

MENTAL HEALTH SYSTEMS, INC. AND SUBSIDIARIES
CONSOLIDATED FINANCIAL STATEMENTS
YEARS ENDED JUNE 30, 2019 AND 2018



CLAconnect.com

WEALTH ADVISORY
OUTSOURCING
AUDIT, TAX, AND
CONSULTING

MENTAL HEALTH SYSTEMS, INC. AND SUBSIDIARIES
TABLE OF CONTENTS
YEARS ENDED JUNE 30, 2019 AND 2018

INDEPENDENT AUDITORS' REPORT	1
CONSOLIDATED FINANCIAL STATEMENTS	
CONSOLIDATED STATEMENTS OF FINANCIAL POSITION	3
CONSOLIDATED STATEMENTS OF ACTIVITIES	4
CONSOLIDATED STATEMENTS OF FUNCTIONAL EXPENSES	6
CONSOLIDATED STATEMENTS OF CASH FLOWS	8
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS	9
INDEPENDENT AUDITORS' REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING AND ON COMPLIANCE AND OTHER MATTERS BASED ON AN AUDIT OF FINANCIAL STATEMENTS PERFORMED IN ACCORDANCE WITH <i>GOVERNMENT AUDITING STANDARDS</i>	18



INDEPENDENT AUDITORS' REPORT

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, 2019 and 2018, and the related consolidated statements of activities, functional expenses, and cash flows for the years 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 audits 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 audits 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.

Opinion

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of the Organization as of June 30, 2019 and 2018, and the changes in their net assets and their cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

Other Reporting Required by Government Auditing Standards

In accordance with *Government Auditing Standards*, we have also issued our report dated December 13, 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
December 13, 2019

MENTAL HEALTH SYSTEMS, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF FINANCIAL POSITION
JUNE 30, 2019 AND 2018

ASSETS	<u>2019</u>	<u>2018</u>
Cash and Cash Equivalents	\$ 734,380	\$ 1,247,539
Contracts and Grants Receivable, Net	16,273,874	12,430,680
Other Receivables	623,190	-
Prepaid Expenses	385,049	1,220,518
Deposits	924,870	570,904
Property and Equipment, Net	1,319,417	8,949,718
Restricted Cash	-	105,580
Total Assets	<u>\$ 20,260,780</u>	<u>\$ 24,524,939</u>
LIABILITIES AND NET ASSETS		
LIABILITIES		
Accounts Payable	\$ 5,774,373	\$ 5,182,129
Accrued Liabilities	5,714,159	7,468,868
Deferred Revenue	239,850	188,971
Line of Credit	6,905,002	4,163,028
Notes Payable	1,003,676	4,652,602
Total Liabilities	<u>19,637,060</u>	<u>21,655,598</u>
NET ASSETS		
Without Donor Restrictions	623,720	2,807,976
With Donor Restrictions	-	61,365
Total Net Assets	<u>623,720</u>	<u>2,869,341</u>
Total Liabilities and Net Assets	<u>\$ 20,260,780</u>	<u>\$ 24,524,939</u>

See accompanying Notes to Consolidated Financial Statements.

