

MENTAL HEALTH SYSTEMS, INC. AND SUBSIDIARIES

**CONSOLIDATED FINANCIAL STATEMENTS
AND
INDEPENDENT AUDITORS' REPORT**

JUNE 30, 2018 and 2017



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MENTAL HEALTH SYSTEMS, INC. AND SUBSIDIARIES
CONSOLIDATED FINANCIAL STATEMENTS
JUNE 30, 2018 and 2017

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INDEPENDENT AUDITORS' REPORT

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

We have audited the accompanying consolidated financial statements of Mental Health Systems, Inc. and subsidiaries (collectively, the "Organization" or "MHS"), which comprise the consolidated statements of financial position as of June 30, 2018, and the related consolidated statements of activities, functional expenses and cash flows for the year then ended, and the related notes to the consolidated financial statements.

Management's Responsibility for the Financial Statements

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

Auditors' Responsibility

Our responsibility is to express an opinion on these consolidated 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 consolidated financial statements are free of material misstatement.

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

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

INDEPENDENT AUDITORS' REPORT (CONT.)

Opinion

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Mental Health Systems, Inc. and subsidiaries as of June 30, 2018, and the changes in their net assets and their cash flows for the year then ended in accordance with accounting principles generally accepted in the United States of America.

Other Matter

Mental Health Systems, Inc. and subsidiaries 2017 financial statements were audited by NSBN LLP, whose practice became part of CliftonLarsonAllen LLP as of January 1, 2018, and whose report dated December 27, 2017 expressed an unmodified opinion on those audited financial statements.

Other Reporting Required by Government Auditing Standards

In accordance with *Government Auditing Standards*, we have also issued our report dated January 24, 2019 on our consideration of the Organization's internal control over financial reporting and on our tests of their compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is solely to describe the scope of our testing of internal control over financial reporting and compliance and the results of the testing, and not to provide an opinion on the effectiveness of internal control over financial reporting or compliance. That report is an integral part of an audit performed in accordance with Governmental Auditing Standards in considering the Organization's internal control over financial reporting and compliance.



CliftonLarsonAllen LLP
Los Angeles, California
January 24, 2019

MENTAL HEALTH SYSTEMS, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF FINANCIAL POSITION
JUNE 30, 2018 and 2017

	<u>2018</u>	<u>2017</u>
ASSETS		
Cash and cash equivalents	\$ 1,247,539	\$ 3,542,357
Restricted cash	105,580	546,335
Contracts and grants receivable, net	12,430,680	9,645,674
Prepaid expenses	1,220,518	1,234,846
Deposits	570,904	397,862
Property and equipment, net	<u>8,949,718</u>	<u>11,038,250</u>
TOTAL ASSETS	<u>\$ 24,524,939</u>	<u>\$ 26,405,324</u>
LIABILITIES		
Accounts payable	\$ 5,182,129	\$ 3,680,044
Accrued liabilities	7,468,868	8,872,984
Deferred revenue	188,971	230,421
Line of credit	4,163,028	3,662,290
Notes payable	<u>4,652,602</u>	<u>8,807,929</u>
TOTAL LIABILITIES	21,655,598	25,253,668
NET ASSETS		
Unrestricted	2,807,976	1,062,175
Temporarily restricted	<u>61,365</u>	<u>89,481</u>
TOTAL NET ASSETS	<u>2,869,341</u>	<u>1,151,656</u>
TOTAL LIABILITIES AND NET ASSETS	<u>\$ 24,524,939</u>	<u>\$ 26,405,324</u>

See accompanying independent auditors' report.
The notes are an integral part of these financial statements.

