



Hosaka, Rotherham & Company
Certified Public Accountants

James A. Rotherham, CPA
CEO & Managing Partner

.....
Roy T. Hosaka, CPA
Retired

James C. Nagel, CPA
Retired

MENTAL HEALTH SYSTEMS, INC.
INDEPENDENT AUDITORS' REPORT
FOR THE FISCAL YEAR ENDED JUNE 30, 2013
(SUMMARIZED FINANCIAL INFORMATION FOR THE FISCAL YEAR ENDED JUNE 30, 2012)

MENTAL HEALTH SYSTEMS, INC.

INTRODUCTORY SECTION

JUNE 30, 2013

**MENTAL HEALTH SYSTEMS, INC.
TABLE OF CONTENTS
JUNE 30, 2013**

	<u>Page Number</u>
INTRODUCTORY SECTION	
Table of Contents	i
FINANCIAL SECTION	
Independent Auditors' Report	2 - 3
Statement of Financial Position	4
Statement of Activities	5
Statement of Functional Expenses	6
Statement of Cash Flows	7
Notes to Financial Statements	8 - 16
SUPPLEMENTARY INFORMATION SECTION	
Supplementary Schedule of Other Direct Expense	18
Supplementary Schedule of Other Indirect Expense	19
Schedule of Expenditures of Federal Awards	20 - 21
OTHER INDEPENDENT AUDITORS' REPORTS SECTION	
Independent Auditors' Report on Internal Control Over Financial Reporting and on Compliance and Other Matters Based on an Audit of Financial Statements Performed in Accordance with <i>Government Auditing Standards</i>	23 - 24
Independent Auditors' Report on Each Major Program and on Internal Control Over Compliance Required by OMB Circular A-133	25 - 26
FINDINGS AND RECOMMENDATIONS SECTION	
Schedule of Audit Findings and Questioned Costs	28 - 29
Summary Schedule of Prior Audit Findings	30

MENTAL HEALTH SYSTEMS, INC.

FINANCIAL SECTION

JUNE 30, 2013



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INDEPENDENT AUDITORS' REPORT

Board of Directors
Mental Health Systems, Inc.
San Diego, California

Report on the Financial Statements

We have audited the accompanying financial statements of Mental Health Systems, Inc. (a nonprofit organization), which comprise the statement of financial position as of June 30, 2013, and the related statements of activities, functional expenses, and cash flows for the fiscal year then ended, and the related notes to the financial statements.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with auditing standards generally accepted 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 from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

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

INDEPENDENT AUDITORS' REPORT

Page 2

Opinion

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Mental Health Systems, Inc. as of June 30, 2013, and the changes in its net assets and its cash flows for the fiscal year then ended in accordance with accounting principles generally accepted in the United States of America.

Report on Summarized Comparative Information

We have previously audited Mental Health Systems, Inc.'s 2012 financial statements, and our report dated January 14, 2013, expressed an unmodified opinion on those audited financial statements. In our opinion, the summarized comparative information presented herein as of and for the fiscal year ended June 30, 2012, is consistent, in all material respects, with the audited financial statements from which it has been derived.

Other Matters

Other Information

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

Other Reporting Required by Government Auditing Standards

In accordance with *Government Auditing Standards*, we have also issued our report dated December 23, 2013, on our consideration of Mental Health Systems, Inc.'s internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering Mental Health Systems, Inc.'s internal control over financial reporting and compliance.

Hosaka, Rotherham & Company

San Diego, California
December 23, 2013

MENTAL HEALTH SYSTEMS, INC.
STATEMENT OF FINANCIAL POSITION
JUNE 30, 2013
(WITH SUMMARIZED FINANCIAL INFORMATION AS OF JUNE 30, 2012)

	2013	2012
ASSETS:		
Current assets:		
Cash and cash equivalents (Note 3)	\$ 1,389,560	\$ 5,771,850
Investments (Note 4)	-	287,251
Contract receivable, net of allowance of \$350,000 (Note 5)	15,191,201	12,191,597
Short-term loan receivable	60,000	-
Other receivable	66,380	39,723
Prepaid expenditures	479,512	164,395
Total current assets	17,186,653	18,454,816
Fixed assets, net of depreciation (Note 6)	12,545,022	12,540,980
Noncurrent assets:		
Investment	5,000	5,000
Deposits	876,099	361,838
Total noncurrent assets	881,099	366,838
Total assets	\$ 30,612,774	\$ 31,362,634
 LIABILITIES AND NET ASSETS		
Current liabilities:		
Accounts payable	\$ 2,466,876	\$ 3,105,158
Accrued payroll and related taxes	1,209,582	1,081,416
Accrued employee benefits	4,397,468	5,015,051
Deferred revenue	430,681	630,663
Other current liabilities	1,604,691	1,226,570
Current portion of long-term debt (Note 7)	256,150	290,278
Total current liabilities	10,365,448	11,349,136
Long-term debt:		
Notes payable, net of current portion (Note 7)	8,904,963	9,198,427
Total long-term debt	8,904,963	9,198,427
Total liabilities	19,270,411	20,547,563
Net assets:		
Unrestricted	11,296,316	10,787,749
Temporarily restricted (Note 9)	46,047	27,322
Total net assets	11,342,363	10,815,071
Total liabilities and net assets	\$ 30,612,774	\$ 31,362,634

The notes to the financial statements are an integral part of the statement.

