

*Audited Financial Statements
and Supplementary Schedules*

MENTAL HEALTH SYSTEMS, INC.

For the Year Ended June 30, 2010

(With Comparative Totals for 2009)

MENTAL HEALTH SYSTEMS, INC.

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MCLEAN, ROTHERHAM & CO.
CERTIFIED PUBLIC ACCOUNTANTS
BUSINESS CONSULTANTS

INDEPENDENT AUDITOR'S REPORT

To the Board of Directors of
Mental Health Systems, Inc.

We have audited the accompanying statement of financial position of Mental Health Systems, Inc. (a nonprofit organization) as June 30, 2010, and the related statements of activities, change in net assets, functional expenses and cash flows for the year then ended. These financial statements are the responsibility of the Organization's management. Our responsibility is to express an opinion on these financial statements based on our audit. The prior year summarized information was derived from the Organization's 2009 financial statements and in our report dated February 5, 2010, we expressed an unqualified opinion on those statements.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America and *Government Auditing Standards*, issued by the U.S. Comptroller General. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant management estimates, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Mental Health Systems, Inc. as of June 30, 2010, and the changes in its net assets and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

In accordance with *Government Auditing Standards*, we have also issued our report dated January 24, 2011 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 the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be read in conjunction with this report in considering the results of our audit.

Our audit was conducted for the purpose of forming an opinion on the Organization's financial statements taken as a whole. The supplementary schedules of expenditures of federal awards and of findings and questioned costs are presented for the purpose of additional analysis as required by U.S. Office of Management and Budget Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*, and are not required parts of the basic financial statements. The supplemental schedules of direct and indirect expense are also presented for purposes of additional analysis and are not required parts of the basic financial statements. The information in these schedules have been subjected to the auditing procedures applied in the audit of the basic financial statements and, in our opinion, is fairly presented in all material respects in relation to the basic financial statements taken as a whole.

McLean Rotherham + Co.

San Diego, California
January 24, 2011

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MENTAL HEALTH SYSTEMS, INC.
A CALIFORNIA NOT-FOR-PROFIT CORPORATION
STATEMENT OF FINANCIAL POSITION
June 30, 2010 and 2009

	<u>2010</u>	<u>2009</u>
ASSETS		
Current Assets		
Cash and cash equivalents	\$ 2,690,752	2,355,385
Investments	184,524	138,561
Contracts receivables, net of allowance of \$400,000	12,996,980	18,389,766
Other receivables	492,247	766,040
Prepaid expense	<u>473,531</u>	<u>161,210</u>
Total Current Assets	16,838,034	21,810,962
Property and Equipment		
Land	3,163,183	3,163,183
Building/facilities	9,759,347	9,478,883
Construction in progress	73,433	-
Automobiles	823,698	403,305
Furniture and fixtures	1,820,004	1,770,861
Leasehold improvements	950,008	962,001
Software	160,562	51,652
Less: Accumulated depreciation	<u>(4,107,308)</u>	<u>(3,372,357)</u>
Net Property and Equipment	12,642,927	12,457,528
Other Assets		
Investment	5,000	-
Deposits	<u>364,693</u>	<u>481,348</u>
Total Other Assets	<u>369,693</u>	<u>481,348</u>
Total Assets	<u>\$ 29,850,654</u>	<u>\$ 34,749,838</u>
LIABILITIES AND NET ASSETS		
Current Liabilities		
Accounts payable	\$ 3,662,630	\$ 4,834,883
Accrued employee benefits	4,668,704	4,940,755
Accrued payroll and related taxes	1,370,194	2,244,602
Unearned contract revenue	323,693	590,910
Other liabilities	581,760	333,069
Notes payable, current portion	<u>151,038</u>	<u>169,027</u>
Total Current Liabilities	10,758,019	13,113,246
Notes payable, net of current portion	<u>9,360,726</u>	<u>12,769,851</u>
Total Liabilities	20,118,745	25,883,097
Net Assets		
Unrestricted	9,706,286	8,823,160
Restricted	<u>25,623</u>	<u>43,581</u>
Total Net Assets	<u>9,731,909</u>	<u>8,866,741</u>
Total Liabilities and Net Assets	<u>\$ 29,850,654</u>	<u>\$ 34,749,838</u>