MENTAL HEALTH SYSTEMS, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENT OF ACTIVITIES
FOR THE YEAR ENDED JUNE 30, 2018

	2018			Total
	Unrestricted	Temporarily Restricted	Permanently Restricted	
REVENUES AND OTHER SUPPORT				
Mental Health Systems - Contract revenue	\$ 62,665,474	\$ -	\$ -	\$ 62,665,474
Mental Health Systems - Other revenue	1,441,293	-	-	1,441,293
Mental Health Systems - Donations	79,120	-	-	79,120
Gain on sale of assets	5,618,915	-	-	5,618,915
Net assets released from restrictions:				
Restriction satisfied by program expenditures	28,116	(28,116)	-	-
TOTAL REVENUES AND OTHER SUPPORT	69,832,918	(28,116)	-	69,804,802
EXPENSES				
Mental Health Systems - Program services	56,882,610	-	-	56,882,610
Mental Health Systems - Management and general	10,055,040	-	-	10,055,040
Novata Behavioral Health - Expenses	1,015	-	-	1,015
Sportfisher - Expenses	560,201	-	-	560,201
TOTAL EXPENSES	67,498,866	-	-	67,498,866
OTHER CHANGES				
Contract settlements	(588,251)	-	-	(588,251)
CHANGE IN NET ASSETS	1,745,801	(28,116)	-	1,717,685
NET ASSETS AT BEGINNING OF YEAR	1,062,175	89,481	-	1,151,656
NET ASSETS, END OF YEAR	\$ 2,807,976	\$ 61,365	\$ -	\$ 2,869,341

See accompanying independent auditors' report.
The notes are an integral part of these financial statements.

MENTAL HEALTH SYSTEMS, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENT OF ACTIVITIES
FOR THE YEAR ENDED JUNE 30, 2017

	2017			Total
	Unrestricted	Temporarily Restricted	Permanently Restricted	
REVENUES AND SUPPORT				
Mental Health Systems - Contract revenue	\$ 63,380,061	\$ -	\$ -	\$ 63,380,061
Mental Health Systems - Other revenue	1,136,536	-	-	1,136,536
Mental Health Systems - Donations	-	79,552	-	79,552
Gain on sale of assets	1,028,050	-	-	1,028,050
Net assets released from restrictions:				
Restriction satisfied by program expenditures	75,667	(75,667)	-	-
Novata Behavioral Health - Revenues	1,471,309	-	-	1,471,309
TOTAL REVENUES AND SUPPORT	67,091,623	3,885	-	67,095,508
EXPENSES				
Mental Health Systems - Program services	56,598,380	-	-	56,598,380
Mental Health Systems - Management and general	9,793,060	-	-	9,793,060
Novata Behavioral Health - Expenses	1,891,869	-	-	1,891,869
Sportfisher - Expenses	160,079	-	-	160,079
TOTAL EXPENSES	68,443,388	-	-	68,443,388
OTHER CHANGES				
Contract settlements	(748,027)	-	-	(748,027)
CHANGE IN NET ASSETS	(2,099,792)	3,885	-	(2,095,907)
NET ASSETS, BEGINNING OF YEAR,	3,161,967	85,596	-	3,247,563
NET ASSETS, END OF YEAR	\$ 1,062,175	\$ 89,481	\$ -	\$ 1,151,656

See accompanying independent auditors' report.
The notes are an integral part of these financial statements.

MENTAL HEALTH SYSTEMS, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENT OF FUNCTIONAL EXPENSES
FOR THE YEAR ENDED JUNE 30, 2018