MENTAL HEALTH SYSTEMS, INC.
STATEMENT OF ACTIVITIES
FOR THE FISCAL YEAR ENDED JUNE 30, 2013
(WITH SUMMARIZED FINANCIAL INFORMATION AS OF JUNE 30, 2012)

	Unrestricted	Temporarily Restricted	Total	
			2013	2012
REVENUES AND SUPPORT				
Contract revenues	\$ 75,345,557	\$ -	\$ 75,345,557	\$ 80,420,270
Other revenue	2,673,130	-	2,673,130	1,914,380
Fundraising, net of direct expenses	173,308	-	173,308	180,229
Donations	55,951	22,036	77,987	91,896
Total support	78,247,946	22,036	78,269,982	82,606,775
Net assets released from restrictions	3,311	(3,311)	-	-
Total revenues and support	78,251,257	18,725	78,269,982	82,606,775
EXPENSES:				
Direct expenses:				
Payroll	25,506,678	-	25,506,678	26,067,981
Payroll benefits	6,159,044	-	6,159,044	6,343,609
Purchased services	16,013,185	-	16,013,185	18,315,781
Occupancy costs	4,125,103	-	4,125,103	5,089,459
Consultants	4,132,690	-	4,132,690	3,504,977
Other direct expense	12,436,293	-	12,436,293	13,630,703
Unallocable expense	-	-	-	111
Total direct expenses	68,372,993	-	68,372,993	72,952,621
Indirect expenses:				
Payroll	4,490,846	-	4,490,846	4,115,790
Payroll benefits	505,456	-	505,456	669,731
Occupancy costs	459,931	-	459,931	424,776
Consultants	319,223	-	319,223	409,277
Other indirect expense	2,540,851	-	2,540,851	2,813,904
Unallocable expense	1,053,390	-	1,053,390	635,481
Total indirect expenses	9,369,697	-	9,369,697	9,068,959
Total expenses	77,742,690	-	77,742,690	82,021,580
CHANGE IN NET ASSETS	508,567	18,725	527,292	585,195
NET ASSETS, BEGINNING OF YEAR	10,787,749	27,322	10,815,071	10,229,876
NET ASSETS, END OF YEAR	\$ 11,296,316	\$ 46,047	\$ 11,342,363	\$ 10,815,071

The notes to the financial statements are an integral part of the statement.

MENTAL HEALTH SYSTEMS, INC.
STATEMENT OF FUNCTIONAL EXPENSES
FOR THE FISCAL YEAR ENDED JUNE 30, 2013
(WITH SUMMARIZED FINANCIAL STATEMENT INFORMATION AS OF JUNE 30, 2012)

	Program Service	Management & General	Total	
			2013	2012
Total Direct and Indirect Expenses				
Accounting and legal	\$ 5,972	\$ 61,813	\$ 67,785	\$ 58,529
Consultants	4,132,691	319,222	4,451,913	3,914,254
Depreciation	279,400	327,584	606,984	766,337
Dues and subscriptions	15,718	55,658	71,376	98,456
Equipment rental	288,076	131,646	419,722	544,816
Housekeeping and general supplies	166,594	10,376	176,970	175,693
Insurance	1,732,316	212,292	1,944,608	2,731,232
Interest and bank fees	355,022	243,158	598,180	576,700
Laboratory fees	1,200,380	-	1,200,380	1,193,059
Licenses, fees and taxes	158,734	19,919	178,653	191,147
Minor/Major equipment	525,919	92,154	618,073	1,085,926
Occupancy costs	4,125,103	459,931	4,585,034	5,514,235
Office supplies	434,433	65,533	499,966	531,833
Other business services	2,832,286	718,713	3,550,999	3,105,958
Payroll	25,506,678	4,490,846	29,997,524	30,183,771
Payroll benefits	6,159,044	505,456	6,664,500	7,013,340
Printing and advertising	124,523	36,416	160,939	183,736
Purchased services	16,013,185	-	16,013,185	18,315,781
Repairs and maintenance	300,277	110,293	410,570	372,749
RT/ OT supplies and food	851,914	-	851,914	1,206,542
Staff development	283,343	73,959	357,302	515,193
Travel and transportation	1,321,722	183,253	1,504,975	1,425,369
Utilities and telephone	1,540,941	216,807	1,757,748	1,681,332
Total Direct and Indirect Expenses	68,354,271	8,335,029	76,689,300	81,385,988
Unallocable Expenses				
Bad debt	16,838	346,415	363,253	-
Unallowable/Unallocable Expenses	1,884	688,253	690,137	635,592
Total Unallocable Expenses	18,722	1,034,668	1,053,390	635,592
Total Direct, Indirect Expenses and Unallocable Expenses	\$ 68,372,993	\$ 9,369,697	\$ 77,742,690	\$ 82,021,580

The notes to the financial statements are an integral part of the statement.

MENTAL HEALTH SYSTEMS, INC.
STATEMENT OF CASH FLOWS
FOR THE FISCAL YEAR ENDED JUNE 30, 2013
(WITH SUMMARIZED FINANCIAL STATEMENT INFORMATION AS OF JUNE 30, 2012)

