

*Audited Financial Statements
and Supplementary Schedules*

MENTAL HEALTH SYSTEMS, INC.

For the Year Ended June 30, 2011

(With Comparative Totals for 2010)

MENTAL HEALTH SYSTEMS, INC.

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McLean, Rotherham & Company
Certified Public Accountants

James A. Rotherham, CPA
CEO & Managing Partner

Don R. Copeland, CPA
Office Managing Partner

.....
Donald D. McLean, CPA
Chairman Emeritus

Ronald J. Rotherham, CPA
1938-2007

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 of June 30, 2011, 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 2010 financial statements and in our report dated January 24, 2011, 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, 2011, 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 February 15, 2012 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

February 15, 2012

MENTAL HEALTH SYSTEMS, INC.
A CALIFORNIA NOT-FOR-PROFIT CORPORATION
STATEMENT OF FINANCIAL POSITION
June 30, 2011 and 2010

	<u>2011</u>	<u>2010</u>
ASSETS		
Current Assets		
Cash and cash equivalents	\$ 5,530,856	\$ 2,690,752
Investments	237,431	184,524
Contracts receivables, net of allowance of \$350,000	10,043,671	12,996,980
Other receivables	132,232	492,247
Prepaid expense	<u>563,880</u>	<u>473,531</u>
Total Current Assets	16,508,070	16,838,034
Property and Equipment		
Land	3,163,183	3,163,183
Building/facilities	10,249,287	9,759,347
Construction in progress	87,845	73,433
Automobiles	823,698	823,698
Furniture and fixtures	1,852,743	1,820,004
Leasehold improvements	950,008	950,008
Software	219,790	160,562
Less: Accumulated depreciation	<u>(4,893,027)</u>	<u>(4,107,308)</u>
Net Property and Equipment	12,453,527	12,642,927
Other Assets		
Investment	3,820	5,000
Deposits	<u>348,323</u>	<u>364,693</u>
Total Other Assets	<u>352,143</u>	<u>369,693</u>
Total Assets	<u><u>\$ 29,313,740</u></u>	<u><u>\$ 29,850,654</u></u>
LIABILITIES AND NET ASSETS		
Current Liabilities		
Accounts payable	\$ 3,154,366	\$ 3,662,630
Accrued payroll and related taxes	4,589,034	4,668,704
Accrued employee benefits	1,018,817	1,370,194
Unearned contract revenue	403,586	323,693
Other liabilities	735,065	581,760
Notes payable, current portion	<u>355,167</u>	<u>151,038</u>
Total Current Liabilities	10,256,035	10,758,019
Notes payable, net of current portion	<u>8,827,829</u>	<u>9,360,726</u>
Total Liabilities	19,083,864	20,118,745
Net Assets		
Unrestricted	10,203,609	9,706,286
Restricted	<u>26,267</u>	<u>25,623</u>
Total Net Assets	<u>10,229,876</u>	<u>9,731,909</u>
Total Liabilities and Net Assets	<u><u>\$ 29,313,740</u></u>	<u><u>\$ 29,850,654</u></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, 2011

	Total Funds	Operating	Temporarily Restricted	2010 (Summarized)
Revenue and Support				
Contract revenue	\$ 80,885,066	\$ 80,885,066	\$ -	\$ 89,298,268
Other revenue	1,990,074	1,990,074	-	2,102,940
Fundraising, net of direct expenses	86,781	86,781		17,148
Donations	71,638	70,994	644	84,953
	<hr/>	<hr/>	<hr/>	<hr/>
Total Revenue	83,033,559	83,032,915	644	91,503,309
Net Assets Released from Restriction	-	-	-	-
Total Revenue and Support	<hr/>	<hr/>	<hr/>	<hr/>
	83,033,559	83,032,915	644	91,503,309
Direct Expense				
Payroll	25,717,197	25,717,197	-	27,478,466
Payroll benefits	6,148,092	6,148,092	-	6,657,979
Purchased services	22,408,421	22,408,421	-	27,950,742
Occupancy costs	4,816,704	4,816,704	-	5,166,390
Consultants	3,186,255	3,186,255		3,223,193
Other direct expense	11,849,291	11,849,291	-	11,593,785
Unallocable expense	-	-	-	9,048
	<hr/>	<hr/>	<hr/>	<hr/>
Total Direct Expense	74,125,960	74,125,960	-	82,079,603
Indirect Expense				
Payroll	4,027,564	4,027,564	-	3,967,090
Payroll benefits	566,283	566,283	-	601,126
Occupancy costs	463,136	463,136		452,388
Consultants	345,263	345,263		513,282
Other indirect expense	2,514,879	2,514,879	-	2,404,029
Unallocable expense	492,507	492,507	-	620,623
	<hr/>	<hr/>	<hr/>	<hr/>
Total Indirect Expense	8,409,632	8,409,632	-	8,558,538
Total Expense	<hr/>	<hr/>	<hr/>	<hr/>
	82,535,592	82,535,592	-	90,638,141
Increase / (Decrease) in Net Assets	\$ <u>497,967</u>	\$ <u>497,323</u>	\$ <u>644</u>	\$ <u>865,168</u>