MENTAL HEALTH SYSTEMS, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENT OF ACTIVITIES
YEAR ENDED JUNE 30, 2019

	2019		Total
	Without Donor Restrictions	With Donor Restrictions	
REVENUES AND OTHER SUPPORT			
Mental Health Systems - Contract Revenue	\$ 72,026,528	\$ -	\$ 72,026,528
Mental Health Systems - Other Revenue	1,438,054	-	1,438,054
Mental Health Systems - Donations	53,524	26,785	80,309
Loss on Sale of Property and Equipment	(2,235,083)	-	(2,235,083)
Debt Forgiveness	250,000	-	250,000
Net Assets Released from Restrictions:			
Restriction Satisfied by Program			
Expenditures	88,150	(88,150)	-
Total Revenues and Other Support	<u>71,621,173</u>	<u>(61,365)</u>	<u>71,559,808</u>
EXPENSES			
Mental Health Systems - Program Services	63,082,981	-	63,082,981
Mental Health Systems - Management and General	<u>10,722,448</u>	<u>-</u>	<u>10,722,448</u>
Total Expenses	<u>73,805,429</u>	<u>-</u>	<u>73,805,429</u>
OTHER CHANGES			
Contract Settlements	<u>-</u>	<u>-</u>	<u>-</u>
CHANGE IN NET ASSETS	(2,184,256)	(61,365)	(2,245,621)
Net Assets - Beginning of Year	<u>2,807,976</u>	<u>61,365</u>	<u>2,869,341</u>
NET ASSETS - END OF YEAR	<u><u>\$ 623,720</u></u>	<u><u>\$ -</u></u>	<u><u>\$ 623,720</u></u>

See accompanying Notes to Consolidated Financial Statements.

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

	2018		
	Without Donor Restrictions	With Donor Restrictions	Total
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 Property and Equipment	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	<u>69,832,918</u>	<u>(28,116)</u>	<u>69,804,802</u>
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	<u>67,498,866</u>	<u>-</u>	<u>67,498,866</u>
OTHER CHANGES			
Contract Settlements	<u>(588,251)</u>	<u>-</u>	<u>(588,251)</u>
CHANGE IN NET ASSETS	1,745,801	(28,116)	1,717,685
Net Assets - Beginning of Year	<u>1,062,175</u>	<u>89,481</u>	<u>1,151,656</u>
NET ASSETS - END OF YEAR	<u><u>\$ 2,807,976</u></u>	<u><u>\$ 61,365</u></u>	<u><u>\$ 2,869,341</u></u>

See accompanying Notes to Consolidated Financial Statements.

MENTAL HEALTH SYSTEMS, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENT OF FUNCTIONAL EXPENSES
YEAR ENDED JUNE 30, 2019

	Mental Health Systems		
	Program Services	Management and General	Total
Salaries	\$ 30,716,457	\$ 4,011,707	\$ 34,728,164
Employee Benefits	2,784,425	130,756	2,915,181
Payroll Taxes	2,298,287	289,554	2,587,841
Total Salary Related Expenses	<u>35,799,169</u>	<u>4,432,017</u>	<u>40,231,186</u>
Professional Fees and Outside Services	6,122,414	1,172,186	7,294,600
Consulting Fees	5,348,468	1,026,651	6,375,119
Occupancy	5,125,707	711,774	5,837,481
Purchased Services	2,685,235	-	2,685,235
Utilities and Telephone	2,102,935	183,635	2,286,570
Travel	1,026,266	95,766	1,122,032
Program Expense	890,938	34,214	925,152
Equipment Purchase	740,884	130,941	871,825
Interest and Bank Charges	93,603	771,337	864,940
Insurance	619,368	213,450	832,818
Office Supplies	547,918	36,584	584,502
Computer	40,472	532,059	572,531
Taxes and Licenses	504,248	21,017	525,265
Equipment Rental	303,777	186,731	490,508
Miscellaneous Expense	-	411,360	411,360
Staff Development	276,891	81,825	358,716
Equipment and Maintenance	208,247	105,220	313,467
Laboratory Fees	261,106	-	261,106
Disallowed Expense	217,690	7,642	225,332
Printing and Postage	91,820	34,698	126,518
Dues and Subscriptions	4,071	9,878	13,949
Expenses before Depreciation and Amortization	<u>63,011,227</u>	<u>10,198,985</u>	<u>73,210,212</u>
Depreciation and Amortization	<u>71,754</u>	<u>523,463</u>	<u>595,217</u>
Total Expenses	<u>\$ 63,082,981</u>	<u>\$ 10,722,448</u>	<u>\$ 73,805,429</u>

See accompanying Notes to Consolidated Financial Statements.

