31, 2003 and 2002, the Organization was at risk for \$564,732 and \$431,886, respectively, in cash deposited at individual financial institutions. The Federal Deposit Insurance Corporation (FDIC) insures individual deposits up to \$ 100,000. In addition, the Organization's investments are exposed to various risks, such as interest rate fluctuations and market valuations. Due to the level of risk associated with certain investment securities and the level of uncertainty related to changes in the value of investment securities, it is at least reasonably possible that changes in risks in the near term could materially effect the Organization's statement of financial position and the statement of activities.