	<u>2013</u>	<u>2012</u>
CASH FLOWS FROM OPERATING ACTIVITIES:		
Change in net assets	\$ 527,292	\$ 585,195
Adjustments to reconcile change in net assets to net cash from operations:		
Depreciation	606,984	766,337
Unrealized gain on investments	(14,358)	(16,565)
(Increase) decrease in operating assets:		
Contract receivable and other receivable	(3,026,261)	(2,055,416)
Prepaid expenditures	(315,117)	399,485
Deposits	(514,261)	(13,515)
Increase (decrease) in operating liabilities:		
Accounts payable and accrued expenses	(749,578)	930,913
Deferred revenue	(199,982)	227,077
Net cash flows provided by (used in) operating activities	<u>(3,685,281)</u>	<u>823,511</u>
CASH FLOWS FROM INVESTING ACTIVITIES:		
Investment purchases	(35,015)	(34,435)
Proceed from sale of investment	336,624	-
Disbursement for short-term note receivable	(60,000)	-
Disposals of property and equipment	-	128,260
Acquisition of property and equipment	<u>(611,026)</u>	<u>(982,051)</u>
Net cash flows (used in) investing activities	(369,417)	(888,226)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Proceed on note payable	-	655,000
Payments on notes payable	(332,467)	(349,291)
Other cash flow from financing activities	4,875	-
Net cash flows provided by (used in) financing activities	<u>(327,592)</u>	<u>305,709</u>
NET CHANGE IN CASH AND CASH EQUIVALENTS	(4,382,290)	240,994
CASH AND CASH EQUIVALENTS, BEGINNING OF YEAR	<u>5,771,850</u>	<u>5,530,856</u>
CASH AND CASH EQUIVALENTS, END OF YEAR	<u>\$ 1,389,560</u>	<u>\$ 5,771,850</u>
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION		
Cash paid for interest	<u>\$ 562,415</u>	<u>\$ 542,843</u>

The notes to the financial statements are an integral part of the statement.

MENTAL HEALTH SYSTEMS, INC.
NOTES TO FINANCIAL STATEMENTS
JUNE 30, 2013

NOTE 1 - ORGANIZATION

Mental Health Systems, Inc. (Organization) was organized June 2, 1978, pursuant to the General Nonprofit Corporation Law of the State of California and does not contemplate pecuniary gain or profit to the members thereof and it is organized for nonprofit purposes. The Organization was founded to provide mental health, drug and alcohol rehabilitation services in an innovative and cost effective manner primarily via government contracts. The mission of the Organization is to improve lives and instill hope by using new and creative treatment strategies while respecting time proven methods of intervention.

The Organization also provides case management services as one of California's Substance Abuse System Coordinating Agencies for the department of Corrections & Rehabilitation. In addition the Organization administers various mental health, substance abuse, vocational rehabilitation and educational programs for individuals, families and communities.

NOTE 2 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

A. Financial Statement Presentation

The financial statements are presented in conformity with Accounting Standards Codification (ASC) 958-205, *Non-For-Profit Entities – Presentation of Financial Statements*. Under ASC 958-205, the Organization reports information regarding its financial position and activities according to three classes of net assets:

Unrestricted net assets: Unrestricted net assets are available to support all activities of the Organization, and are not subject to donor-imposed stipulations. These generally result from revenues generated by providing services, receiving unrestricted contributions, and receiving interest from investments, less expenses incurred in providing program-related services, raising contributions, and performing administrative functions.

Temporarily restricted net assets: Net assets that are subject to donor-imposed stipulations that will be met either by actions of the Organization and/or the passage of time. When a donor restriction expires, that is, when a stipulated time restriction ends or purpose restriction is accomplished, temporarily restricted net assets are reclassified to unrestricted net assets and are reported in the statement of activities as net assets released from restrictions. Temporarily restricted net assets at June 30, 2013 and 2012, were \$46,047 and \$27,322, respectively.

Permanently restricted net assets: Net assets that are subject to donor-imposed stipulations that the restrictions be maintained permanently by the Organization. Generally, the donors of these assets permit the Organization to use all or part of the income earned on the related investments for general or specific purposes. There were no permanently restricted assets as of June 30, 2013.

B. Accounting Method - Basis of Accounting

The financial statements were prepared in accordance with accounting principles generally accepted in the United States of America as applicable to not-for-profit organizations. Basis of accounting refers to when revenues and expenses are recognized in the accounts and reported on the financial statements. Basis of accounting relates to the timing of measurement made, regardless of the measurement focus applied. The Organization uses the accrual basis of accounting. Revenues are recognized when they are earned and expenditures are recognized in the accounting period in which the liability is incurred.

MENTAL HEALTH SYSTEMS, INC.
NOTES TO FINANCIAL STATEMENTS
JUNE 30, 2013

NOTE 2 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

C. Comparative Financial Information

The financial statements include certain summarized comparative information from the prior year. This information is presented in total but not by net asset class and does not include sufficient detail to be in conformity with generally accepted accounting principles. Accordingly, such information should be read together with the Organization's financial statements for the year ended June 30, 2012, from which the summarized information was extracted. Certain amounts in the prior year financial statements have been reclassified for comparison purposes to conform to the current year presentation.

D. Use of Estimates

The preparation of 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.

E. Fair Value of Financial Instruments

Accounting Standards Codification ("ASC") 820 provides a definition of fair value, establishes a hierarchy for measuring fair value under generally accepted accounting principles, and requires certain disclosures about fair values used in financial statements. ASC 820 defines fair value as the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. Valuation techniques used to measure fair value under ASC 820 aim to maximize the use of observable inputs and minimize the use of unobservable inputs. The standard describes a fair value hierarchy based on three levels of inputs, of which the first two are considered observable, and the last unobservable, that may be used to measure fair value as follows:

- Level 1 - Quoted prices in active markets for identical assets or liabilities.
- Level 2 - Inputs other than Level 1 that are observable, either directly or indirectly, such as quoted prices for similar assets or liabilities; quoted prices in 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.