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

	Mental Health Systems			Novata		Total
	Program Services	Management and General	Total	Behavioral Health	Sportfisher	
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	32,886,218	4,083,561	36,969,779	-	-	36,969,779
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	56,768,598	9,447,511	66,216,109	1,015	547,078	66,764,202
Depreciation and Amortization	114,012	607,529	721,541	-	13,123	734,664
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 Notes to Consolidated Financial Statements.

MENTAL HEALTH SYSTEMS, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS
YEARS ENDED JUNE 30, 2019 AND 2018

	2019	2018
CASH FLOWS FROM OPERATING ACTIVITIES		
Change in Net Assets	\$ (2,245,621)	\$ 1,717,685
Adjustments to Reconcile Change in Net Assets to Net Cash Used in Operating Activities:		
Depreciation	595,217	734,664
Gain (Loss) on Sale of Fixed Assets	2,235,083	(5,618,915)
 (Increase) Decrease in Assets:		
Contracts and Grants Receivable, Net	(3,843,194)	(2,785,006)
Other Receivables	(623,190)	
Prepaid Expenses	835,469	14,328
Deposits	(353,966)	(173,042)
 Increase (Decrease) in Liabilities:		
Accounts Payable	592,244	1,502,085
Accrued Liabilities	(1,754,709)	(1,404,116)
Deferred Revenue	50,879	(41,450)
Net Cash Used by Operating Activities	(4,511,788)	(6,053,767)
 CASH FLOWS FROM INVESTING ACTIVITIES		
Sale of Property and Equipment	4,800,001	7,393,113
Purchase of Property and Equipment	-	(420,330)
Net Cash Provided by Investing Activities	4,800,001	6,972,783
 CASH FLOWS FROM FINANCING ACTIVITIES		
Borrowings on Line of Credit	74,424,173	18,908,084
Borrowings on Notes Payable	577,500	-
Payments Made on Line of Credit	(71,682,199)	(18,407,346)
Payments Made on Notes Payable	(4,226,426)	(4,155,327)
Net Cash Used by Financing Activities	(906,952)	(3,654,589)
 NET DECREASE IN CASH, CASH EQUIVALENTS, AND RESTRICTED CASH	(618,739)	(2,735,573)
 Cash, Cash Equivalents, and Restricted Cash - Beginning of Year	1,353,119	4,088,692
 CASH, CASH EQUIVALENTS, AND RESTRICTED CASH - END OF YEAR	\$ 734,380	\$ 1,353,119
 SUPPLEMENTAL CASH FLOW INFORMATION		
Cash Paid During the Year:		
Interest	\$ 519,293	\$ 676,756
Taxes	\$ -	\$ -

See accompanying Notes to Consolidated Financial Statements.

MENTAL HEALTH SYSTEMS, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
JUNE 30, 2019 AND 2018

NOTE 1 ORGANIZATION

Mission and History

Mental Health Systems, Inc. and subsidiaries (collectively, the "Organization" or "MHS") has designed, developed, and successfully implemented programs to address its Mission: "To improve the lives of individuals, families, and communities impacted by substance abuse and behavioral health disorders." Organized on June 2, 1978 pursuant to the General Nonprofit Corporation Law of the State of California, MHS has become one of the most well-established behavioral health service providers in the State of California with an extensive range of community-based treatment programs serving individuals with unique needs and challenges. As a decades-long provider of substance use disorder and mental health treatment, MHS has successfully transitioned and adapted our services to meet changing models utilized by the federal, state, and county entities we serve. MHS has navigated significant changes in mental health services requirements and funding throughout the years, including changes brought about by the Mental Health Services Act (MHSA) and the 1115 Waiver. Throughout all these changes, MHS has remained a leader in the behavioral health field responding quickly and effectively to new substance use and mental health treatment requirements and standards while implementing evidence-based programs and best practices throughout all its programs.

