

**MENTAL HEALTH SYSTEMS, INC.**

*Financial Section*

***June 30, 2014***

INDEPENDENT AUDITOR'S REPORT

To the Board of Directors of  
Mental Health Services, Inc.  
San Diego, California

**Report on the Financial Statements**

We have audited the accompanying financial statements of Mental Health Services, Inc. (a nonprofit organization), which comprise the statement of financial position as June 30, 2014, and the related statements of activities, functional expenses and cash flows 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 representation 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 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 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 AUDITOR'S REPORT

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### 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, 2014, and the changes in its net assets and its cash flows for the year then ended in accordance with accounting principles generally accepted in the United States of America.

### Prior Period Financial Statements and Summarized Comparative Information

The financial statements of Mental Health Systems, Inc. as of June 30, 2013, were audited by other auditors whose report dated December 23, 2013, expressed an unmodified opinion on those statements.

In our opinion, the summarized comparative information presented herein as of and for the fiscal year ended June 30, 2013, 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 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 March 5, 2015, 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.

 CPA

Temecula, California  
March 5, 2015

**MENTAL HEALTH SYSTEMS, INC.**  
**STATEMENT OF FINANCIAL POSITION**  
June 30, 2014  
(WITH SUMMARIZED FINANCIAL INFORMATION AS OF JUNE 30, 2013)

<b>ASSETS</b>	2014	2013
<b>Current Assets</b>		
Cash and cash equivalents (Note 3)	\$ 2,683,248	\$ 1,389,560
Investments (Note 4)	-	-
Contracts receivables, net of allowance of \$350,000 (Note 5)	12,354,099	15,191,201
Short-term notes receivable	61,614	60,000
Other receivables	2,583,149	66,380
Prepaid expense	790,863	479,512
<b>Total Current Assets</b>	<b>18,472,973</b>	<b>17,186,653</b>
Fixed assets, net of depreciation (Note 6)	13,374,340	12,545,022
<b>Noncurrent assets</b>		
Investment	5,000	5,000
Deposits	867,592	876,099
<b>Total Other Assets</b>	<b>872,592</b>	<b>881,099</b>
<b>Total Assets</b>	<b>\$ 32,719,905</b>	<b>\$ 30,612,774</b>
<b>LIABILITIES AND NET ASSETS</b>		
<b>Current Liabilities</b>		
Accounts payable	\$ 2,571,329	\$ 2,466,876
Accrued payroll and related taxes	1,265,210	1,209,582
Accrued employee benefits	4,384,253	4,397,468
Deferred revenue	513,998	430,681
Other liabilities	1,102,681	1,604,691
Line of credit	2,177,057	-
Current portion of long-term debt (Note 7)	-	256,150
<b>Total Current Liabilities</b>	<b>12,014,528</b>	<b>10,365,448</b>
Notes payable, net of current portion (Note 7)	8,861,881	8,904,963
<b>Total Liabilities</b>	<b>20,876,409</b>	<b>19,270,411</b>
<b>Net Assets</b>		
Unrestricted	11,764,305	11,296,316
Temporarily restricted (Note 9)	79,191	46,047
<b>Total Net Assets</b>	<b>11,843,496</b>	<b>11,342,363</b>
<b>Total Liabilities and Net Assets</b>	<b>\$ 32,719,905</b>	<b>\$ 30,612,774</b>

The accompanying notes are an integral part of these financial statements

**MENTAL HEALTH SYSTEMS, INC.**  
**STATEMENT OF ACTIVITIES**  
For the Fiscal Year Ended June 30, 2014  
(WITH SUMMARIZED FINANCIAL INFORMATION AS OF JUNE 30, 2013)