The accompanying notes are an integral part of these financial statements

MENTAL HEALTH SYSTEMS, INC.
A CALIFORNIA NOT-FOR-PROFIT CORPORATION
STATEMENT OF ACTIVITIES
For the Year Ended June 30, 2010

	Total Funds	Operating	Temporarily Restricted	2009 (Summarized)
Revenue and Support				
Contract revenue	\$ 89,298,268	\$ 89,298,268	\$ -	\$ 95,457,880
Other revenue	2,102,940	2,102,940	-	1,607,878
Fundraising, net of direct expenses	17,148	17,148		12,181
Donations	84,953	84,953	-	58,684
	<hr/>	<hr/>	<hr/>	<hr/>
Total Revenue	91,503,309	91,503,309	-	97,136,623
Net Assets Released from Restriction	-	17,958	(17,958)	-
Total Revenue and Support	<hr/>	<hr/>	<hr/>	<hr/>
	91,503,309	91,521,267	(17,958)	97,136,623
Direct Expense				
Payroll	27,478,466	27,478,466	-	29,695,902
Payroll benefits	6,657,979	6,657,979	-	7,568,976
Purchased services	27,950,742	27,950,742	-	30,791,696
Occupancy costs	5,166,390	5,166,390	-	4,994,866
Consultants	3,223,193	3,223,193		3,024,360
Other direct expense	11,593,785	11,593,785	-	12,687,123
Unallocable expense	9,048	9,048	-	493,467
	<hr/>	<hr/>	<hr/>	<hr/>
Total Direct Expense	82,079,603	82,079,603	-	89,256,390
Indirect Expense				
Payroll	3,967,090	3,967,090	-	4,563,960
Payroll benefits	601,126	601,126	-	675,207
Occupancy costs	452,388	452,388		479,451
Consultants	513,282	513,282		308,077
Other indirect expense	2,404,029	2,404,029	-	1,549,163
Unallocable expense	620,623	620,623	-	-
	<hr/>	<hr/>	<hr/>	<hr/>
Total Indirect Expense	8,558,538	8,558,538	-	7,575,858
Total Expense	<hr/>	<hr/>	<hr/>	<hr/>
	90,638,141	90,638,141	-	96,832,248
Increase / (Decrease) in Net Assets	<hr/>	<hr/>	<hr/>	<hr/>
	\$ 865,168	\$ 883,126	\$ (17,958)	\$ 304,375

The accompanying notes are an integral part of these financial statements

MENTAL HEALTH SYSTEMS, INC.
A CALIFORNIA NOT-FOR-PROFIT CORPORATION
STATEMENT OF CHANGES IN NET ASSETS
For the Year Ended June 30, 2010

Description	Total Net Assets	Unrestricted	Temporarily Restricted
Balance 6/30/09	\$ 8,866,741	\$ 8,823,160	\$ 43,581
Increase in Net Assets	<u>865,168</u>	<u>883,126</u>	<u>(17,958)</u>
Balance 6/30/10	\$ <u>9,731,909</u>	\$ <u>9,706,286</u>	\$ <u>25,623</u>

The accompanying notes are an integral part of these financial statements

MENTAL HEALTH SYSTEMS, INC.
A CALIFORNIA NOT-FOR-PROFIT CORPORATION
STATEMENT OF CASH FLOWS
For the Years Ended June 30, 2010 and 2009