	Mental Health Systems			Novata Behavioral Health	Sportfisher	Total
	Program Services	Management and General	Total			
Salaries	\$ 26,883,378	\$ 3,347,789	\$ 30,231,167	\$ -	\$ -	\$ 30,231,167
Employee benefits	4,018,221	498,789	4,517,010	-	-	4,517,010
Payroll taxes	1,984,619	236,983	2,221,602	-	-	2,221,602
Total salary related expenses	<u>32,886,218</u>	<u>4,083,561</u>	<u>36,969,779</u>	-	-	<u>36,969,779</u>
Professional fees and outside services	4,211,330	2,165,162	6,376,492	64	387,590	6,764,146
Consulting fees	4,812,087	684,570	5,496,657	-	-	5,496,657
Occupancy	4,530,032	720,201	5,250,233	-	90,947	5,341,180
Purchased services	2,582,324	-	2,582,324	-	-	2,582,324
Utilities and telephone	1,788,449	219,621	2,008,070	-	-	2,008,070
Insurance	1,064,760	140,485	1,205,245	-	-	1,205,245
Travel	869,989	54,146	924,135	-	-	924,135
Equipment purchase	779,858	70,736	850,594	-	-	850,594
Program expense	825,403	15,405	840,808	-	-	840,808
Interest and bank charges	174,715	530,034	704,749	951	37,407	743,107
Office supplies	523,910	35,099	559,009	-	-	559,009
Taxes and licenses	434,227	48,317	482,544	-	31,134	513,678
Equipment rental	231,264	125,463	356,727	-	-	356,727
Computer	24,510	316,425	340,935	-	-	340,935
Staff development	247,858	86,819	334,677	-	-	334,677
Equipment and maintenance	194,785	87,832	282,617	-	-	282,617
Printing and postage	237,971	20,947	258,918	-	-	258,918
Laboratory fees	236,681	-	236,681	-	-	236,681
Disallowed Expense	100,456	7,761	108,217	-	-	108,217
Miscellaneous expense	-	25,308	25,308	-	-	25,308
Dues and subscriptions	11,771	9,619	21,390	-	-	21,390
Expenses before depreciation and amortization	<u>56,768,598</u>	<u>9,447,511</u>	<u>66,216,109</u>	<u>1,015</u>	<u>547,078</u>	<u>66,764,202</u>
Depreciation and amortization	<u>114,012</u>	<u>607,529</u>	<u>721,541</u>	<u>-</u>	<u>13,123</u>	<u>734,664</u>
Total expenses	<u>\$ 56,882,610</u>	<u>\$ 10,055,040</u>	<u>\$ 66,937,650</u>	<u>\$ 1,015</u>	<u>\$ 560,201</u>	<u>\$ 67,498,866</u>

See accompanying independent auditors' report.
The notes are an integral part of these financial statements.

MENTAL HEALTH SYSTEMS, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENT OF FUNCTIONAL EXPENSES
FOR THE YEAR ENDED JUNE 30, 2017

	Mental Health Systems			Novata Behavioral Health	Sportfisher	Total
	Program Services	Management and General	Total			
Salaries	\$26,970,491	\$ 2,913,990	\$29,884,481	\$ 1,001,388	\$ -	\$30,885,869
Employee benefits	3,686,246	436,147	4,122,393	47,464	-	4,169,857
Payroll taxes	1,999,337	224,322	2,223,659	110,483	-	2,334,142
Total salary related expenses	<u>32,656,074</u>	<u>3,574,459</u>	<u>36,230,533</u>	<u>1,159,335</u>	<u>-</u>	<u>37,389,868</u>
Professional fees and outside services	3,330,440	2,897,297	6,227,737	15,158	131	6,243,026
Consulting fees	4,794,649	396,161	5,190,810	67,358	-	5,258,168
Occupancy	4,278,167	523,436	4,801,603	133,100	19,365	4,954,068
Purchased services	3,876,354	-	3,876,354	-	-	3,876,354
Utilities and telephone	1,653,836	148,831	1,802,667	54,715	-	1,857,382
Insurance	898,405	143,349	1,041,754	59,486	8,363	1,109,603
Interest and bank charges	154,508	675,272	829,780	8,647	132,064	970,491
Travel	796,001	54,890	850,891	57,891	-	908,782
Program expense	781,661	20,434	802,095	-	-	802,095
Equipment purchase	629,691	48,855	678,546	-	-	678,546
Office supplies	554,436	72,575	627,011	9,272	-	636,283
Taxes and licenses	495,910	47,064	542,974	2,421	156	545,551
Laboratory fees	527,965	2,200	530,165	-	-	530,165
Equipment and maintenance	288,127	153,832	441,959	11,633	-	453,592
Bad debt expense	45,214	156,698	201,912	140,881	-	342,793
Staff development	240,416	25,053	265,469	3,462	-	268,931
Equipment rental	150,657	35,270	185,927	1,899	-	187,826
Computer	67,472	60,245	127,717	40,514	-	168,231
Miscellaneous expense	82,977	82,336	165,313	-	-	165,313
Printing and postage	125,622	27,500	153,122	1,174	-	154,296
Donated property	-	-	-	95,510	-	95,510
Dues and subscriptions	5,249	12,712	17,961	2,765	-	20,726
Expenses before depreciation and amortization	<u>56,433,831</u>	<u>9,158,469</u>	<u>65,592,300</u>	<u>1,865,221</u>	<u>160,079</u>	<u>67,617,600</u>
Depreciation and amortization	<u>164,549</u>	<u>634,591</u>	<u>799,140</u>	<u>26,648</u>	<u>-</u>	<u>825,788</u>
Total expenses	<u>\$56,598,380</u>	<u>\$ 9,793,060</u>	<u>\$66,391,440</u>	<u>\$ 1,891,869</u>	<u>\$ 160,079</u>	<u>\$68,443,388</u>