At June 30, 2013, the fair value of the Organization's financial assets and liabilities that are measured on a recurring basis are categorized as follows using the fair value hierarchy:

	Total	Identical Assets (Level 1)	Observable Input (Level 2)	Unobservable Input (Level 3)
Assets:				
Cash and cash equivalents	\$ 1,389,560	\$ 1,389,560	\$ -	\$ -
Securities	5,000	-	5,000	-
Total	<u>\$ 1,394,560</u>	<u>\$ 1,389,560</u>	<u>\$ 5,000</u>	<u>\$ -</u>

MENTAL HEALTH SYSTEMS, INC.
NOTES TO FINANCIAL STATEMENTS
JUNE 30, 2013

NOTE 2 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

F. Functional Allocation of Expenses

The costs of providing the program services have been summarized on a functional basis in the statement of activities. Accordingly, certain costs have been allocated among the program services based on employees' time incurred and management's estimates of the usage of resources.

G. Income Taxes

The Organization is exempt from income taxes under Internal Revenue Code Section (IRC §) 501(c)(3). It is, however, subject to income taxes from activities unrelated to its tax-exempt purpose. The Organization uses the same accounting methods for tax and financial reporting.

Generally accepted accounting principles (GAAP) provides accounting and disclosure guidance about positions taken by an entity in its tax returns that might be uncertain. Management has considered its tax positions and believes that all of the positions taken in its federal and state exempt organization tax returns are more likely than not to be sustained upon examination. The Organization's returns are subject to examination by federal and state taxing authorities, generally for three years and four years, respectively, after they are filed.

H. Cash and Cash Equivalents

Cash and cash equivalents are from time to time variously composed of cash on hand and in banks, and liquid investments with original maturities of three months or less.

I. Investments

The Organization presents its investments in accordance with Accounting Standards Codification (ASC) 958-320, *Not-For-Profit Entities - Investments Debt & Equity Securities*. Under ASC 958-320, 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. The fair values of these investments are subject to change based on the fluctuations of market values. Unrealized gains and losses are included in the change in net assets.

J. Contract receivable and accounts receivable

Contracts receivable consists of balances due for services provided pursuant to written and verbal contracts with various public and private agencies. Generally accepted accounting principles in the United States of America require that an allowance for doubtful accounts be established for accounts receivable. It is the Organization's policy to evaluate the collectability of receivables on a regular and ongoing basis, if deemed necessary, an adjustment to the allowance for bad debt account is recorded. Accordingly, contracts and accounts receivable are shown net of an allowance for doubtful accounts.

**MENTAL HEALTH SYSTEMS, INC.
NOTES TO FINANCIAL STATEMENTS
JUNE 30, 2013**

NOTE 2 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

K. Fixed Assets

Fixed assets are recorded at cost and depreciated under the straight-line method over their estimated useful life. Repair and maintenance costs, which do not extend the useful lives of the asset, are charged to expense. The cost of assets sold or retired and related amounts of accumulated depreciation are eliminated from the accounts in the year of disposal, and any resulting gain or loss is included in the earnings. Management has elected to capitalize and depreciate all assets costing \$5,000 or more; all other assets are charged to expense in the year incurred.

L. Deferred Revenue

Deferred revenue represents funds received, but not expended. These funds must be expended in accordance with the provisions of the contract to which they apply, or if not expended in the current period, are carried over into the subsequent year.

NOTE 3 - CASH AND CASH EQUIVALENTS

Cash and cash equivalents at June 30, 2013 and 2012, consisted of the following:

	<u>2013</u>	<u>2012</u>
Deposits:		
Cash in banks	\$ 866,912	\$ 3,794,499
Money market funds	392,463	1,746,801
Certificates of deposit	100,350	200,239
Cash on hand		
Petty cash	29,835	30,311
Total cash and cash equivalents	<u>\$ 1,389,560</u>	<u>\$ 5,771,850</u>

Cash balances held in banks are insured up to \$250,000 by the Federal Deposit Insurance Corporation (FDIC). The Organization maintains its cash in bank deposit accounts that at times may exceed federally insured limits. At June 30, 2013, the Organization had \$2,262,518 of uninsured funds.

NOTE 4 - INVESTMENTS

Investments at June 30, 2013, are summarized as follows:

<u>Description</u>	<u>Cost</u>	<u>Fair Value</u>	<u>Carrying Value</u>
Behavioral Healthcare Solutions, Inc.	\$ 3,820	\$ 5,000	\$ 5,000
Total investments	<u>\$ 3,820</u>	<u>\$ 5,000</u>	<u>\$ 5,000</u>

The following schedule summarizes the investment return and its classification in the statement of activities as of June 30, 2013 and 2012, respectively:

**MENTAL HEALTH SYSTEMS, INC.
NOTES TO FINANCIAL STATEMENTS
JUNE 30, 2013**

NOTE 4 – INVESTMENTS (CONTINUED)

	2013	2012
Interest and dividends	\$ 10,015	\$ 9,435
Unrealized gain	14,358	16,565
Check purchase	25,000	25,000
Net investment return	<u>\$ 49,373</u>	<u>\$ 51,000</u>

NOTE 5 - CONTRACT RECEIVABLE

Contracts receivable are balances due Mental Health Systems, Inc. for services provided and expenses incurred prior to June 30, 2013 and 2012, pursuant to written contracts with various public agencies. The balance shown on the financial statements is net of an allowance for doubtful accounts of \$350,000 and \$350,000 as of June 30, 2013 and 2012, respectively.

The Organization's policy for determining when receivables are past due is based on the contractual terms associated therewith. Management evaluates all accounts believed to be uncollectible and recognizes bad debt if all reasonable efforts to collect the amount due have been unsuccessful.