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, 2011

Description	Total Net Assets	Unrestricted	Temporarily Restricted
Balance 6/30/10	\$ 9,731,909	\$ 9,706,286	\$ 25,623
Increase in Net Assets	<u>497,967</u>	<u>497,323</u>	<u>644</u>
Balance 6/30/11	\$ <u><u>10,229,876</u></u>	\$ <u><u>10,203,609</u></u>	\$ <u><u>26,267</u></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, 2011 and 2010

	2011	2010
Cash Flow from Operating Activities:		
Increase in net assets	\$ 497,967	\$ 865,170
Add charges to revenue not requiring use of cash:		
Depreciation	786,329	765,540
Adjustments to reconcile excess of revenue over expenses to net cash flow from operating activities		
Decrease in contracts and other receivables	3,313,324	5,666,579
Increase in prepaid expense	(90,349)	(312,321)
Decrease in deposits	16,370	116,655
(Decrease) in accounts payable and accrued expenses	(786,006)	(2,070,023)
Increase / {Decrease} in unearned revenue	79,893	(267,217)
Net cash provided / (used) for operating activities	3,817,528	4,764,383
Cash Flow from Investing Activities:		
Investment purchases and changes in investment value	(51,727)	(50,963)
Disposals of property and equipment	31,160	32,015
Acquisition of property and equipment	(628,089)	(982,954)
Net cash provided / (used) for investing activities	(648,656)	(1,001,902)
Cash Flow from Financing Activities:		
Proceeds on new borrowings	-	399,458
Principal payments on notes payable	(328,768)	(3,826,572)
Net cash provided by financing activities	(328,768)	(3,427,114)
Net increase in cash and cash equivalents	2,840,104	335,367
Cash and cash equivalents beginning of year	2,690,752	2,355,385
Cash and cash equivalents at end of year	\$ 5,530,856	\$ 2,690,752
Supplemental disclosure of cash flow information		
Cash payments for:		
Interest	\$ 624,489	\$ 667,641

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, 2011

	<u>Total Expense</u>	<u>Program Service</u>	<u>Management & General</u>	<u>2010 (Summarized)</u>
Total Direct and Indirect Expense				
Accounting & legal	\$ 53,618	\$ 28,140	\$ 25,478	\$ 34,332
Consultants	3,531,518	3,186,255	345,263	3,736,475
Depreciation	786,328	301,583	484,745	765,540
Dues and subscriptions	86,839	25,385	61,454	97,897
Equipment rental	513,056	371,797	141,259	428,536
Housekeeping and general supplies	195,473	188,639	6,834	202,209
Insurance	2,600,373	2,365,856	234,517	1,944,453
Interest and bank fees	654,104	298,263	355,841	667,641
Laboratory fees	1,117,209	1,117,209	-	1,280,052
Licenses and taxes	173,938	161,448	12,490	179,362
Minor/major equipment	510,292	443,946	66,346	794,092
Occupancy costs	5,279,840	4,816,704	463,136	5,618,778
Office supplies	464,654	398,727	65,927	599,658
Other business services	1,789,229	1,433,401	355,828	1,468,171
Payroll	29,744,761	25,717,197	4,027,564	31,445,556
Payroll benefits	6,714,375	6,148,092	566,283	7,259,105
Printing and advertising	236,981	164,385	72,596	267,518
Purchased services	22,408,421	22,408,421	-	27,950,742
Repair and maintenance	384,366	340,551	43,815	317,395
RT / OT supplies and food	1,288,634	1,288,634	-	1,260,400
Staff development	451,269	329,402	121,867	611,967
Travel and transportation	1,361,566	1,095,971	265,595	1,221,110
Utilities and telephone	1,696,241	1,495,954	200,287	1,857,479
Total Direct and Indirect Expense	\$ 82,043,085	\$ 74,125,960	\$ 7,917,125	\$ 90,008,468
Unallocable Expense				
Bad debt	103,128	-	103,128	43,049
Unallowable/Unallocable expenses	389,379	-	389,379	586,622
	<u>\$ 492,507</u>	<u>\$ -</u>	<u>492,507</u>	<u>\$ 629,671</u>
Total Direct, Indirect and Unallocable Expense	\$ 82,535,592	\$ 74,125,960	8,409,632	\$ 90,638,139

