MENTAL HEALTH SYSTEMS, INC. AND SUBSIDIARIES

CONSOLIDATED FINANCIAL STATEMENTS
AND
INDEPENDENT AUDITORS' REPORT

JUNE 30, 2016 and 2015

NSBN LLP
CPAs & ADVISORS

MENTAL HEALTH SYSTEMS, INC. AND SUBSIDIARIES
CONSOLIDATED FINANCIAL STATEMENTS
JUNE 30, 2016 and 2015

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NSBN LLP
CPAs & ADVISORS

INDEPENDENT AUDITORS' REPORT

February 28, 2017

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

We have audited the accompanying consolidated financial statements of Mental Health Systems, Inc. and subsidiaries (collectively, the "Organization" or "MHS"), which comprise the consolidated statements of financial position as of June 30, 2016 and 2015, 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 audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement.

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

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

Opinion

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Mental Health Systems, Inc. and subsidiaries as of June 30, 2016 and 2015, 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 February 28, 2017 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 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 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.

NSBN LLP

NSBN LLP
Los Angeles, California

MENTAL HEALTH SYSTEMS, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF FINANCIAL POSITION
JUNE 30, 2016 and 2015

	2016	Reaudited 2015
ASSETS		
Cash and cash equivalents	$ 2,210,912	$ 5,379,721
Contracts and grants receivable, net (Note 3)	13,217,836	14,078,203
Short-term notes receivable	-	31,614
Prepaid expenses	820,706	1,153,602
Deposits	898,989	922,728
Property and equipment, net (Note 4)	12,410,630	13,970,994
Intangible assets (Note 5)	6,944	23,611
TOTAL ASSETS	$ 29,566,017	$ 35,560,473
LIABILITIES		
Accounts payable	$ 2,787,857	$ 3,324,922
Accrued liabilities	9,035,235	8,849,192
Deferred revenue	269,435	536,865
Line of credit (Note 7)	4,970,642	5,108,587
Notes payable (Note 8)	9,255,285	11,830,503
TOTAL LIABILITIES	26,318,454	29,650,069
NET ASSETS		
Unrestricted	3,161,967	5,858,122
Temporarily restricted (Note 10)	85,596	52,282
TOTAL NET ASSETS	3,247,563	5,910,404
TOTAL LIABILITIES AND NET ASSETS	$ 29,566,017	$ 35,560,473

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

MENTAL HEALTH SYSTEMS, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENT OF ACTIVITIES
FOR THE YEAR ENDED JUNE 30, 2016

	2016			
	Unrestricted	Temporarily Restricted	Permanently Restricted	Total
REVENUES AND OTHER SUPPORT				
Mental Health Systems - Contract revenue	$ 67,885,390	$ -	$ -	$ 67,885,390
Mental Health Systems - Other revenue	3,704,982	-	-	3,704,982
Mental Health Systems - Donations	213,325	68,500	-	281,825
Net assets released from restrictions:				
Restriction satisfied by program expenditures	35,186	(35,186)	-	-
Novata Behavioral Health - Revenues	5,482,017	-	-	5,482,017
TOTAL REVENUES AND OTHER SUPPORT	77,320,900	33,314	-	77,354,214
EXPENSES				
Mental Health Systems - Program services	61,037,376	-	-	61,037,376
Mental Health Systems - Management and general	12,181,222	-	-	12,181,222
Novata Behavioral Health - Expenses	6,733,497			6,733,497
Sportfisher - Expenses	64,960	-	-	64,960
TOTAL EXPENSES	80,017,055	-	-	80,017,055
CHANGE IN NET ASSETS	(2,696,155)	33,314	-	(2,662,841)
NET ASSETS AT BEGINNING OF YEAR	5,858,122	52,282	-	5,910,404
NET ASSETS, END OF YEAR	$ 3,161,967	$ 85,596	$ -	$ 3,247,563

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

MENTAL HEALTH SYSTEMS, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENT OF ACTIVITIES
FOR THE YEAR ENDED JUNE 30, 2015 (REAUDITED)

	2015			
	Unrestricted	Temporarily Restricted	Permanently Restricted	Total
REVENUES AND SUPPORT				
Mental Health Systems - Contract revenue	$ 72,807,955	$ -	$ -	$ 72,807,955
Mental Health Systems - Other revenue	1,760,954	-	-	1,760,954
Donations	176,798	90,587	-	267,385
Net assets released from restrictions:				
Restriction satisfied by program expenditures	117,496	(117,496)	-	-
Novata Behavioral Health - Revenues	6,210,740	-	-	6,210,740
TOTAL REVENUES AND SUPPORT	81,073,943	(26,909)	-	81,047,034
EXPENSES				
Mental Health Systems - Program services	66,527,803	-	-	66,527,803
Mental Health Systems - Management and general	8,707,623	-	-	8,707,623
Novata Behavioral Health - Expenses	7,560,565	-	-	7,560,565
TOTAL EXPENSES	82,795,991	-	-	82,795,991
CHANGE IN NET ASSETS	(1,722,048)	(26,909)	-	(1,748,957)
NET ASSETS, BEGINNING OF YEAR BEFORE RESTATEMENT	11,764,305	79,191	-	11,843,496
Prior Period Adjustments (Note 15)	(4,184,135)	-	-	(4,184,135)
NET ASSETS, BEGINNING OF YEAR, AS RESTATED	7,580,170	79,191	-	7,659,361
NET ASSETS, END OF YEAR	$ 5,858,122	$ 52,282	$ -	$ 5,910,404

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

MENTAL HEALTH SYSTEMS, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENT OF FUNCTIONAL EXPENSES
FOR THE YEAR ENDED JUNE 30, 2016