Nature of Activities

MHS has been delivering compassionate, expertly managed, ever-evolving treatment services for individuals struggling with substance use disorders, serious mental illness, co-occurring disorders, transition age youth, LGBTQ+ adults and youth, veterans, children and families, adults and juveniles with criminal justice system involvement, and homelessness for over forty years. MHS currently manages approximately 80 federal, state, county, and city contracts throughout California. Treatment modalities include residential substance use disorder programs for women and children, outpatient services for adults with substance use disorders and/or serious mental illness, case management, housing support, vocational rehabilitation, and Assertive Community Treatment programs which meet and engage clients wherever they are in the community to assist them with living their best quality lives.

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. ("Sportfisher") was a wholly owned subsidiary of the Organization that owned a building providing housing for MHS programs. Sportfisher was sold in September 2017. Both entities are still legally active.

The Organization is supported primarily through government contracts, donor contributions, and grants. Approximately 98.50% and 90.00% of the Organization's support for the years ended June 30, 2019 and 2018, respectively, came from government contracts.

MENTAL HEALTH SYSTEMS, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
JUNE 30, 2019 AND 2018

NOTE 2 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Accounting

The financial statements of Mental Health Systems, Inc. have been prepared on the accrual basis of accounting and accordingly reflect all significant receivables, payables, and other liabilities.

The accompanying financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America. These standards require that the Organization report information regarding its financial position and activities according to two classes of net assets: net assets without donor restrictions and net assets with donor restrictions.

Net Assets Without Donor Restrictions

Net assets available for use in general operations and not subject to donor (or certain grantor) restrictions.

Net Assets With Donor Restrictions

Net assets subject to donor- (or certain grantor-) imposed restrictions. Some donor-imposed restrictions are temporary in nature, such as those that will be met by the passage of time or other events specified by the donor. Other donor-imposed restrictions are perpetual in nature, where the donor stipulates that resources be maintained in perpetuity. Gifts of long-lived assets and gifts of cash restricted for the acquisition of long-lived assets are recognized as revenue when the assets are placed in service. Donor-imposed restrictions are released when a restriction expires, that is, when the stipulated time has elapsed, when the stipulated purpose for which the resource was restricted has been fulfilled, or both.

We report contributions restricted by donors as increases in net assets without donor restrictions if the restrictions expire (that is, when a stipulated time restriction ends or purpose restriction is accomplished) in the reporting period in which the revenue is recognized. All other donor-restricted contributions are reported as increases in net assets with donor restrictions, depending on the nature of the restrictions. When a restriction expires, net assets with donor restrictions are reclassified to net assets without donor restrictions and reported in the consolidated statements of activities as Net Assets Released from Restrictions.

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.

MENTAL HEALTH SYSTEMS, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
JUNE 30, 2019 AND 2018

NOTE 2 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

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. In December 2018, the Hacienda property was sold and the restricted cash balance was closed. Restricted cash balances at June 30, 2019 and 2018 totaled \$-0- and \$105,580, 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, 2019 and 2018.

Approximately 57% of the Organization's revenues are provided by the County of San Diego.

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 without donor restriction or with donor restriction 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), net assets with donor restrictions are reclassified to net assets without donor restrictions and reported in the statements of activities as net assets released from restrictions.

MENTAL HEALTH SYSTEMS, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
JUNE 30, 2019 AND 2018

NOTE 2 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

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.

Deferred Revenue

Deferred revenue represents funds received, but not earned as qualifying expenses have not been incurred. 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.

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 upon time and effort. 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, 2019 AND 2018

NOTE 2 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

Change in Accounting Principle

On August 18, 2016, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2016-14, *Not-for-Profit Entities (Topic 958) – Presentation of Financial Statements of Not-for-Profit Entities*. The update addresses the complexity and understandability of net asset classification, deficiencies in information about liquidity and availability of resources, and the lack of consistency in the type of information provided about expenses and investment return. The Organization has implemented ASU 2016-14 and has adjusted the presentation in these financial statements accordingly.