NOTE 6 - FIXED ASSETS

Fixed assets at June 30, 2013 and 2012, consisted of the following:

	2013	2012
Land	\$ 3,539,328	\$ 3,109,368
Construction in progress	532,972	10,885
Building and facilities	10,537,730	10,878,751
Leasehold Improvements	950,008	950,008
Vehicles	857,235	857,235
Furniture and Fixtures	1,248,599	1,248,599
Software	518,259	518,259
Less: accumulated depreciation	<u>(5,639,109)</u>	<u>(5,032,125)</u>
Total fixed assets, net of depreciation	<u>\$ 12,545,022</u>	<u>\$ 12,540,980</u>

Depreciation expense for the fiscal years ended June 30, 2013 and 2012, were \$606,984 and \$766,337, respectively.

NOTE 7 - NOTES PAYABLE

A. Long-term liabilities activity

Long-term liabilities activity includes debt and other long-term liabilities. Changes in obligations for the fiscal year ended June 30, 2013, are as follows:

**MENTAL HEALTH SYSTEMS, INC.
NOTES TO FINANCIAL STATEMENTS
JUNE 30, 2013**

NOTE 7 - NOTES PAYABLE (CONTINUED)

	Balance 2012	Additions	Payments	Balance 2013	Due in One year
California Department of Housing and Community Development	\$ 243,814	\$ 4,875	\$ -	\$ 248,689	\$ -
City of Oceanside #1	80,000	-	(26,864)	53,136	26,864
City of Oceanside #2	655,000	-	(10,107)	644,893	10,598
California Health Facilities Financing Authority	358,874	-	(30,079)	328,795	30,994
National Cooperative Bank	1,143,021	-	(187,421)	955,600	187,694
U.S. Bancorp	6,930,000	-	-	6,930,000	-
Vehicles loans	77,996	-	(77,996)	-	-
Total	<u>\$ 9,488,705</u>	<u>\$ 4,875</u>	<u>\$ (332,467)</u>	<u>\$ 9,161,113</u>	<u>\$ 256,150</u>

B. California Department of Housing and Community Development

The note payable is to the Department of Housing and Community Development, a public agency of the State of California for special user housing rehabilitation known as the Boston Villas Housing Project. The thirty year note which is secured by the Deed of Trust accrues simple interest at 3% per annum, does not require interim principal payments and has a scheduled maturity date of June 29, 2019. The principal balance as of June 30, 2013, is \$162,500. Accrued interest as of June 30, 2013, is \$86,169.

C. City of Oceanside #1

The Organization has a note payable to the city of Oceanside in the amount of \$234,026. The note is a zero interest note and will be forgiven at the end of 10 years if the Organization meets all requirements. The balance as of June 30, 2013, was \$53,136.

D. City of Oceanside #2

The Organization has a note payable to the City of Oceanside, California. The thirty year note which is secured by the deed of trust accrues simple interest at 4.75% per annum, does not require interim principal payments and has a scheduled maturity date of January 4, 2042. The principal balance as of June 30, 2013, was \$644,893.

E. California Health Facilities Financing Authority

The Organization has a note payable to California Health Facilities Financing Authority for the purchase and renovation of property located at 474 Vermont Ave., Escondido, CA. The interest is variable and will become fixed at the prevailing rate in effect at the onset of the second phase. The monthly principal and interest payment is \$3,370. The principal balance as of June 30, 2013, was \$328,795.

MENTAL HEALTH SYSTEMS, INC.
NOTES TO FINANCIAL STATEMENTS
JUNE 30, 2013

NOTE 7 - NOTES PAYABLE (CONTINUED)

F. National Cooperative Bank

The Organization has a note payable to National Cooperative Bank for the purchase of the facility located at 1100 Sportfisher Drive, Oceanside, CA. The face amount of the note is \$2,250,000 with variable interest at the bank's index rate plus .25%, a 15-year loan term maturing on November 30, 2017, with minimum monthly payments of principal and interest. The note is fully collateralized by the deed of trust to the property and contains certain financial covenants and ratio requirements, of which the Organization was in compliance at June 30, 2013. The annual interest rate and minimum monthly payment at June 30, 2013, was 7.80% and \$21,383, respectively. The principal balance at June 30, 2013, was \$955,600.

G. U.S. Bancorp

The Organization has notes payable to U.S. Bancorp in the amount of \$4,952,500 (Note A) and \$1,977,500 (Note B) for the purchase and construction of property in Fresno, CA. Interest for both loans is 5.923% per year. Maturity on Note A is December 17, 2015. Payments are interest only with principal and any unpaid interest due at maturity. Maturity on Note B is December 17, 2038, with interest only payments through December 17, 2015. After December 17, 2015, interest and principal is to be paid over 276 months.

H. Vehicles loans

The Organization purchased various autos throughout the year ended June 30, 2010, that were financed through Toyota and Hyundai at 5.0% and 0.0% interest, respectively. This loan was fully paid off during the fiscal year.

NOTE 8 - LINE OF CREDIT

The Organization has available an \$8,000,000 Line of Credit (LOC) with National Cooperative Bank. The LOC will mature on July 31, 2013, and has an interest rate of 4.6%. The balance as of June 30, 2013, was \$0.

NOTE 9 - TEMPORARILY RESTRICTED NET ASSETS

Temporarily restricted net assets have been restricted by donors for specific programs within the Organization. Temporarily restricted net assets were \$46,047 and \$27,322 as of June 30, 2013 and 2012, respectively.