	2010	2009
Cash Flow from Operating Activities:		
Increase in net assets	\$ 865,168	304,375
Add charges to revenue not requiring use of cash:		
Depreciation	765,540	559,516
Adjustments to reconcile excess of revenue over expenses to net cash flow from operating activities		
Decrease in contracts and accounts receivable	5,666,579	(512,524)
Increase in prepaid expense	(312,321)	282,430
Decrease in deposits	116,655	(45,591)
Decrease in accounts payable and accrued expenses	(2,070,023)	(1,537,339)
Decrease in unearned revenue	(267,217)	(221,086)
Net cash provided / (used) for operating activities	4,764,381	(1,170,219)
Cash Flow from Investing Activities:		
Investment purchases and changes in investment value	(50,963)	321,852
Disposals of property and equipment	32,015	2,350
Acquisition of property and equipment	(982,954)	(890,553)
Net cash provided / (used) for investing activities	(1,001,902)	(566,351)
Cash Flow from Financing Activities:		
Proceeds on new borrowings	399,458	9,902,243
Principal payments on notes payable	(3,826,572)	(7,111,833)
Net cash provided by financing activities	(3,427,114)	2,790,410
Net increase in cash and cash equivalents	335,365	1,053,840
Cash and cash equivalents beginning of year	2,355,385	1,301,545
Cash and cash equivalents at end of year	\$ 2,690,750	\$ 2,355,385
Supplemental disclosure of cash flow information		
Cash payments for:		
Interest	\$ 667,641	\$ 724,396

The accompanying notes are an integral part of these financial statements

MENTAL HEALTH SYSTEMS, INC.
A CALIFORNIA NOT-FOR-PROFIT CORPORATION
STATEMENT OF FUNCTIONAL EXPENSE
For the Year Ended June 30, 2010

	<u>Total Expense</u>	<u>Program Service</u>	<u>Management & General</u>	<u>2009 (Summarized)</u>
Total Direct and Indirect Expense				
Accounting & legal	\$ 34,332	\$ 8,650	\$ 25,682	\$ 71,340
Consultants	3,736,475	3,223,193	513,282	4,043,988
Depreciation	765,540	320,702	444,838	559,516
Dues and subscriptions	97,897	24,324	73,573	48,569
Equipment rental	428,536	359,054	69,482	361,704
Housekeeping and general supplies	202,209	195,152	7,057	138,161
Insurance	1,944,453	1,705,655	238,798	1,836,174
Interest and bank fees	667,641	298,317	369,324	724,396
Laboratory fees	1,280,052	1,278,516	1,536	1,429,323
Licenses and taxes	179,362	167,561	11,801	269,262
Minor/major equipment	794,092	700,034	94,058	719,629
Occupancy costs	5,618,778	5,166,390	452,388	5,474,317
Office supplies	599,658	522,882	76,776	864,483
Other business services	1,468,171	1,168,163	300,008	511,197
Payroll	31,445,556	27,478,466	3,967,090	34,259,862
Payroll benefits	7,259,105	6,657,979	601,126	8,244,183
Printing and advertising	267,518	190,582	76,936	196,266
Purchased services	27,950,742	27,950,742	-	30,791,695
Repair and maintenance	317,395	264,692	52,703	365,255
RT / OT supplies and food	1,260,400	1,260,400	-	1,624,967
Staff development	611,967	422,535	189,432	439,995
Travel and transportation	1,221,110	1,048,523	172,587	1,435,320
Utilities and telephone	1,857,479	1,658,041	199,438	1,929,178
Total Direct and Indirect Expense	\$ 90,008,468	\$ 82,070,553	\$ 7,937,915	\$ 96,338,780
Unallocable Expense				
Unallocable expense	9,048	9,048	-	-
Bad debt	43,049	-	43,049	82,630
Unallowable costs	577,574	-	577,574	410,838
	<u>\$ 629,671</u>	<u>\$ 9,048</u>	<u>620,623</u>	<u>\$ 493,468</u>
Total Direct, Indirect and Unallocable Expense	\$ 90,638,139	\$ 82,079,601	8,558,538	\$ 96,832,248

The accompanying notes are an integral part of these financial statements

NOTE 1 – ORGANIZATION

Mental Health Systems, Inc. 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 administrative services as one of California's Substance Abuse System Coordinating Agencies. In addition the Organization administers programs for charitable purposes in connection with the community and individual mental health, substance abuse (drugs and alcohol) and vocational rehabilitation programs.