	<u>Unrestricted</u>	<u>Temporarily Restricted</u>	<u>2014</u>	<u>Total 2013</u>
<b>Revenue and Support</b>				
Contract revenue	\$ 72,452,425	\$ -	\$ 72,452,425	\$ 75,345,557
Other revenue	2,271,978	-	2,271,978	2,673,130
Fundraising, net of direct expenses	154,409	-	154,409	173,308
Donations	66,083	43,608	109,691	77,987
Total support	74,944,895	43,608	74,988,503	78,269,982
Net assets released from restrictions	10,464	(10,464)	-	-
Total revenues and support	74,955,359	33,144	74,988,503	78,269,982
<b>Direct Expense</b>				
Payroll	25,305,813	-	25,305,813	25,506,678
Payroll benefits	6,061,016	-	6,061,016	6,159,044
Purchased services	14,362,597	-	14,362,597	16,013,185
Occupancy costs	4,160,350	-	4,160,350	4,125,103
Consultants	3,856,563	-	3,856,563	4,132,690
Other direct expense	12,032,857	-	12,032,857	12,436,293
Unallocable expense	-	-	-	-
Total direct expense	65,779,196	-	65,779,196	68,372,993
<b>Indirect Expense</b>				
Payroll	4,532,837	-	4,532,837	4,490,846
Payroll benefits	612,552	-	612,552	505,456
Occupancy costs	501,406	-	501,406	459,931
Consultants	328,218	-	328,218	319,223
Other indirect expense	2,187,403	-	2,187,403	2,540,851
Unallocable expense	545,758	-	545,758	1,053,390
Total indirect expense	8,708,174	-	8,708,174	9,369,697
Total expenses	74,487,370	-	74,487,370	77,742,690
<b>CHANGE IN NET ASSETS</b>	467,989	33,144	501,133	527,292
<b>NET ASSETS, BEGINNING OF YEAR</b>	11,296,316	46,047	11,342,363	10,815,071
<b>NET ASSETS, END OF YEAR</b>	\$ 11,764,305	\$ 79,191	\$ 11,843,496	\$ 11,342,363

The accompanying notes are an integral part of these financial statements

**MENTAL HEALTH SYSTEMS, INC.**  
**STATEMENT OF FUNCTIONAL EXPENSE**  
For the Fiscal Year Ended June 30, 2014  
(WITH SUMMARIZED FINANCIAL STATEMENT INFORMATION AS OF JUNE 30, 2013)

	Program Service	Management & General	Total	
			2014	2013
<b>Total Direct and Indirect Expense</b>				
Accounting & legal	\$ 9,007	\$ (57,291)	\$ (48,284)	\$ 67,785
Consultants	3,856,563	328,218	4,184,781	4,451,913
Depreciation	213,562	230,269	443,831	606,984
Dues and subscriptions	9,747	101,790	111,537	71,376
Equipment rental	195,284	52,254	247,538	419,722
Housekeeping and general supplies	203,491	13,100	216,591	176,970
Insurance	1,600,074	204,194	1,804,268	1,944,608
Interest and bank fees	322,371	297,275	619,646	598,180
Laboratory fees	1,179,916	-	1,179,916	1,200,380
License, fees and taxes	132,206	11,014	143,220	178,653
Minor/major equipment	608,429	138,549	746,978	618,073
Occupancy costs	4,160,350	501,406	4,661,756	4,585,034
Office supplies	484,189	47,753	531,942	499,966
Other business services	2,888,258	526,802	3,415,060	3,550,999
Payroll	25,305,813	4,532,837	29,838,650	29,997,524
Payroll benefits	6,061,016	612,551	6,673,567	6,664,500
Printing and advertising	96,521	27,820	124,341	160,939
Purchased services	14,362,597	-	14,362,597	16,013,185
Repair and maintenance	349,226	147,701	496,927	410,570
RT / OT supplies and food	898,034	-	898,034	851,914
Staff development	176,200	51,315	227,515	357,302
Travel and transportation	1,134,400	202,249	1,336,649	1,504,975
Utilities and telephone	1,521,534	192,610	1,714,144	1,757,748
<b>Total Direct and Indirect Expense</b>	<b>\$ 65,768,788</b>	<b>\$ 8,162,416</b>	<b>\$ 73,931,204</b>	<b>\$ 76,689,300</b>
<b>Unallocable Expense</b>				
Bad debt	10,408	394,603	405,011	363,253
Unallowable/Unallocable expenses	-	151,155	151,155	690,137
<b>Total Unallocable Expense</b>	<b>10,408</b>	<b>545,758</b>	<b>556,166</b>	<b>1,053,390</b>
<b>Total Direct, Indirect Expense and Unallocable Expense</b>	<b>\$ 65,779,196</b>	<b>\$ 8,708,174</b>	<b>\$ 74,487,370</b>	<b>\$ 77,742,690</b>