See accompanying independent auditors' report.
The notes are an integral part of these financial statements.

MENTAL HEALTH SYSTEMS, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS
FOR THE YEAR ENDED JUNE 30, 2018 and 2017

	2018	2017
CASH FLOWS FROM OPERATING ACTIVITIES		
Change in net assets	\$ 1,717,685	\$ (2,095,907)
Adjustments to reconcile change in net assets to net cash provided by (used in) operating activities:		
Depreciation	734,664	818,844
Amortization	-	6,944
Gain on sale of fixed assets	(5,618,915)	(1,028,050)
(Increase) decrease in assets:		
Contracts and grants receivable, net	(2,785,006)	3,572,162
Prepaid expenses	14,328	56,666
Deposits	(173,042)	30,321
Increase (decrease) in liabilities:		
Accounts payable	1,502,085	940,199
Accrued liabilities	(1,404,116)	(210,263)
Deferred revenue	(41,450)	(39,014)
NET CASH PROVIDED BY (USED IN) OPERATING ACTIVITIES	(6,053,767)	2,051,902
CASH FLOWS FROM INVESTING ACTIVITIES		
Sale of property and equipment	7,393,113	1,650,197
Purchase of property and equipment	(420,330)	(68,611)
NET CASH PROVIDED BY INVESTING ACTIVITIES	6,972,783	1,581,586
CASH FLOWS FROM FINANCING ACTIVITIES		
Borrowings on line of credit	18,908,084	-
Payments made on line of credit	(18,407,346)	(1,308,352)
Payments made on notes payable	(4,155,327)	(447,356)
NET CASH USED IN FINANCING ACTIVITIES	(3,654,589)	(1,755,708)
NET INCREASE (DECREASE) IN CASH, CASH EQUIVALENTS AND RESTRICTED CASH	(2,735,573)	1,877,780
CASH, CASH EQUIVALENTS AND RESTRICTED CASH BEGINNING OF YEAR	4,088,692	2,210,912
CASH, CASH EQUIVALENTS AND RESTRICTED CASH END OF YEAR	\$ 1,353,119	\$ 4,088,692
SUPPLEMENTAL CASH FLOW INFORMATION		
CASH PAID DURING THE YEAR:		
Interest	\$ 676,756	\$ 936,394
Taxes	\$ -	\$ -

See accompanying independent auditors' report.
The notes are an integral part of these financial statements.

MENTAL HEALTH SYSTEMS, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
JUNE 30, 2018 and 2017

NOTE 1 ORGANIZATION

Mission and History

Mental Health Systems, Inc. and subsidiaries (collectively, the "Organization" or "MHS") 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 creative treatment strategies while respecting time proven methods of intervention.

Nature of Activities

The Organization provides case management, substance abuse treatment and various mental health, substance abuse, vocational rehabilitation, and educational programs for individuals, families, and communities. In addition, the Organization provides temporary housing for the temporarily homeless. Women and children stay in facilities owned by the Organization, and men stay in rented facilities. Residents are provided with counseling services to help them obtain permanent housing, employment, and financial assistance and to help them with substance abuse. Novata Behavioral Health, Inc. ("NBH") was a for-profit corporation and a wholly owned subsidiary of the Organization that provided behavioral health services for autistic individuals. NBH ceased operations during October 2016. Sportfisher Properties, Inc. is a wholly owned subsidiary of the Organization that owns a building providing housing for MHS programs.