NOTE 2 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Accounting

The financial statements of Mental Health Systems, Inc. have been prepared in accordance with accounting principles generally accepted in the United States of America on an accrual basis of accounting.

Basis of Presentation

Financial statement presentation follows the recommendations of the Financial Accounting Standards Board in its Statement of Financial Accounting Standards (SFAS) No. 117, Financial Statements of Not-for-Profit Organizations. Under SFAS No. 117, the Organization is required to report information regarding its financial position and activities according to three classes of net assets: unrestricted net assets, temporarily restricted net assets, and permanently restricted net assets.

Comparative Financial Information

The financial statements include certain prior-year summarized comparative information in total but not by net asset class. Such information does not include sufficient detail to constitute a presentation in conformity with generally accounting principles. Accordingly, such information should be read in conjunction with the Organization's financial statements for the year ended June 30, 2009.

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 the reported amounts of 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.

NOTE 2 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES, *Continued*

Depreciation and Fixed Assets

Fixed assets are recorded at cost. Depreciation is computed using the straight-line method over the estimated useful life of the asset. Assets purchased pursuant to contractual agreements are either capitalized or charged directly to the program in accordance with the agreement and the related budgetary line item. The Organization's administrative policy is to capitalize all assets with a cost basis of \$5,000 or more.

Cash and Cash Equivalents

Cash equivalents consist of short-term highly liquid investments that are readily converted to cash with an original maturity of 3 months or less.

Fair value

The carrying amounts reported in the statements of financial position for cash and cash equivalents, accounts receivable, and accounts payable approximate fair value due to their immediate short-term maturity.

Investments

In accordance with accounting principles generally accepted in the United States of America, the Organization accounts for its investments with a readily determinable market value by recording and reporting those investments at fair value. Information about the fair value of investments and unrealized gains and losses is discussed in Note 5.

Contracts 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.

NOTE 2 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES, *Continued*

Income Taxes

The Organization is exempt from income taxes as a charitable organization under Section 501 (c)(3) of the Internal Revenue Code. In addition, the Organization has been determined by the Internal Revenue Service not to be a “private foundation” within the meaning of Section 509(a) of the Internal Revenue Code. There was no unrelated business income for the year ended June 30, 2010.

Functional Expense

The costs of providing the Organization’s programs have been summarized on a functional basis in the supplementary schedule of functional expense. Based on management’s estimates, costs have been allocated between programs and supporting services as they relate to those functions.

NOTE 3 – RESTRICTIONS ON NET ASSETS

Permanently restricted net assets are donations restricted by the donor in ways that permit only the earnings to be used for the programs and general operations of the Organization. There were no permanently restricted net assets as of June 30, 2010.

Temporarily restricted net assets have been restricted by donors for specific programs within the Organization. Temporarily restricted net assets were \$25,623 as of June 30, 2010.

When restrictions on contributions are satisfied in the same period as the receipt of the contribution, the Organization reports both the revenue and the related expense in the unrestricted net assets.

NOTE 4 – CONTRACTS RECEIVABLE

Contracts receivable are balances due Mental Health Systems, Inc. for services provided and expenses incurred prior to June 30, 2010 pursuant to written contracts with various public agencies. The balance shown on the financial statements is net of an allowance for doubtful accounts of \$400,000 and \$500,000 as of June 30, 2010 and 2009 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.

MENTAL HEALTH SYSTEMS, INC.
A CALIFORNIA NOT-FOR-PROFIT CORPORATION
NOTES TO FINANCIAL STATEMENTS
June 30, 2010

NOTE 5 – INVESTMENTS

The following is a summary of the investment portfolio shown at fair value at June 30, 2010:

Mutual funds	\$ 184,524
Stock - Behavioral Healthcare Solutions, Inc.	5,000
	<u>\$ 189,524</u>

Behavioral Healthcare Solutions, Inc. is a for-profit company that is 100% owned by MHS. See Note 14 for further discussion.