The accompanying notes are an integral part of these financial statements

**MENTAL HEALTH SYSTEMS, INC.**  
**STATEMENT OF CASH FLOWS**  
For the Fiscal Year Ended June 30, 2014  
(WITH SUMMARIZED FINANCIAL STATEMENT INFORMATION AS OF JUNE 30, 2013)

	2014	2013
<b>Cash Flow from Operating Activities:</b>		
Change in net assets	\$ 501,132	\$ 527,292
Add charges to revenue not requiring use of cash:		
Depreciation	443,831	606,984
Unrealized gain on investments	-	(14,358)
Adjustments to reconcile change in net assets to net cash from operations:		
(Increase) decrease in operating assets:		
Contract receivable and other receivables	320,334	(3,026,261)
Prepaid expense	(311,351)	(315,117)
Deposits	8,507	(514,261)
Increase (decrease) in operating liabilities:		
Accounts payable and accrued expenses	(355,144)	(749,578)
Deferred revenue	83,317	(199,982)
Net cash provided / (used) for operating activities	690,626	(3,685,281)
<b>Cash Flow from Investing Activities:</b>		
Investment purchases	-	(35,015)
Proceed from sale of investment	-	336,624
Dispersement for short-term note receivable	(1,614)	(60,000)
Disposals of property and equipment	16,421	-
Acquisition of property and equipment	(1,289,571)	(611,026)
Net cash provided / (used) for investing activities	(1,274,764)	(369,417)
<b>Cash Flow from Financing Activities:</b>		
Proceeds on notes payable and line of credit	8,987,718	-
Payments on notes payable	(7,114,767)	(332,467)
Other cash flow from financing activities	4,875	4,875
Net cash provided by financing activities	1,877,826	(327,592)
<b>Net increase in cash and cash equivalents</b>	1,293,688	(4,382,290)
<b>Cash and cash equivalents beginning of year</b>	1,389,560	5,771,850
<b>Cash and cash equivalents at end of year</b>	\$ 2,683,248	\$ 1,389,560
<b>Supplemental disclosure of cash flow information</b>		
Cash payments for:		
Interest	\$ 543,137	\$ 562,415

The accompanying notes are an integral part of these financial statements

## 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

### Financial statement presentation

The financial statements are presented in conformity with Accounting Standards Codification (ASC) 958-205, *Not-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, temporarily restricted, and permanently restricted. Contributions of cash or other assets are recorded as temporarily restricted support if they are received with donor restrictions regarding their use. When a donor-imposed restriction expires, that is, when a stipulated time restriction ends or stipulated 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. As permitted by ASC 958-205, the Organization reports all temporarily restricted support as unrestricted support if the funds were expended during the same year. The Organization does not have any permanently restricted net assets.

### 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.

### Comparative Financial Statements

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, 2013, 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.



**NOTE 2 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)**

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 to the valuation methodology include:

- Quoted prices for similar assets or liabilities in active markets;
- Quoted prices for identical assets or liabilities in inactive markets;
- Inputs other than quoted prices that are observable for the asset or liability;
- Inputs that are derived principally from or corroborated by observable market data by correlation or other means.

Level 3 – Inputs to the valuation methodology are unobservable that are supported by little or no market activity and that are significant to the fair value of the asset or liability.

At June 30, 2014, 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:

Assets:	<u>Total</u>	<u>Identical Assets (Level 1)</u>	<u>Observable Input (Level 2)</u>	<u>Unobservable Input (Level 3)</u>
Cash and cash equivalents	\$ 2,683,248	\$ 2,683,248	\$ -	\$ -
Securities	<u>5,000</u>	<u>-</u>	<u>5,000</u>	<u>-</u>
Total	<u>\$ 2,688,248</u>	<u>\$ 2,683,248</u>	<u>\$ 5,000</u>	<u>\$ -</u>

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.

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.