The Organization is supported primarily through government contracts, donor contributions, and grants. Approximately 90% and 93% of the Organization's support for the years ended June 30, 2018 and 2017, respectively, came from government contracts.

NOTE 2 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Principles of Consolidation

The consolidated financial statements include the accounts of Mental Health Systems, Inc. and its wholly owned subsidiaries, Novata Behavioral Health, Inc. and Sportfisher Properties, Inc. All material inter-entity transactions have been eliminated in consolidation.

Basis of Accounting

The consolidated financial statements of the Organization have been prepared on the accrual basis of accounting and accordingly reflect all significant receivables, payables and other liabilities.

Basis of Presentation

Accounting principles generally accepted in the United States of America require that the Organization report information regarding its financial position and activities according to three classes of net assets: unrestricted net assets, temporarily restricted net assets, and permanently restricted net assets.

MENTAL HEALTH SYSTEMS, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
JUNE 30, 2018 and 2017

NOTE 2 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

Unrestricted Net Assets

The unrestricted class is the portion of the net assets of the Organization that are not subject to donor-imposed stipulations. The only limits on unrestricted net assets are broad limits resulting from the nature of the Organization and the purposes specified in its articles of incorporation or bylaws and, perhaps, limits resulting from contractual agreements.

Temporarily Restricted Net Assets

The temporarily restricted class is the portion of the net assets of the Organization resulting from contributions and other inflows of assets whose use by the Organization is limited by donor imposed stipulations that either expire by passage of time or can be fulfilled and removed by actions of the Organization pursuant to those stipulations. The majority of contributions with restrictions are stipulated to be used as funding for specific production projects.

Permanently Restricted Net Assets

The permanently restricted class is the portion used to record resources received that are permanently restricted as to use by the donor or grantor. There are no permanently restricted net assets at June 30, 2018 and 2017.

Cash and Cash Equivalents

Certain contracts require cash to be held in separate bank accounts, which are used for contract purposes and included in the Cash and Cash Equivalent balances. For the purposes of the financial statements, the Organization considers all debt instruments purchased with a maturity date of less than 9 months to be cash equivalents.

Restricted Cash

Under the terms of the State of California Department of Transportation Right of Way Contract-State Highway, the Organization is required to escrow funds for curative improvements to the Hacienda property. Any improvements made to the Hacienda property will draw against this balance. Restricted cash balances at June 30, 2018 and 2017 totaled \$105,580 and \$546,335, respectively.

Concentration of Credit Risk

The Organization maintains its cash and cash equivalents at several banks which may, at times, exceed federally insured limits. Cash balances held in banks are insured up to \$250,000 by the Federal Depository Insurance Corporation (FDIC). The Organization has not experienced any losses in such accounts and believes it is not exposed to any significant credit risk on cash and cash equivalents at June 30, 2018 and 2017.

Approximately 60% of the Organization's revenues are provided by the County of San Diego.

MENTAL HEALTH SYSTEMS, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
JUNE 30, 2018 and 2017

NOTE 2 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

Certificates of Deposit

Certificates of deposit at June 30, 2018 and 2017 totaling \$31 and \$43 bear interest at .05%, and have maturities ranging from three to nine months, with penalties for early withdrawal. Any penalties for early withdrawal would not have a material effect on the financial statements.

Contracts and Grants 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 is recorded. Accordingly, contracts and accounts receivable are shown net of an allowance for doubtful accounts.

Contributions and Pledges Receivable

As required by accounting principles generally accepted in the United States of America, contributions received are recorded as unrestricted, temporarily restricted, or permanently restricted depending on the existence and/or nature of any donor restrictions. When a 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 reported in the statement of activities as net assets released from restrictions.

Donated Services and Materials

Consistent with accounting principles generally accepted in the United States of America, the Organization recognizes as support only those donated services which create or enhance nonfinancial assets or which require specialized skills which the Organization would otherwise have paid for. However, many individuals volunteer their time and perform a variety of tasks that assist the Organization with specific assistance programs and various assignments. The Organization receives more than 5,000 volunteer hours per year.