NOTE 6 – 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 \$1,960,825 and \$2,248,652 for the years ended June 30, 2010 and 2009 respectively.

NOTE 7 – OPERATING LEASE COMMITMENTS

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 July 2018. 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, 2015.

Aggregate future minimum operating lease commitments are as follows:

<u>Years ending June 30,</u>	<u>Facilities</u>	<u>Equipment</u>
2011	\$ 2,906,818	188,788
2012	2,130,166	119,634
2013	1,763,187	69,868
2014	1,607,287	-
Thereafter	3,986,243	-
Total	<u>\$ 12,393,701</u>	<u>\$ 378,290</u>

NOTE 7 – OPERATING LEASE COMMITMENTS, *Continued*

During the year ended June 30, 2010, the Organization incurred expenses of \$4,866,724 and \$428,222, respectively associated with facility and equipment leases.

NOTE 8 – 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 9 – BOSTON VILLAS

Boston Villas (the “Project”) is a rental housing development occupied by mentally disabled persons of low income. Mental Health Systems, Inc. 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 \$35,019 on reserve as of June 30, 2010.

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 \$14,645 on reserve as of June 30, 2010.

NOTE 10 – NOTES PAYABLE

Notes payable consist of the following at June 30, 2010:

Note payable 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, 2010 is \$162,500. Accrued interest as of June 30, 2010 is \$91,064.

NOTE 10 – NOTES PAYABLE, *Continued*

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 current monthly principal and interest payment is \$3,370. The principal balance as of June 30, 2010 is \$416,394.

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 with at June 30, 2010. The interest rate and minimum monthly payment at June 30, 2010, was 7.80% and \$21,383, respectively. The principal balance at June 30, 2010 was \$1,437,327.

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, 2010 was \$133,729.

The Organization has available an \$8,000,000 line of credit with National Cooperative Bank. The LOC will mature on July 31, 2011 and has an interest rate of 4.6%. The balance as of June 30, 2010 was \$0.00.

Note payable to Gobezie MD, Inc. for the purchase of property in Barstow. The note had a balance of \$11,960 as of June 30, 2009 and accrued interest at 6.25%. This note was paid off during 2010.

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. Interest for both loans is 5.923%. Maturity on Note A is December 17, 2015; the note is interest only; principal and any unpaid interest will be due at maturity. Maturity on Note B is December 17, 2038; interest only payments through December 17, 2015. After December 17, 2015, interest and principal to be paid over 276 months.

The Organization purchased various autos throughout the year ended June 30, 2010 that were financed through either Toyota or Hyundai at 5.0% and 0.0% interest respectively. The balances in the Toyota and Hyundai notes as of June 30, 2010 were \$229,957 and \$110,794 respectively.

MENTAL HEALTH SYSTEMS, INC.
A CALIFORNIA NOT-FOR-PROFIT CORPORATION
NOTES TO FINANCIAL STATEMENTS
June 30, 2010

NOTE 10 – NOTES PAYABLE, *Continued*

Aggregate future maturities of long-term debt are as follows:

<u>Years Ending June 30,</u>	
2011	\$ 151,038
2012	154,067
2013	103,791
2014	30,994
Thereafter	<u>9,071,875</u>
Total Notes Payable	9,511,765
Less: Current Portion	<u>151,038</u>
Non-Current Portion	<u><u>\$ 9,360,727</u></u>

NOTE 11 – JOB OPTIONS, A RELATED PARTY

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 has both an equipment leasing agreement and 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.

NOTE 12 – CASH IN EXCESS OF FEDERAL DEPOSIT INSURANCE CORPORATION LIMIT

The Organization has at various times during the year maintained cash balances in excess of the Federal Deposit Insurance Corporation (FDIC) limit of \$250,000. The funds are deposited in four separate high quality financial institutions.