**NOTE 2 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)**

Income taxes

The Organization is exempt from income taxes under Internal Revenue 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. The Organization will incur unrelated business income in regards to the management fee earned from Novata Behavioral Health. (See Note 14)

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.

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.

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.

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'

Fixed Assets

Fixed assets are reported 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.

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, 2014 and 2013, consist of the following:

Concentration of risk:	<u>2014</u>	<u>2013</u>
Deposits:		
Cash in banks	\$ 2,159,543	\$ 866,912
Money market funds	393,104	392,463
Certificates of deposit	100,451	100,350
Cash on hand:		
Petty cash	30,150	29,835
Total cash and cash equivalents	<u>\$ 2,683,248</u>	<u>\$ 1,389,560</u>

Cash balances held in banks are insured up to \$250,000 by the Federal Depository Insurance Corporation (FDIC). The Organization maintains its cash in bank deposit accounts that at times may exceed federally insured limits. At June 30, 2014, the Organization had \$1,933,248 in uninsured funds.

**NOTE 4 – INVESTMENTS**

Investments at June 30, 2014, are summarized as follows:

<u>Description</u>	<u>Cost</u>	<u>Fair Value</u>	<u>Carrying Value</u>
Novata Behavioral Health, Inc. (Previously named Behavioral Healthcare Solutions, Inc.)	\$ 3,820	\$ 5,000	\$ 5,000

The following schedule summarizes the investment return and its classification in the statement of activities as of June 30, 2014 and 2013, respectively.

	<u>2014</u>	<u>2013</u>
Interest and dividends	\$ 3,217	\$ 10,015
Unrealized gain	-	14,358
Check purchase	-	25,000
Net Investment return	<u>\$ 3,217</u>	<u>\$ 49,373</u>

**NOTE 5 – CONTRACTS RECEIVABLE**

Contracts receivable are balances due Mental Health Systems, Inc. for services provided and expenses incurred prior to June 30, 2014 and 2013, pursuant to written contracts with various public agencies. The balance shown on the financial statements is net of an allowance for doubtful accounts of \$500,000 and \$350,000 as of June 30, 2014 and 2013, respectively.

MENTAL HEALTH SYSTEMS, INC.  
 NOTES TO FINANCIAL STATEMENTS  
 JUNE 30, 2014

**NOTE 6 – FIXED ASSETS**

Fixed assets at June 30, 2014 and 2013, consisted of the following:

	<u>2014</u>	<u>2013</u>
Land	\$ 3,539,328	\$ 3,539,328
Construction in progress	1,960,997	532,972
Buildings and facilities	10,979,878	10,537,730
Leasehold improvements	950,008	950,008
Vehicles	857,235	857,235
Furniture and fixtures	1,239,915	1,248,599
Software	366,565	518,259
	<u>19,893,926</u>	<u>18,184,131</u>
Less: accumulated depreciation	(6,519,586)	(5,639,109)
Total fixed assets, net of depreciation	<u>\$ 13,374,340</u>	<u>\$ 12,545,022</u>

Depreciation expense for the fiscal years ended June 30, 2014 and 2013, were \$443,831 and \$606,984 respectively.

**NOTE 7 – NOTES PAYABLE**

Notes payable consist of the following:

	<u>Balance</u> <u>2013</u>	<u>Additions</u>	<u>Payments</u>	<u>Balance</u> <u>2014</u>	<u>Due in</u> <u>One Year</u>
California Department of Housing and Community Development	\$ 248,689	\$ 4,875	\$ 47,957	\$ 205,607	\$ 47,938
City of Oceanside #1	53,136	-	26,864	26,272	26,273
City of Oceanside #2	644,893	-	10,598	634,295	11,112
California Health Facilities Financing Authority	328,795	-	30,994	297,801	31,936
National Cooperative Bank	955,600	-	187,694	767,906	185,490
U.S. Bancorp	6,930,000	-	-	6,930,000	-
	<u>\$ 9,161,113</u>	<u>\$ 4,875</u>	<u>\$ 304,107</u>	<u>\$ 8,861,881</u>	<u>\$ 302,749</u>

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, 2014, is \$162,500. Accrued interest as of June 30, 2014, is \$43,106.