Property and Equipment

Property and equipment are recorded at historical cost and are being depreciated using the straight-line method over the estimated useful life of the assets. The cost of maintenance and repairs is charged to operations as incurred; the Organization capitalizes all expenditures for property and equipment more than \$5,000.

Advertising

Advertising costs are charged to operations when incurred and are included in Management and General functional expenses.

MENTAL HEALTH SYSTEMS, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
JUNE 30, 2018 and 2017

NOTE 2 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

Deferred Revenue

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

Use of Estimates

The preparation of consolidated financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, disclosures of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Reclassifications

Certain 2017 financial information has been reclassified to conform to the 2018 presentation. The reclassifications have no impact on the previously reported changes in net assets.

Tax Status

The Organization is exempt from federal income taxes under Section 501(c)(3) of the Internal Revenue Code, and is exempt from California franchise taxes under Section 23701(d) of the State Revenue and Taxation Code.

The Organization files IRS Form 990 and State Forms 199 and RRF-1. Generally accepted accounting principles provide accounting and disclosure guidance about positions taken by an organization in its tax returns that might be uncertain. The Organization recognizes the effect of income tax positions only if those positions are more likely than not of being sustained. Management of the Organization does not believe the financial statements include any uncertain tax positions. With few exceptions, The Organization is not subject to U.S. federal and state examinations by tax authorities for the years before 2015 and 2014, respectively.

Functional Allocation of Expenses

The costs of providing the program and the supporting services have been summarized on a functional basis in the Consolidated Statement of Activities, and in the Consolidated Statement of Functional Expenses. Accordingly, certain costs have been allocated between the program and the supporting services in reasonable ratios determined by management.

Directly identifiable expenses are charged to programs and supporting services. Expenses related to more than one function are charged to programs and supporting services based on various allocation methods. Management and general expenses include those expenses that are not directly identifiable with any other specific function but provide for the overall support and direction of the Organization.

MENTAL HEALTH SYSTEMS, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
JUNE 30, 2018 and 2017

NOTE 2 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

Subsequent Events

Management has evaluated subsequent events through January 24, 2019, the date the financial statements were available to be issued.

NOTE 3 CONTRACTS AND GRANTS RECEIVABLE

Contracts, grants and other receivable are balances due to the Organization for services provided and expenses incurred prior to June 30, 2018 and 2017, pursuant to written contracts with various public agencies. All receivables are pledged as collateral on the Line of Credit. Contract receivable and grants receivable consist of the following at June 30, 2018 and 2017:

	2018	2017
Contracts Receivable	\$ 12,624,948	\$ 9,839,942
Less allowance for doubtful accounts	(194,268)	(194,268)
	\$ 12,430,680	\$ 9,645,674

NOTE 4 PROPERTY AND EQUIPMENT

Property and equipment as of June 30, 2018 and 2017 consists of the following:

	2018	2017
Land	\$ 2,470,005	\$ 3,099,503
Building and facilities	9,067,069	10,926,250
Vehicles	722,015	722,015
Furniture, fixtures, equipment	489,133	489,133
Leasehold improvements	530,953	530,953
Software	2,463,832	2,463,832
Construction in progress	-	-
Total property and equipment	15,743,007	18,231,686
Less accumulated depreciation	(6,793,289)	(7,193,436)
Property and equipment, net	\$ 8,949,718	\$ 11,038,250

Depreciation expense for the fiscal years ended June 30, 2018 and 2017 was \$734,664 and \$818,844, respectively.

MENTAL HEALTH SYSTEMS, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
JUNE 30, 2018 and 2017

NOTE 5 INTANGIBLE ASSETS

The accounting for the acquisition of Center for Autism Research Evaluation and Services resulted in recognizing a non-compete agreement with the seller in the amount of \$50,000. Under accounting principles generally accepted in the United States of America, the carrying amount of the non-compete is amortized over the term of the contract. At June 30, 2018 and 2017, the unamortized balances were \$0 and \$6,944, respectively.