NOTE 13 – CASH AND CASH EQUIVALENTS

Cash and cash equivalents as of June 30, 2010 consist of the following:

Petty Cash	\$ 28,563
Wells Fargo Bank	1,320,955
CBT	70,356
US Bank	350,887
National Cooperative Bank	919,991
Total	<u><u>\$ 2,690,752</u></u>

MENTAL HEALTH SYSTEMS, INC.
A CALIFORNIA NOT-FOR-PROFIT CORPORATION
NOTES TO FINANCIAL STATEMENTS
June 30, 2010

NOTE 14– RELATED PARTIES – BEHAVIORAL HEALTHCARE SOLUTIONS, INC.

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

Supplementary Schedules

MENTAL HEALTH SYSTEMS, INC.

For the Year Ended June 30, 2010

MENTAL HEALTH SYSTEMS, INC.
A CALIFORNIA NOT-FOR-PROFIT CORPORATION
SUPPLEMENTARY SCHEDULE OF OTHER DIRECT EXPENSE
For the Years Ended June 30, 2010 and 2009

	<u>2010</u>	<u>2009</u>
Accounting & legal	\$ 8,650	\$ 10,219
Depreciation	320,702	361,907
Dues and subscriptions	24,324	21,823
Equipment rental	359,054	309,112
Housekeeping and general supplies	195,152	133,347
Insurance	1,705,655	1,692,900
Interest and bank fees	298,316	685,200
Laboratory fees	1,280,052	1,429,324
Licenses, fees and taxes	172,013	262,712
Minor/major equipment	700,034	590,986
Office supplies	522,882	660,821
Other business services	1,162,175	1,600,154
Printing and advertising	190,582	155,745
Repairs and maintenance	264,692	300,742
RT / OT supplies and food	1,260,400	1,088,906
Staff development	422,536	351,938
Travel and transportation	1,048,523	1,307,414
Utilities and telephone	1,658,041	1,723,873
Total Other Direct Expense	\$ <u><u>11,593,783</u></u>	\$ <u><u>12,687,123</u></u>

The accompanying notes are an integral part of these financial statements

MENTAL HEALTH SYSTEMS, INC.
A CALIFORNIA NOT-FOR-PROFIT CORPORATION
SUPPLEMENTARY SCHEDULE OF OTHER INDIRECT EXPENSE
For the Years Ended June 30, 2010 and 2009

	<u>2010</u>	<u>2009</u>
Accounting & legal	\$ 25,682	\$ 61,121
Depreciation	444,838	197,609
Dues and subscriptions	73,573	26,746
Equipment rental	69,482	52,592
Housekeeping and general supplies	7,057	4,814
Insurance	238,798	143,276
Interest and other bank charges	369,324	39,197
Licenses and taxes	7,349	6,550
Minor/major equipment	94,058	131,861
Office expense	76,776	90,802
Other business services	305,996	284,433
Printing and advertising	76,936	40,520
Repairs and maintenance	52,703	48,376
Staff development	189,432	88,056
Travel and transportation	172,587	127,907
Utilities and telephone	199,438	205,303
Total Other Indirect Expense	\$ <u>2,404,029</u>	\$ <u>1,549,163</u>

The accompanying notes are an integral part of these financial statements

MENTAL HEALTH SYSTEMS, INC.
A CALIFORNIA NOT-FOR-PROFIT CORPORATION
SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS
For the Year Ended June 30, 2010