Subsequent Events

Management has evaluated subsequent events through December 13, 2019, the date the financial statements were available to be issued.

NOTE 3 LIQUIDITY AND AVAILABILITY

Financial assets available for general expenditure, that is, without donor or other restrictions limiting their use, within one year of the statement of financial position date, comprise the following:

	2019	2018
Cash and Cash Equivalents	\$ 734,380	\$ 1,247,539
Contracts and Grants Receivable	16,273,874	12,430,680
Total	\$ 17,008,254	\$ 13,678,219

As part of the Organization's liquidity management plan, cash in excess of daily requirements is invested in short-term savings accounts.

NOTE 4 CONTRACTS AND GRANTS RECEIVABLE

Contracts, grants, and other receivables are balances due to the Organization for services provided and expenses incurred prior to June 30, 2019 and 2018, 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:

	2019	2018
Contracts Receivable	\$ 16,521,396	\$ 12,624,948
Less: Allowance for Doubtful Accounts	(247,522)	(194,268)
Total Due in One Year or Less	\$ 16,273,874	\$ 12,430,680

MENTAL HEALTH SYSTEMS, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
JUNE 30, 2019 AND 2018

NOTE 5 PROPERTY AND EQUIPMENT

Property and equipment consists of the following as of June 30:

	<u>2019</u>	<u>2018</u>
Land	\$ 555,260	\$ 2,470,005
Building and Facilities	914,634	9,067,069
Vehicles	722,015	722,015
Furniture, Fixtures, and Equipment	476,283	489,133
Leasehold Improvements	530,953	530,953
Software	2,463,832	2,463,832
Total Property and Equipment	<u>5,662,977</u>	<u>15,743,007</u>
Less: Accumulated Depreciation	<u>(4,343,560)</u>	<u>(6,793,289)</u>
Property and Equipment, Net	<u>\$ 1,319,417</u>	<u>\$ 8,949,718</u>

Depreciation expense for the fiscal years ended June 30, 2019 and 2018 was \$595,217 and \$734,664, respectively.

NOTE 6 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. During the years ended June 30, 2019 and 2018, the amortization expense was \$-0- and \$6,944, respectively. At June 30, 2019 and 2018 there is no remaining carrying value for the non-compete agreement.

NOTE 7 ACCRUED LIABILITIES

	<u>2019</u>	<u>2018</u>
Accrued Payroll	\$ 1,815,953	\$ 1,820,696
Accrued Benefits	2,720,997	3,873,023
Other Liabilities	1,177,209	1,775,149
Total Notes Payable	<u>\$ 5,714,159</u>	<u>\$ 7,468,868</u>

MENTAL HEALTH SYSTEMS, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
JUNE 30, 2019 AND 2018

NOTE 8 LINE OF CREDIT

In March 2018, the Organization obtained a \$5,000,000 revolving line of credit with Pacific Mercantile Bank (PMB) and secured by the Organization's accounts receivable. The line of credit had an interest rate of 6.75% and matured in March 2019. The balance as of June 30, 2018 was \$4,163,028. In December 2018, the Organization closed the line of credit and paid the balance with proceeds from a new line of credit, described below.

In December 2018, the Organization obtained a \$10,000,000, increased to \$12,500,000 in April 2019, revolving line of credit with CNH Finance Fund and secured by the Organization's accounts receivable. The line of credit has a variable interest rate and matures in December, 2021. The line of credit contains certain financial covenants and ratio requirements. As of June 30, 2019, the Organization was compliant with financial covenants and ratio requirements. As of June 30, 2019, the line of credit was \$6,905,002 and had an interest rate of 7.25%.