**NOTE 7 – NOTES PAYABLE (CONTINUED)**

City of Oceanside #1

The Organization has a note payable to the City of Oceanside, California 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, 2014, was \$26,272.

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, 2014, was \$634,295.

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, California. 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, 2014, was \$297,801.

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, California. 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, 2014. The annual interest rate and minimum monthly payment at June 30, 2014, was 7.80% and \$21,383, respectively. The principal balance at June 30, 2014, was \$767,906.

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, California. 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.

**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, 2014, and has an interest rate of 4.6%. The balance as of June 30, 2014, was \$2,177,057. As of the date of this financial statement, the LOC has been renewed and will mature September 30, 2015.

**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 \$79,191 and \$46,047 as of June 30, 2014 and 2013, respectively.

**NOTE 10 – 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 December 2019. 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 office equipment under non-cancelable operating lease agreements that expire throughout the years ending August 31, 2017.

Aggregate future minimum operating lease commitments are as follows:

<u>Years ending June 30,</u>	<u>Facilities</u>	<u>Equipment</u>	<u>Total</u>
2015	\$ 4,335,732	\$ 101,668	\$ 4,437,400
2016	2,842,111	30,152	2,872,263
2017	2,474,654	11,128	2,485,782
2018	1,996,221	-	1,996,221
Thereafter	1,586,427	-	1,586,427
Total future lease payments	\$ <u>13,235,145</u>	\$ <u>142,948</u>	<u>13,378,093</u>

During the year ended June 30, 2014, the Organization incurred expenses of \$4,661,756 and \$247,538, respectively, associated with facility and equipment leases.

**NOTE 11 – 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 \$1,967,125 and \$1,869,482 for the years ended June 30, 2014 and 2013, respectively.

**NOTE 12 – MATERIAL CONTRACTS**

Mental Health Systems, Inc. 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. This is not considered 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 \$58,015 on reserve as of June 30, 2014.

**NOTE 13 – BOSTON VILLAS, (CONTINUED)**

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 \$28,920 on reserve as of June 30, 2014.

**NOTE 14 – RELATED PARTIES**

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.

During the year, there were two members that were interested parties at Job Options, Inc with which MHS provided 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.

Behavioral Healthcare Solutions, Inc.  
Center for Autism Research Evaluation and Services ("CARES")  
Novata Behavioral Health

Behavioral Healthcare Solutions, Inc. ("BHS") was a for-profit company and was 100% owned by the Organization. BHS was incorporated during the year ended June 30, 2010 to administer certain government contracts.

On November 23, 2013, BHS acquired the stock of CARES for \$4,000,000. BHS obtained a \$4,000,000 loan with a 7 year repayment term from National Cooperative Bank for the purchase. The loan agreement required the Organization to sign a "Guarantor Agreement" for BHS, whereby the Organization agrees to provide cash as needed for the ongoing operations of BHS/CARES.

On January 1, 2014, BHS was merged into CARES. Simultaneously, the name of the corporation was changed to Novata Behavioral Health, Inc., a California corporation.

The Organization received revenue from Novata in the form of a management fee during the year ended June 30, 2014 in the amount of \$357,701.

**NOTE 15 – SUBSEQUENT EVENTS**

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 March 5, 2015, 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 financial statements.

MENTAL HEALTH SYSTEMS, INC.  
 SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS  
 FOR THE FISCAL YEAR ENDED JUNE 30, 2014