<i>Federal Grantor/ Pass-Through Grantor/Program Title</i>	<i>Federal CFDA Number</i>	<i>Pass-Through Entity Identifying Number</i>	<i>Federal Expenditures</i>
<i>U.S. Department of Education</i>			
Pass-Through State of California Dept of Rehabilitation			
Vocational Rehabilitation - Employment Services	84.126	N/A	\$ 678,844
Safe and Drug Free Schools Grant	84.186	N/A	2,000
Rehabilitation Services-Vocational Rehabilitation Grants	84.390	N/A	71,770
Special Education Grant	84.027	N/A	1,190,553
<i>U.S. Department of Housing and Urban Development</i>			
Supportive Housing Program	14.235	N/A	591,036
Supportive Housing Program	14.238	N/A	83,884
<i>U.S. Department of Labor</i>			
WIA Formula Youth	17.259	N/A	123,851
Homeless Veterans Reintegration Project	17.805	N/A	300,000
<i>U.S. Department of Health and Human Services</i>			
Substance Abuse Treatment and Education	93.243	N/A	916,665
Drug Abuse and Addiction Research	93.279	N/A	19,435
<i>U.S. Department of Health and Human Services</i>			
Pass-Through San Diego County Department of Health Services			
Projects for Assistance in Transition from Homelessness	93.150	N/A	88,501
Substance Abuse Treatment and Mental Health	93.275	N/A	87,148
Substance Abuse Treatment and Education	93.778	N/A	45,376
Substance Abuse Treatment and Education	93.959	N/A	1,352,713
<i>U.S. Department of Health and Human Services</i>			
Pass-Through Riverside Department of Health Services			
Promoting Safe and Stable Families	93.556	N/A	346,378
Substance Abuse Treatment and Education	93.778	N/A	184,803
<i>U.S. Department of Health and Human Services</i>			
Pass-Through Fresno Department of Health Services			
Substance Abuse Treatment and Education	93.958	N/A	267,086
Substance Abuse Treatment and Education	93.959	N/A	454,395
Substance Abuse Treatment and Education	93.778	N/A	87,635
<i>U.S. Department of Health and Human Services</i>			
Pass-Through Santa Barbara Department of Health Services			
Substance Abuse Treatment and Education	93.959	N/A	17,315
<i>U.S. Department of Health and Human Services</i>			
Pass Through San Bernardino County Department of Mental Health			
Substance Abuse Treatment and Education	93.778	N/A	1,160,391
Substance Abuse Treatment and Education	93.959	N/A	740,595
<i>Total U.S. Department of Health and Human Services</i>			<u>4,832,336</u>
TOTAL FEDERAL AWARDS			<u><u>\$ 8,810,374</u></u>



MCLEAN, ROTHERHAM & CO.
CERTIFIED PUBLIC ACCOUNTANTS
BUSINESS CONSULTANTS

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

To the Board of Directors of
Mental Health Systems, Inc.

We have audited the financial statements of Mental Health Systems, Inc. (a nonprofit organization) as of and for the year ended June 30, 2010, and have issued our report thereon dated January 24, 2011. 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 U.S. Comptroller General.

Internal Control Over Financial Reporting

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

A *deficiency in internal control* exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis. A *material weakness* is a deficiency, or 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.

Our consideration of the internal control over financial reporting was for the limited purpose described in the first paragraph of this section and would not necessarily identify all deficiencies in internal control that might be significant deficiencies or material weaknesses. We did not identify any deficiencies in internal control over financial reporting that we considered to be material weaknesses, as defined above.

Compliance

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

This report is intended solely for the information and use of the Organization's management, the board of directors, and the federal awarding agencies and pass-through agencies. This report is not intended to be used and should not be used by anyone other than these specified parties.

McLean Rotherham & Co.

San Diego, California
January 24, 2011

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MCLEAN, ROTHERHAM & CO.
CERTIFIED PUBLIC ACCOUNTANTS
BUSINESS CONSULTANTS

REPORT ON COMPLIANCE WITH REQUIREMENTS APPLICABLE TO EACH
MAJOR PROGRAM AND ON INTERNAL CONTROL OVER COMPLIANCE
IN ACCORDANCE WITH OMB CIRCULAR A-133

To the Board of Directors of
Mental Health Systems, Inc.

Compliance

We have audited the Organization's compliance with the types of compliance requirements described in the U.S. Office of Management and Budget (OMB) Circular A-133 *Compliance Supplement* that are applicable to each of its major federal programs for the year ended June 30, 2010. The Organization's major federal programs are identified in the summary of auditor's results section of the accompanying schedule of findings and questioned costs. Compliance with the requirements of laws, regulations, contracts, and grants applicable to each of its major federal programs is the responsibility of the Organization's management. Our responsibility is to express an opinion on its compliance based on our audit.