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 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

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

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

The Organization reports contributions as restricted if they are received with donor stipulations that limit the use of the donated asset. When a donor-imposed restriction expires, that is, when the time restriction expires, or the purpose restriction is accomplished, temporarily restricted net assets are reclassified to unrestricted net assets. 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.

Comparative Financial Information

The financial statements include certain summarized comparative information from the prior year. This information is presented in total but not by net asset class and does not include sufficient detail to be in conformity with generally accepted accounting principles. Accordingly, such information should be read together with the Organization's financial statements for the year ended June 30, 2010, 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*

Use of Estimates

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

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

Generally accepted accounting principles (GAAP) provide guidance on how fair value should be determined when financial statement elements are required to be measured at fair value. Valuation techniques are ranked in three levels depending on the degree of objectivity of the inputs used with each level:

Level 1 inputs – quoted prices in active markets for identical assets

Level 2 inputs – quoted prices in active or inactive markets for the same or similar assets

Level 3 inputs – estimates using best information available when there is little or no market

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, 2011 and 2010.

Temporarily restricted net assets have been restricted by donors for specific programs within the Organization. Temporarily restricted net assets were \$26,267 and \$25,623 as of June 30, 2011 and 2010, respectively.

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 \$350,000 and \$400,000 as of June 30, 2011 and 2010 respectively.

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

NOTE 5 – FAIR VALUE MEASUREMENTS

Investments are reported at fair value in the accompanying statement of financial position. The fair value measurement accounting literature establishes a fair value hierarchy that prioritizes the inputs to valuation techniques used to measure fair value. This hierarchy consists of three broad levels:

Level 1 Fair Value Measurements

The fair value of mutual funds is based on the closing price reported in the active market where the individual securities are traded, when available. The fair value of the BHS stock is based on book value as reported on the latest tax return.

There were no Level 2 investments.

	(Level 1)	(Level 1)
December 31,	2011	2010
Mutual funds	\$ 237,431	\$ 184,524
	<u>\$ 237,431</u>	<u>\$ 184,524</u>
	(Level 2)	(Level 2)
Stock - BHS	<u>3,820</u>	<u>5,000</u>

Behavioral Healthcare Solutions, Inc. (BHS) 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 \$1,839,184 and \$1,960,824 for the years ended June 30, 2011 and 2010 respectively.

MENTAL HEALTH SYSTEMS, INC.
A CALIFORNIA NOT-FOR-PROFIT CORPORATION
NOTES TO FINANCIAL STATEMENTS
June 30, 2011

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>
2012	\$ 2,304,400	182,366
2013	1,838,991	114,142
2014	1,668,091	41,334
2015	1,237,852	26,246
Thereafter	2,767,042	14,582
Total	\$ <u>9,816,376</u>	\$ <u>378,670</u>

During the year ended June 30, 2011, the Organization incurred expenses of \$4,630,380 and \$513,056, 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.

MENTAL HEALTH SYSTEMS, INC.
A CALIFORNIA NOT-FOR-PROFIT CORPORATION
NOTES TO FINANCIAL STATEMENTS
June 30, 2011

NOTE 9 – BOSTON VILLAS, *Continued*

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 \$36,819 on reserve as of June 30, 2011.

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 \$15,736 on reserve as of June 30, 2011.

NOTE 10 – NOTES PAYABLE

Notes payable consist of the following at June 30, 2011:

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, 2011 is \$162,500. Accrued interest as of June 30, 2010 is \$95,939.

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, 2011 is \$388,065.