NOTE 9 NOTES PAYABLE

Notes payable consist of the following as of June 30:

	<u>2019</u>	<u>2018</u>
Clementine	\$ 573,070	\$ 586,503
CNH Term Loan	302,500	-
Vermont	128,106	164,109
Hacienda	-	3,901,990
Total Notes Payable	<u>\$ 1,003,676</u>	<u>\$ 4,652,602</u>
Due in One Year	\$ 353,683	\$ 49,435
Due in Two to Five Years	172,377	188,681
Thereafter	477,616	4,414,486
Total	<u>\$ 1,003,676</u>	<u>\$ 4,652,602</u>

The Organization had a note payable with National Cooperative Bank that was secured by a deed of trust for Hacienda, a Fresno property. The note contained certain financial covenants and ratio requirements. The note required monthly interest payments at a rate of 7.25%. The principal balance at June 30, 2018 was \$3,901,990. In December 2018, the Hacienda property was sold and a portion of the proceeds were used to pay off the note in full. As of June 30, 2019, there was no remaining balance on the note.

The Organization has a note payable with the City of Oceanside secured by a Deed of Trust for Clementine, an Oceanside property. The note requires monthly payments totaling \$3,417, including interest at 4.75%, through June 2042. The principal balance at June 30, 2019 and 2018 was \$573,070 and \$586,503, respectively.

MENTAL HEALTH SYSTEMS, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
JUNE 30, 2019 AND 2018

NOTE 9 NOTES PAYABLE (CONTINUED)

The Organization has a note payable with California Health Facilities Financing Authority secured by a Deed of Trust for Vermont, an Escondido property. The note requires monthly payments totaling \$3,369, including interest at 3.00%, through October 2022. The principal balance at June 30, 2019 and 2018 was \$128,106 and \$164,109, respectively.

In April 2019, the Organization entered into a note payable with CNH Finance Fund for \$550,000. The note requires weekly principal payments of \$27,500 and monthly variable interest payments through September 2019. As of June 30, 2019, the note had an interest rate of 7.25% and a balance of \$302,500.

NOTE 10 COMMITMENTS AND CONTINGENCIES

Commitments

The Organization entered into long-term operating lease agreements for program facilities, equipment, and the corporate office facility. These leases expire throughout the years ending June 2029. Aggregate future minimum operating lease commitments are as follows:

<u>Year Ending June 30,</u>	<u>Amount</u>
2020	\$ 4,948,557
2021	4,002,037
2022	3,545,509
2023	2,477,375
2024	2,196,433
Thereafter	4,170,484
Total	<u>\$ 21,340,395</u>

During the years ended June 30, 2019 and 2018, the Organization incurred expenses of \$5,112,560 and \$4,475,839, 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 \$5,837,480 and \$5,341,180, respectively

Contingencies

Litigation

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, 2019 AND 2018

NOTE 10 COMMITMENTS AND CONTINGENCIES (CONTINUED)

Contract Settlements

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, 2019 and 2018 of \$-0- and \$588,251, respectively, shown on the statements 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 consolidated financial statements.

NOTE 11 NET ASSETS WITH DONOR RESTRICTIONS

Net assets with donor restrictions have been restricted by donors for specific programs within the Organization. Net assets with donor restrictions were \$-0- and \$61,365 as of June 30, 2019 and 2018, 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 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, 2019 and 2018, total expense was \$824,741 and \$1,606,237, 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***

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 consolidated financial statements of Mental Health Systems, Inc. and subsidiaries (collectively, the Organization), which comprise the consolidated statement of financial position as of June 30, 2019, 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, and have issued our report thereon dated December 13, 2019.

Internal Control Over Financial Reporting

In planning and performing our audit of the consolidated 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 consolidated 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.

Compliance and Other Matters

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

A handwritten signature in cursive script that reads "CliftonLarsonAllen LLP".

CliftonLarsonAllen LLP

Los Angeles, California
December 13, 2019

Investment advisory services are offered through CliftonLarsonAllen Wealth Advisors, LLC,
an SEC-registered investment advisor. | CliftonLarsonAllen LLP