NOTE 10 - RETIREMENT PLAN

Mental Health Systems, Inc. has adopted a non-contributory retirement plan covering all full time employees who have met certain service requirements. The plan has received Internal Revenue Service approval under Section 401 (A) and Section 501 (A) of the Internal Revenue Code. It provides discretionary contributions by the Corporation up to the maximum amount permitted under the Internal Revenue Code, such amount to be determined annually by the Board of Directors. The contribution was \$1,869,482 and \$2,093,166 for the years ended June 30, 2013 and 2012, respectively.

**MENTAL HEALTH SYSTEMS, INC.
NOTES TO FINANCIAL STATEMENTS
JUNE 30, 2013**

NOTE 11 - OPERATING LEASES

The Organization has entered into long-term operating lease agreements for program facilities and the corporate office facility. These leases expire throughout the years ending October 2020. All facility leases include an early termination clause that allows the Organization to terminate the lease, without penalty, should the funding agency terminate funding for the program or require relocation.

The Organization leases various types of office equipment under non-cancelable operating lease agreements that expire throughout the years ending January 2016. Aggregate future minimum operating lease commitments are as follows:

Year ending June 30,	Facilities	Equipments	Total
2014	\$ 4,244,616	\$ 154,756	\$ 4,399,372
2015	2,743,330	61,664	2,804,994
2016	1,696,718	14,921	1,711,639
2017	1,387,128	-	1,387,128
Thereafter	2,128,417	-	2,128,417
Total future lease payments	<u>\$ 12,200,209</u>	<u>\$ 231,341</u>	<u>\$ 12,431,550</u>

During the year ended June 30, 2013, the Organization incurred expenses of \$4,585,034 and \$419,722, respectively, associated with facility and equipment leases.

NOTE 12 - MATERIAL CONTRACTS

The Organization is the recipient of funds under numerous contracts, several of which could be considered material to the overall operations of the Organization when considered separate from other contracts. Management does not consider this to be a material exposure as the expenses related to such revenue can be terminated simultaneously with the cessation of revenue.

NOTE 13 - BOSTON VILLAS

Boston Villas (the "Project") is a rental housing development occupied by mentally disabled persons of low income. The Organization administers the program and also provides supportive services for the residents.

Replacement Reserve

The Organization is required to maintain a reserve for capital improvements such as replacing structural elements, furniture, fixtures or equipment of the Project. There is \$56,298 on reserve as of June 30, 2013.

Operating Reserve

The Organization is also required to maintain an operating reserve for the Project. This reserve can be used only for cash shortages that may occur resulting from unusually high maintenance expenses, seasonal fluctuations in utility costs, abnormally high vacancies, and other expenses that vary seasonally from month-to-month. There is \$28,833 on reserve as of June 30, 2013.

MENTAL HEALTH SYSTEMS, INC.
NOTES TO FINANCIAL STATEMENTS
JUNE 30, 2013

NOTE 14 - RELATED PARTIES

A. Job Options, Inc.

Three members of the Board of Directors are interested persons of entities with which the Organization engages in business transactions. One member of the Board of Directors provides leased facilities for one of the Organization's programs at fair market value. Two members are interested parties at Job Options, Inc., with which MHS provides employee assistance counselors. The vocational rehabilitation segment of Mental Health Systems, Inc.'s business was incorporated into a separate entity known as Job Options, Inc. on April 1, 1994.

B. Behavioral Healthcare Solutions, Inc.

Behavioral Healthcare Solutions, Inc. ("BHS") is a for-profit company and is 100% owned by the Organization. BHS was incorporated during the year ended June 30, 2010. BHS was incorporated to administer certain government contracts. There was no activity during the fiscal year ended June 30, 2013.

NOTE 15 - SUBSEQUENT EVENT

The Organization's management has evaluated events or transactions that may occur for potential recognition or disclosure in the financial statements from the balance sheet date through December 23, 2013, which is the date the financial statements were available to be issued. Management has determined that there were no subsequent events or transactions that would have a material impact on the current year financial statements.

MENTAL HEALTH SYSTEMS, INC.
SUPPLEMENTARY INFORMATION SECTION
JUNE 30, 2013

MENTAL HEALTH SYSTEMS, INC.
SUPPLEMENTARY SCHEDULE OF OTHER DIRECT EXPENSE
FOR THE FISCAL YEARS ENDED JUNE 30, 2013
(WITH SUMMARIZED FINANCIAL INFORMATION AS OF JUNE 30, 2012)

	2013	2012
Accounting and legal services	\$ 5,972	\$ 17,036
Depreciation	279,400	340,611
Dues and subscriptions	15,718	18,127
Equipment rental	288,076	340,195
Housekeeping and general supplies	166,594	165,529
Insurance	1,732,316	2,476,543
Interest and bank fees	355,022	306,149
Laboratory fees	1,200,380	1,193,059
Licenses, fees and taxes	158,734	171,550
Minor/major equipment	525,919	978,740
Office supplies	434,433	478,821
Other business services	2,851,008	2,450,626
Printing and advertising	124,523	141,413
Repairs and maintenance	300,277	334,037
RT / OT supplies and food	851,914	1,204,615
Staff development	283,343	390,140
Travel and transportation	1,321,722	1,140,327
Utilities and telephone	1,540,942	1,483,185
Total other direct expense	<u>\$ 12,436,293</u>	<u>\$ 13,630,703</u>