NOTE 6 JUDGEMENT

The Organization was involved in arbitration with regard to a disputed lease agreement and received an adverse judgment. The balance due as of June 30, 2018 and 2017 was \$2,909 and \$2,085,460, respectively, and is included with accrued liabilities.

NOTE 7 LINE OF CREDIT

The Organization had an \$8,000,000 line of credit with a bank secured by the Organization's accounts receivable. The line of credit had an interest rate of 4.5%. The balance as of June 30, 2018 and 2017 was \$0 and \$3,662,290, respectively.

The Organization obtained a line of credit with a new bank in March 2018 of \$5,000,000 secured by the Organization's accounts receivable at an interest rate of 6.75%. The maturity date is March 2019. The line of credit with the previous bank was paid in full with proceeds from the new line of credit. Balance at June 30, 2018 is \$4,163,028.

NOTE 8 NOTES PAYABLE

Notes payable as of June 30, 2018 and 2017 consists of the following:

	2018	2017
Hacienda	\$ 3,901,990	\$ 4,952,500
Clementine	586,503	599,313
Vermont	164,109	199,049
Sportsfisher	-	3,057,067
	\$ 4,652,602	\$ 8,807,929
Due in one year	\$ 49,435	\$ 272,174
Due in two to five years	188,681	3,054,525
Thereafter	4,414,486	5,481,230
	\$ 4,652,602	\$ 8,807,929

MENTAL HEALTH SYSTEMS, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
JUNE 30, 2018 and 2017

NOTE 9 NOTES PAYABLE

Hacienda, a Fresno property, was acquired and renovated by the Organization through notes payable to U.S. Bancorp in the amount of \$4,952,500 (Note A) and 1,977,500 (Note B). Interest for both loans is 5.923% per year. Maturity on Note A and B was December 17, 2015 and December 17, 2038, respectively. Note A was refinanced by National Cooperative Bank at a rate of 7.25% and is secured by the deed of trust and contains certain financial covenants and ratio requirements, with which the Organization was compliant at June 30, 2018 and 2017. At June 30, 2018, the annual interest rate was 7.25% and with interest only payments due monthly. Note B was forgiven on December 31, 2015 in the amount of \$1,977,500. The principal balance of the notes at June 30, 2018 and 2017 was \$3,901,990 and \$4,952,500, respectively.

Clementine, an Oceanside property, has a note payable to the City of Oceanside secured by a Deed of Trust, bearing Interest at 4.75% through January 2042. The principal balance at June 30, 2018 and 2017 was \$586,503 and \$599,313, respectively.

Vermont, an Escondido property, has a deed of trust to California Health Facilities Financing Authority secured by a Deed of Trust, for the acquisition and renovation of the property, and has monthly installments of \$3,969, including interest at 3.00%, due October 1, 2022. The principal balance at June 30, 2018 and 2017 was \$164,109 and \$199,049, respectively.

The Organization had a note payable to National Cooperative Bank for the purchase of the facility located at 1100 Sportfisher Drive, Oceanside, California. The property was then placed into a special interest entity on December 31, 2015 and refinanced with a note due to National Cooperative Bank in the amount of \$3,375,000. At June 30, 2017, the interest rate was 4.47% and the principal balance as was \$3,057,067. The proceeds of the refinance were used to extinguish the debt incurred to acquire CARES. This property was sold in September 2017 and the note payable was retired.

MENTAL HEALTH SYSTEMS, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
JUNE 30, 2018 and 2017

NOTE 10 COMMITMENTS AND CONTINGENCIES

Commitments

The Organization has entered into long-term operating lease agreements for program facilities, equipment, and the corporate office facility. These leases expire throughout the years ending June 2025. Aggregate future minimum operating lease commitments are as follows:

Year Ending June 30,	Total
2019	\$ 3,820,850
2020	3,304,130
2021	2,211,545
2022	1,632,219
2023	85,058
Totals	\$ 11,053,802

During the year ended June 30, 2018 and 2017, the Organization incurred expenses of \$4,475,839 and \$4,084,544, respectively, associated with facility leases and equipment leases (inclusive of month-to-month lease agreements). When facility maintenance and non-recurring repairs are included, the Organization incurred total occupancy expenses of \$5,341,180 and \$4,954,068, respectively.