We conducted our audit of compliance in accordance with auditing standards generally accepted in the United States of America; the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the U.S. Comptroller General; and the provisions OMB Circular A-133, *Audits of States, Local Governments, and Nonprofit Organizations*. Those standards and provisions require that we plan and perform the audit to obtain reasonable assurance about whether noncompliance with the types of requirements referred to above that could have a direct and material effect on a major federal program occurred. An audit includes examining, on a test basis, evidence about the Organization's compliance with those requirements and performing such other procedures that we considered necessary in the circumstances. We believe our audit provides a reasonable basis for our opinion. Our audit does not provide a legal determination of the Organization's compliance with those requirements.

In our opinion, the Organization complied, in all material respects, with the requirements referred to above that are applicable to each of its major federal programs for the year ended June 30, 2010.

Internal Control over Compliance

The Organization's management is responsible for establishing and maintaining effective internal control over compliance with the requirements of laws, regulations, contracts, and grants applicable to federal programs. In planning and performing our audit, we considered the Organization's internal control over compliance with requirements that could have a direct and material effect on a major federal program in order to determine our auditing procedures for the purpose of expressing our opinion on compliance, but not for the purpose of expressing an opinion on the effectiveness of the Organization's internal control over compliance.

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 misstatements on a timely basis. A *material weakness in internal control over compliance* is a deficiency, or combination of deficiencies in internal control over compliance such that there is a reasonable possibility that a material noncompliance with a type of compliance requirement of a federal program will not be prevented, or detected and corrected on a timely basis.

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

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

McLean Rotherham + Co.

San Diego, California
January 24, 2011

MENTAL HEALTH SYSTEMS, INC.
SCHEDULE OF FINDINGS AND QUESTIONED COSTS
For the Year Ended June 30, 2010

Section I – Summary of Auditor’s Results

Financial Statements

Type of Auditor’s report issued: unqualified

Internal control over financial reporting:

- Reportable conditions identified that are not considered to be material weaknesses? _____ yes ☒ none reported
- Material weaknesses identified? _____ yes ☒ none reported

Noncompliance material to financial Statements noted? _____ yes ☒ none reported

Federal Awards

Internal control over major programs:

- Reportable conditions identified that are not considered to be material weaknesses? _____ yes ☒ none reported
- Material weaknesses identified? _____ yes ☒ none reported

Type of auditor’s report issued on compliance for major programs: unqualified

Any audit findings disclosed that are required to be reported in accordance with section 510(a) of Circular A-133? _____ yes ☒ no

Identification of major programs:

<i>CFDA Numbers</i>	<i>Name of Federal Program</i>
84.027	Department of Education, Special education grants - children
93.243	Department of HHS, SAMSA grant
93.778	Department of HHS, Medical Assistance Program
93.959	Department of HHS, pass through County of San Diego – Substance Abuse Treatment and Education

Dollar threshold used to distinguish Between type A and type B programs: \$ 300,000

Auditee qualified as low-risk auditee? ☒ yes _____ no

Section II – Financial Statement Findings

No reportable conditions, material weaknesses, and instances of noncompliance were identified that related to the financial statements and that were required to be reported.

Section III – Federal Award Findings and Questioned Costs

No reportable conditions, material weaknesses, and instances of noncompliance, including questioned costs were identified that related to the Federal Awards and that were required to be reported by Section 510(a) of Circular A-133.

MENTAL HEALTH SYSTEMS, INC.
SUMMARY SCHEDULE OF PRIOR AUDIT FINDINGS
For the Year Ended June 30, 2010

Prior Audit Findings

There were no prior audit findings that were required to be reported.

MENTAL HEALTH SYSTEMS, INC.
CORRECTIVE ACTION PLAN
For the Year Ended June 30, 2010

Corrective Action Plan

There was no corrective action plan that was required to be reported.