MENTAL HEALTH SYSTEMS, INC.
SUPPLEMENTARY SCHEDULE OF OTHER INDIRECT EXPENSE
FOR THE YEARS ENDED JUNE 30, 2013
(WITH SUMMARIZED FINANCIAL INFORMATION AS OF JUNE 30, 2012)

	2013	2012
Accounting and legal services	\$ 61,813	\$ 41,493
Depreciation	327,585	423,929
Dues and subscriptions	55,656	80,329
Equipment rental	131,646	204,621
Housekeeping and general supplies	10,376	10,164
Insurance	212,292	254,689
Interest and bank fees	243,158	270,551
Licenses, fees and taxes	19,919	19,597
Minor/major equipment	92,154	107,186
Office supplies	65,533	53,012
Other business services	718,713	659,055
Printing and advertising	36,416	42,323
Repairs and maintenance	110,293	38,712
Staff development	73,959	125,053
Travel and transportation	183,253	285,042
Utilities and telephone	198,085	198,148
Total other direct expense	<u>\$ 2,540,851</u>	<u>\$ 2,813,904</u>

**MENTAL HEALTH SYSTEMS, INC.
SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS
FOR THE FISCAL YEAR ENDED JUNE 30, 2013**

Federal Grantor/ Pass-Through Grantor/ Program Title	Federal CFDA Number	Pass-Through Entity Identifying Number	Federal Expenditures
U.S. Department of Education:			
Pass-Through State of California Dept. of Rehabilitation:			
Rehabilitation Services_Vocational Rehabilitation Grants to States	84.126	N/A	\$ 668,178
Pass-Through State of California Dept. of Ele. and Secondary Education:			
Safe and Drug-Free Schools and Communities_National Programs	84.184	N/A	<u>20,675</u>
Total U.S. Department of Education			688,853
U.S. Department of Housing and Urban Development:			
Supportive Housing Program	14.235	N/A	212,449
Pass-Through San Diego County:			
Shelter Plus Care Program	14.238	N/A	<u>1,258,492</u>
Total U.S. Department of Housing and Urban Development			1,470,941
U.S. Department of Justice:			
Pass-Through San Diego County:			
Edward Byrne Memorial Justice Assistance Grant Program	16.738	N/A	26,622
Recovery Act - Edward Bryne Memorial Justice Assistance Grant/ Grants to States and Territories	16.803	N/A	396,707
Pass-Through Fresno County:			
Drug Court Discretionary Grant Program	16.585	N/A	<u>35,200</u>
Total U.S. Department of Justice			458,529
U.S. Department of Labor:			
Pass-Through San Bernardino County:			
WIA Youth Activities	17.259	N/A	<u>35,960</u>
Total U.S. Department of Labor			35,960
U.S. Department of Health and Human Services:			
Substance Abuse and Mental Health Services_Projects of Regional and National Significance	93.243	N/A	511,035

MENTAL HEALTH SYSTEMS, INC.
SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS (CONTINUED)
FOR THE FISCAL YEAR ENDED JUNE 30, 2013

Federal Grantor/ Pass-Through Grantor/ Program Title	Federal CFDA Number	Pass-Through Entity Identifying Number	Federal Expenditures
Pass-Through San Diego County:			
Projects for Assistance in Transition from Homelessness	93.150	N/A	79,337
Substance Abuse and Mental Health Services_Projects of Regional and National Significance	93.243	N/A	270,232
Teenage Pregnancy Prevention Program	93.297	N/A	188,885
Substance Abuse Prevention and Treatment (SAPT) Block Grant	93.959	N/A	2,324,356
Pass-Through Riverside County:			
Substance Abuse and Mental Health Services_Projects of Regional and National Significance	93.243	N/A	338,681
Promoting Safe and Stable Families	93.556	N/A	365,188
Pass-Through Fresno County:			
Substance Abuse and Mental Health Services_Projects of Regional and National Significance	93.243	N/A	318,634
Medical Assistance Program, Medicaid: Title XIX	93.778	N/A	485,794
Substance Abuse Prevention and Treatment (SAPT) Block Grant	93.959	N/A	459,732
Pass-Through San Bernardino County:			
Substance Abuse and Mental Health Services_Projects of Regional and National Significance	93.243	N/A	53,313
Medical Assistance Program, Medicaid: Title XIX	93.778	N/A	1,193,900
Substance Abuse Prevention and Treatment (SAPT) Block Grant	93.959	N/A	794,434
Total U.S. Department of Health and Human Services			<u>7,383,521</u>
TOTAL EXPENDITURES OF FEDERAL AWARDS			<u><u>\$ 10,037,804</u></u>

NOTE 1 - BASIS OF PRESENTATION

The accompanying schedule of expenditures of federal awards includes the federal grant activity of Mental Health Systems, Inc. and is presented on the modified accrual basis of accounting. The information in this schedule is presented in accordance with the requirements of OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*. Therefore, some amounts presented in this schedule may differ from amounts presented in, or used in preparation of, the basic financial statement.

MENTAL HEALTH SYSTEMS, INC.
OTHER INDEPENDENT AUDITORS' REPORTS SECTION
JUNE 30, 2013



Hosaka, Rotherham & Company
Certified Public Accountants

James A. Rotherham, CPA
CEO & Managing Partner

.....
Roy T. Hosaka, CPA
Retired

James C. Nagel, CPA
Retired

**INDEPENDENT AUDITORS' REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING AND
ON COMPLIANCE AND OTHER MATTERS BASED ON AN AUDIT OF FINANCIAL STATEMENTS
PERFORMED IN ACCORDANCE WITH GOVERNMENT AUDITING STANDARDS**

Board of Directors
Mental Health Systems, Inc.
San Diego, California

We have audited, in accordance with the auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States, the financial statements of Mental Health Systems, Inc. (a nonprofit organization), which comprise the statement of financial position as of June 30, 2013, and the related statements of activities, functional expense, and cash flows for the fiscal year then ended, and the related notes to the financial statements, and have issued our report thereon dated December 23, 2013.