Federal Grantor/ Pass-Through Grantor/Program Title	Federal CFDA Number	Pass-Through Entity Identifying Number	Federal Expenditures
<b>U.S. Department of Education</b>			
Pass-Through State of California Dept of Rehabilitation Rehabilitation Services - Vocational Rehabilitation Grants to States	84.126	N/A	\$ <u>692,547</u>
<b>Total U.S. Department of Education</b>			<u>692,547</u>
<b>U.S. Department of Housing and Urban Development</b>			
Supportive Housing Program Pass-Through San Diego County	14.235	N/A	169,647
Shelter Plus Care Program	14.238	N/A	<u>627,550</u>
<b>Total U.S. Department of Housing and Urban Development</b>			<u>797,197</u>
<b>U.S. Department of Justice</b>			
Pass-Through San Diego County Edward Byrne Memorial Justice Assistance Grant Program	16.738	N/A	<u>25,383</u>
<b>Total U.S. Department of Justice</b>			<u>25,383</u>
<b>U.S. Department of Health and Human Services</b>			
Pass-Through San Diego County Projects for Assistance in Transition from Homelessness Substance Abuse and Mental Health Services-Projects of Regional and National Significance	93.150	N/A	77,163
Teenage Pregnancy Prevention Program	93.243	N/A	72,164
Substance Abuse Prevention and Treatment (SAPT) Block Grant	93.297	N/A	158,649
	93.959	N/A	3,108,811
Pass-Through Riverside County Substance Abuse and Mental Health Services-Projects of Regional and National Significance	93.243	N/A	315,175
Pass-Through Fresno County Substance Abuse and Mental Health Services-Projects of Regional and National Significance	93.243	N/A	288,175
Medical Assistance Program, Medicaid; Title XIX	93.778	N/A	235,347
Substance Abuse Prevention and Treatment (SAPT) Block Grant	93.959	N/A	283,523
Pass Through San Bernardino County Medical Assistance Program, Medicaid; Title XIX	93.778	N/A	1,246,304
Substance Abuse Prevention and Treatment (SAPT) Block Grant	93.959	N/A	<u>639,750</u>
<b>Total U.S. Department of Health and Human Services</b>			<u>6,425,061</u>
<b>TOTAL EXPENDITURES OF FEDERAL AWARDS</b>			<u>\$ <u>7,940,188</u></u>

**NOTE I - 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*

***June 30, 2014***

**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, 2014, and the related statements of activities, functional expense, and cash flows for the year then ended, and the related notes to the financial statements, and have issued our report thereon dated March 5, 2015.

**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.

  
San Diego, California  
March 5, 2015

**INDEPENDENT AUDITOR'S REPORT ON COMPLIANCE FOR EACH  
MAJOR PROGRAMS 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, 2014. 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, 2014.

**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.

  
San Diego, California  
March 5, 2015

**MENTAL HEALTH SYSTEMS, INC.**

*Findings and Recommendations Section*

***June 30, 2014***

**MENTAL HEALTH SYSTEMS, INC.  
SCHEDULE OF FINDINGS AND QUESTIONED COSTS  
FOR THE FISCAL YEAR ENDED JUNE 30, 2014**

**Section I – Summary of Auditor’s Results**

**Financial Statements**

Type of Auditor’s report issued:

Unmodified

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

**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 auditor’s report issued on compliance for major programs:

Unmodified

Any audit findings disclosed that are required to be reported in accordance with section 510(a) of Circular A-133?

\_\_\_\_\_ Yes      X   No

Identification of major programs:

<u>CFDA Number(s)</u>	<u>Name of Federal Program or Cluster</u>
14.238	Shelter Plus
14.235	Supportive Housing
84.126	Vocational Rehabilitation Grants to States
93.243	Substance Abuse and Mental Health Services-Projects of Regional and National Significance
93.297	Teenage Pregnancy Prevention Program

Dollar threshold used to distinguish between Type A and type B Programs:

\$300,000

Auditee qualified as low-risk auditee?

  X   Yes    \_\_\_\_\_ No

**MENTAL HEALTH SYSTEMS, INC.  
SCHEDULE OF FINDINGS AND QUESTIONED COSTS  
FOR THE FISCAL YEAR ENDED JUNE 30, 2014**

**Section I – Summary of Auditor’s Results (continued)**

**State Awards**

Internal control over state programs:

One or more material weaknesses identified?      \_\_\_\_\_ Yes           N/A      No

One or more significant deficiencies identified that  
are not considered to be material weaknesses?      \_\_\_\_\_ Yes           N/A      None Reported

Type of auditor’s report issued on compliance for  
state programs:           N/A    

**Section II – Financial Statement Findings**

None

**Section III – Federal Award Findings and Questioned Costs**

None

**Section IV - State Award Findings and Questioned Costs**

N/A



**MENTAL HEALTH SYSTEMS, INC.  
SUMMARY SCHEDULE OF PRIOR AUDIT FINDINGS  
JUNE 30, 2014**

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