Contingencies

The Organization is, from time to time, named as a defendant in various lawsuits or actions incidental to its business. The lawsuits brought against the Organization that are in the normal course of business are covered by insurance. The Organization also establishes reserves for the insurance deductible for claims related to lawsuits and other contingencies when the Organization believes a loss is probable and is able to estimate its potential exposure. For loss contingencies believed to be reasonably possible, the Organization also discloses the nature of the loss contingency and an estimate of possible loss, range of loss, or a statement that such an estimate cannot be made. While actual losses may differ from the amounts recorded and the ultimate outcome of the Organization's pending actions is generally not yet determinable, the Organization does not believe that the ultimate resolution of currently pending legal proceedings, either individually or in the aggregate, will have a material adverse effect on its financial condition, results of operations, or cash flows.

MENTAL HEALTH SYSTEMS, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
JUNE 30, 2018 and 2017

NOTE 10 COMMITMENTS AND CONTINGENCIES (CONTINUED)

The Organization's grants and contracts are subject to inspection and audit by the appropriate governmental funding agency. The purpose is to determine whether program funds were used in accordance with the governmental funding agency's respective guidelines and regulations. The potential exists for disallowance of previously funded program costs or approval of income due to funding shifts. The Organization records known prior year settlements (disallowances, additional funding, or contract adjustments) as "contract settlements" in its general ledger. The amounts due of for the years ended June 30, 2018 and 2017 of \$588,251 and \$748,027, respectively, shown on the Statement of Activities represents known adjustments for prior year settlements. Liabilities, if any, which may result from any other governmental audits cannot be reasonably estimated and, accordingly, the Organization has no provisions for the possible disallowance of any other program costs on its financial statements.

NOTE 11 TEMPORARILY RESTRICTED NET ASSETS

Temporarily restricted net assets have been restricted by donors for specific programs within the Organization. Temporarily restricted net assets were \$61,365 and \$89,481 as of June 30, 2018 and 2017, 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 expense related to such revenue can be terminated simultaneously with the cession of revenue.

NOTE 13 RELATED PARTY TRANSACTIONS

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 Center for Autism Research Evaluation and Services ("CARES") for \$4,000,000. BHS obtained a \$4,000,000 loan with a 7 year repayment term 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. All intercompany transactions were eliminated in the consolidation. The seller of CARES owns the building leased by Novata Behavioral Health and is an employee of Novata Behavioral Health. The amount paid to the employee for rent was \$0 and \$212,544 for the years ended June 30, 2018 and 2017, respectively. There were no amounts outstanding at June 30, 2018 and 2017.

MENTAL HEALTH SYSTEMS, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
JUNE 30, 2018 and 2017

NOTE 14 RETIREMENT PLAN

The Organization maintains a 401(A) and Section 501 (A) plan for the benefit of all eligible employees. The plan 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. For the years ended June 30, 2018 and 2017, total expense was \$1,606,237 and \$1,489,741, respectively.

The Organization also maintains a 403(B) plan for the benefit of all eligible employees. The plan allows eligible employees to defer a portion of salary to the plan. The Organization does not offer a match.

**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**

January 24, 2019

To The Board of Directors
Mental Health Systems, Inc. and subsidiaries
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. and subsidiaries (collectively, the "Organization"), which comprise the statement of financial position as of June 30, 2018, and the related statements of activities, and cash flows for the year then ended, and the related notes to the financial statements, and have issued our report thereon dated January 24, 2019.

Internal Control Over Financial Reporting

In planning and performing our audit of the financial statements, we considered the Organization'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 the Organization's internal control. Accordingly, we do not express an opinion on the effectiveness of the Organization'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 (CONT.)**

Compliance and Other Matters

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



CliftonLarsonAllen LLP
Los Angeles, California
January 24, 2019