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, 2011. The interest rate and minimum monthly payment at June 30, 2011, was 7.80% and \$21,383, respectively. The principal balance at June 30, 2011 was \$1,289,141.

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, 2011 was \$106,865.

MENTAL HEALTH SYSTEMS, INC.
A CALIFORNIA NOT-FOR-PROFIT CORPORATION
NOTES TO FINANCIAL STATEMENTS
June 30, 2011

NOTE 10 – NOTES PAYABLE, *Continued*

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, 2011 was \$0.01. NCB renewed the line of credit through July 31, 2013 on July 15, 2011.

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, 2011 were \$69,476 and \$141,009 respectively.

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

Years Ending June 30,

2012	\$ 355,167
2013	314,641
2014	251,692
2015	267,321
Thereafter	<u>7,994,176</u>
Total Notes Payable	9,182,997
Less: Current Portion	<u>355,167</u>
Non-Current Portion	<u><u>\$ 8,827,830</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.

MENTAL HEALTH SYSTEMS, INC.
A CALIFORNIA NOT-FOR-PROFIT CORPORATION
NOTES TO FINANCIAL STATEMENTS
June 30, 2011

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, 2011 consist of the following:

Petty Cash	\$ 29,265
Wells Fargo Bank	1,474,821
CBT	1,175,822
US Bank	352,190
National Cooperative Bank	2,498,758
Total	<u>\$ 5,530,856</u>

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.

NOTE 15– SUBSEQUENT EVENTS

Subsequent events were considered and evaluated through the date of this report. No subsequent events occurred that would have required disclosure in these financial statements.

Supplementary Schedules

MENTAL HEALTH SYSTEMS, INC.

For the Year Ended June 30, 2011

MENTAL HEALTH SYSTEMS, INC.
A CALIFORNIA NOT-FOR-PROFIT CORPORATION
SUPPLEMENTARY SCHEDULE OF OTHER DIRECT EXPENSE
For the Years Ended June 30, 2011 amd 2010

	<u>2011</u>	<u>2010</u>
Accounting & legal	\$ 28,140	\$ 8,650
Depreciation	301,583	320,702
Dues and subscriptions	25,385	24,324
Equipment rental	371,797	359,054
Housekeeping and general supplies	188,639	195,152
Insurance	2,365,856	1,705,655
Interest and bank fees	298,263	298,316
Laboratory fees	1,117,209	1,280,052
Licenses, fees and taxes	161,448	172,013
Minor/major equipment	443,946	700,034
Office supplies	398,727	522,882
Other business services	1,433,401	1,162,177
Printing and advertising	164,385	190,582
Repairs and maintenance	340,551	264,692
RT / OT supplies and food	1,288,634	1,260,400
Staff development	329,402	422,536
Travel and transportation	1,095,971	1,048,523
Utilities and telephone	1,495,954	1,658,041
Total Other Direct Expense	\$ <u>11,849,291</u>	\$ <u>11,593,785</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, 2011 and 2010