Internal Control Over Financial Reporting

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

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

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

INDEPENDENT AUDITORS' REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING AND ON COMPLIANCE AND OTHER MATTERS BASED ON AN AUDIT OF FINANCIAL STATEMENTS PERFORMED IN ACCORDANCE WITH GOVERNMENT AUDITING STANDARDS

Page 2

Compliance and Other Matters

As part of obtaining reasonable assurance about whether Mental Health Systems, Inc.'s financial statements are free from material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*.

Purpose of this Report

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

Hosaka, Rotherham & Company

San Diego, California
December 23, 2013



Hosaka, Rotherham & Company
Certified Public Accountants

James A. Rotherham, CPA
CEO & Managing Partner

Roy T. Hosaka, CPA
Retired

James C. Nagel, CPA
Retired

**INDEPENDENT AUDITOR'S REPORT ON COMPLIANCE FOR EACH
MAJOR PROGRAM AND ON INTERNAL CONTROL OVER
COMPLIANCE REQUIRED BY OMB CIRCULAR A-133**

Board of Directors
Mental Health Systems, Inc.
San Diego, California

Report on Compliance for Each Major Federal Program

We have audited Mental Health Systems, Inc.'s 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 Mental Health Systems, Inc.'s major federal programs for the fiscal year ended June 30, 2013. Mental Health Systems, Inc.'s major federal programs are identified in the summary of auditor's results section of the accompanying schedule of findings and questioned costs.

Management's Responsibility

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

Auditor's Responsibility

Our responsibility is to express an opinion on compliance for each of Mental Health Systems, Inc.'s major federal programs based on our audit of the types of compliance requirements referred to above. We conducted our audit of compliance in accordance with auditing standards generally accepted in the United States of America; the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; and 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 Mental Health Systems, Inc.'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 on compliance for each major federal program. However, our audit does not provide a legal determination of Mental Health Systems, Inc.'s compliance.

Opinion on Each Major Federal Program

In our opinion, Mental Health Systems, Inc. complied, in all material respects, with the types of compliance requirements referred to above that could have a direct and material effect on each of its major federal programs for the fiscal year ended June 30, 2013.

**INDEPENDENT AUDITOR'S REPORT ON COMPLIANCE FOR EACH MAJOR PROGRAM
AND ON INTERNAL CONTROL OVER COMPLIANCE REQUIRED BY OMB CIRCULAR A-133
Page 2**

Report on Internal Control Over Compliance

Management of Mental Health Systems, Inc. is responsible for establishing and maintaining effective internal control over compliance with the types of compliance requirements referred to above. In planning and performing our audit of compliance, we considered Mental Health Systems, Inc.'s internal control over compliance with the types of requirements that could have a direct and material effect on each major federal program to determine the auditing procedures that are appropriate in the circumstances for the purpose of expressing an opinion on compliance for each major federal program 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 Mental Health Systems, Inc.'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 material noncompliance with a type of compliance requirement of a federal program will not be prevented, or detected and corrected, on a timely basis. A *significant deficiency in internal control over compliance* is a deficiency, or a combination of deficiencies, in internal control over compliance with a type of compliance requirement of a federal program that is less severe than a material weakness in internal control over compliance, yet important enough to merit attention by those charged with governance.

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

The purpose of this report on internal control over compliance is solely to describe the scope of our testing of internal control over compliance and the results of that testing based on the requirements of OMB Circular A-133. Accordingly, this report is not suitable for any other purpose.

Hosaka, Rotherham & Company

San Diego, California
December 23, 2013

MENTAL HEALTH SYSTEMS, INC.
FINDINGS AND RECOMMENDATIONS SECTION
JUNE 30, 2013

**MENTAL HEALTH SYSTEMS, INC.
SCHEDULE OF AUDIT FINDINGS AND QUESTIONED COSTS
FOR THE FISCAL YEAR ENDED JUNE 30, 2013**

A. Summary of Auditors' Results

1. Financial Statements

Type of auditors' report issued: Unqualified

Internal control over financial reporting:

One or more material weaknesses identified? Yes X No

One or more significant deficiencies identified that are not considered to be material weaknesses? Yes X None Reported

Noncompliance material to financial statements noted? Yes X No

2. Federal Awards

Internal control over major programs:

One or more material weaknesses identified? Yes X No

One or more significant deficiencies identified that are not considered to be material weaknesses? Yes X None Reported

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

Any audit findings disclosed that are required to be reported in accordance with section .510(a) or Circular A-133? Yes X No

Identification of major programs:

<u>CFDA Number(s)</u>	<u>Name of Federal Program or Cluster</u>
93.778	Medical Assistance Program, Medicaid: Title XIX
93.959	Substance Abuse Prevention and Treatment (SAPT) Block Grant

Dollar threshold used to distinguish between type A and type B programs: \$301,134

Auditee qualified as low-risk auditee? X Yes No

**MENTAL HEALTH SYSTEMS, INC.
SUMMARY SCHEDULE OF PRIOR AUDIT FINDINGS
JUNE 30, 2013**

<u>Findings/Recommendations</u>	<u>Current Status</u>	<u>Explanation If Not Implemented</u>
None	N/A	N/A