	<u>2011</u>	<u>2010</u>
Accounting & legal	\$ 25,478	\$ 25,682
Depreciation	484,745	444,838
Dues and subscriptions	61,454	73,573
Equipment rental	141,259	69,482
Housekeeping and general supplies	6,834	7,057
Insurance	234,517	238,798
Interest and other bank charges	355,841	369,324
Licenses and taxes	12,490	7,349
Minor/major equipment	66,346	94,058
Office expense	65,927	76,776
Other business services	355,828	305,996
Printing and advertising	72,596	76,936
Repairs and maintenance	43,815	52,703
Staff development	121,867	189,432
Travel and transportation	265,595	172,587
Utilities and telephone	200,287	199,438
Total Other Indirect Expense	\$ <u>2,514,879</u>	\$ <u>2,404,029</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	\$ 671,965
Pass-Through San Diego County Department of Health Services			
Special Education Grant	84.027	N/A	87,645
Safe and Drug-Free Schools Programs	84.184	N/A	12,250
Pass-Through Sacramento County Department of Health Services			
Rehabilitation Services-Vocational Rehabilitation Grants	84.390	N/A	144,904
<i>Total U.S. Department of Education</i>			<u>916,764</u>
<i>U.S. Department of Housing and Urban Development</i>			
Supportive Housing Program	14.235	N/A	266,554
Pass-Through San Diego County Department of Health Services			
Supportive Housing Program	14.235	N/A	244,653
Supportive Housing Program	14.238	N/A	74,683
<i>Total U.S. Department of Housing and Urban Development</i>			<u>585,890</u>
<i>U.S. Department of Justice</i>			
Pass-Through San Diego County Department of Health Services			
Recovery Act - Justice Assistance Grant	16.803	N/A	398,923
Recovery Act - Justice Assistance Grant	16.804	N/A	392,057
Pass Through San Bernardino County Department of Mental Health			
Recovery Act - Justice Assistance Grant	16.803	N/A	33,381
Pass-Through Fresno Department of Health Services			
Drug Court Discretionary Grant Program	16.585	N/A	81,764
<i>Total U.S. Department of Justice</i>			<u>906,125</u>
<i>U.S. Department of Labor</i>			
Homeless Veterans Reintegration Project	17.805	N/A	301,000
Pass Through San Bernardino County Department of Mental Health			
WIA Formula Youth	17.259	N/A	176,300
<i>Total U.S. Department of Labor</i>			<u>477,300</u>
<i>U.S. Department of Health and Human Services</i>			
Drug Abuse and Addiction Research	93.279	N/A	524
Pass-Through San Diego County Department of Health Services			
Assistance in Transition from Homelessness (PATH)	93.150	N/A	88,501
Substance Abuse Treatment and Education	93.243	N/A	207,504
Substance Abuse Treatment and Mental Health	93.275	N/A	101,588
Teenage Pregnancy Prevention Program	93.297	N/A	48,270
Substance Abuse Treatment and Education	93.959	N/A	1,708,482

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>
Pass-Through Riverside Department of Health Services			
Substance Abuse Treatment and Education	93.243	N/A	259,736
Promoting Safe and Stable Families	93.556	N/A	277,239
Substance Abuse Treatment and Education	93.778	N/A	171,092
Pass-Through Fresno Department of Health Services			
Substance Abuse Treatment and Education	93.778	N/A	628,846
Substance Abuse Treatment and Education	93.958	N/A	581,748
Pass-Through Montgomery Department of Health Services			
Substance Abuse Treatment and Education	93.243	N/A	578,169
Pass-Through Santa Barbara Department of Health Services			
Substance Abuse Treatment and Education	93.243	N/A	128,559
Substance Abuse Treatment and Education	93.959	N/A	32,120
Pass Through San Bernardino County Department of Mental Health			
Substance Abuse Treatment and Education	93.243	N/A	319,813
Substance Abuse Treatment and Education	93.778	N/A	279,576
Substance Abuse Treatment and Education	93.959	N/A	782,136
<i>Total U.S. Department of Health and Human Services</i>			<u>6,193,903</u>
TOTAL FEDERAL AWARDS			\$ <u><u>9,079,982</u></u>



mcrothcpa.com

McLean, Rotherham & Company
Certified Public Accountants

James A. Rotherham, CPA
CEO & Managing Partner

Don R. Copeland, CPA
Office Managing Partner

**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***

Donald D. McLean, CPA
Chairman Emeritus
Ronald J. Rotherham, CPA
1938-2007

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, 2011, and have issued our report thereon dated February 15, 2012. 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
February 15, 2012



McLean, Rotherham & Company
Certified Public Accountants

James A. Rotherham, CPA
CEO & Managing Partner

Don R. Copeland, CPA
Office Managing Partner

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Donald D. McLean, CPA
Chairman Emeritus

Ronald J. Rotherham, CPA
1938-2007

**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, 2011. 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, 2011.

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. Accordingly, we do not express 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
February 15, 2012

MENTAL HEALTH SYSTEMS, INC.
SCHEDULE OF FINDINGS AND QUESTIONED COSTS
For the Year Ended June 30, 2011

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>
84.126	Department of Education, Employment Services
84.390	Department of Education, AARA Vocational Rehabilitation Grant
16.803	Department of Justice, Recovery Act – Justice Assistance Act
16.804	Department of Justice, Recovery Act – Justice Assistance Act
17.805	Department of Labor, Homeless Veterans Reintegration Project
17.259	Department of Labor, WIA Formula Youth
93.275	Department of HHS, pass through County of San Diego – Substance Abuse Treatment and Education
93.958	Department of HHS, Medical Assistance Program

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, 2011

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, 2011

Corrective Action Plan

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