	Mental Health Systems			Novata		
	Program Services	Management and General	Total	Behavioral Health	Sportfisher	Total
Salaries	$ 27,519,682	$ 3,899,807	$ 31,419,489	$ 3,804,850	$ -	$ 35,224,339
Employee benefits	4,098,212	91,867	4,190,079	198,839	-	4,388,918
Payroll taxes	2,062,108	268,817	2,330,925	349,281	-	2,680,206
Total salary related expenses	33,680,002	4,260,491	37,940,493	4,352,970	-	42,293,463
Purchased services	7,546,087	-	7,546,087	-		7,546,087
Professional fees and outside services	2,552,992	3,957,738	6,510,730	139,977	-	6,650,707
Occupancy	4,595,657	443,475	5,039,132	391,082	-	5,430,214
Consulting fees	4,042,890	400,967	4,443,857	747,565		5,191,422
Utilities and telephone	1,528,664	166,215	1,694,879	201,596	-	1,896,475
Insurance	1,187,586	160,811	1,348,397	126,898	-	1,475,295
Travel	968,527	98,923	1,067,450	179,084	-	1,246,534
Interest and bank charges	180,366	581,742	762,108	98,274	64,960	925,342
Taxes and licenses	785,314	68,961	854,275	11,935	-	866,210
Equipment purchase	831,289	29,502	860,791	-		860,791
Program expense	720,079	24,363	744,442	-	-	744,442
Laboratory fees	721,646	6,997	728,643	-		728,643
Office supplies	602,679	39,148	641,827	30,008	-	671,835
Computer	67,744	426,909	494,653	124,730	-	619,383
Miscellaneous expense	131	295,530	295,661	195,459	-	491,120
Equipment and maintenance	268,392	225,526	493,918	20,977	-	514,895
Staff development	260,013	50,916	310,929	14,681	-	325,610
Printing and postage	175,872	35,972	211,844	12,168	-	224,012
Equipment rental	147,608	37,494	185,102	14,332		199,434
Bad debt expense	-	75,003	75,003	-		75,003
Dues and subscriptions	7,472	55,511	62,983	2,160	-	65,143
Expenses before depreciation	60,871,010	11,442,194	72,313,204	6,663,896	64,960	79,042,060
Depreciation	166,366	739,028	905,394	69,601	-	974,995
Total expenses	$ 61,037,376	$ 12,181,222	$ 73,218,598	$ 6,733,497	$ 64,960	$ 80,017,055

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

MENTAL HEALTH SYSTEMS, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENT OF FUNCTIONAL EXPENSES
FOR THE YEAR ENDED JUNE 30, 2015 (REAUDITED)

	Mental Health Systems			Novata	
	Program Services	Management and General	Total	Behavioral Health	Total
Salaries	$ 26,286,274	$ 4,301,756	$ 30,588,030	$ 3,500,631	$ 34,088,661
Employee benefits	4,245,017	514,457	4,759,474	207,228	4,966,702
Payroll taxes	1,941,798	289,138	2,230,936	367,485	2,598,421
Total salary related expenses	32,473,089	5,105,351	37,578,440	4,075,344	41,653,784
Purchased services	13,456,135	-	13,456,135	-	13,456,135
Consulting fees	4,172,471	339,302	4,511,773	703,906	5,215,679
Occupancy	3,950,485	796,605	4,747,090	450,859	5,197,949
Professional fees and outside services	2,836,304	427,575	3,263,879	185,602	3,449,481
Insurance	1,493,262	174,432	1,667,694	108,060	1,775,754
Utilities and telephone	1,514,367	194,272	1,708,639	180,614	1,889,253
Travel	1,006,279	147,166	1,153,445	201,668	1,355,113
Laboratory fees	1,099,429	1,448	1,100,877	-	1,100,877
Equipment purchase	1,038,193	61,426	1,099,619	-	1,099,619
Program expense	911,897	30,566	942,463	-	942,463
Interest and bank charges	275,055	421,678	696,733	188,490	885,223
Miscellaneous expense	530	7,578	8,108	753,400	761,508
Office supplies	576,309	43,845	620,154	35,904	656,058
Bad debt expense	-	245,323	245,323	320,776	566,099
Taxes and licenses	452,286	31,692	483,978	29,490	513,468
Equipment and maintenance	296,045	151,671	447,716	21,096	468,812
Staff development	303,692	77,802	381,494	43,082	424,576
Computer	140,687	45,258	185,945	136,309	322,254
Equipment rental	166,972	49,626	216,598	20,982	237,580
Printing and postage	138,037	28,108	166,145	43,718	209,863
Dues and subscriptions	18,014	71,357	89,371	971	90,342
Expenses before depreciation	66,319,538	8,452,081	74,771,619	7,500,271	82,271,890
Depreciation	208,265	255,542	463,807	60,294	524,101
Total expenses	$ 66,527,803	$ 8,707,623	$ 75,235,426	$ 7,560,565	$ 82,795,991

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

MENTAL HEALTH SYSTEMS, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS
FOR THE YEAR ENDED JUNE 30, 2016 and 2015

	2016	2015
CASH FLOWS FROM OPERATING ACTIVITIES		
Change in net assets	$ (2,662,841)	$ (1,748,957)
Adjustments to reconcile change in net assets to net cash (used in) operating activities:		
Depreciation	974,995	524,101
Amortization	16,667	16,667
(Increase) decrease in assets:		
Contracts and grants receivable, net	860,367	(1,151,908)
Prepaid expenses	332,896	211,627
Deposits	23,739	(50,832)
Increase (decrease) in liabilities:		
Accounts payable	(537,065)	686,027
Accrued liabilities	186,043	1,202,999
Deferred revenue	(267,430)	22,866
NET CASH (USED IN) OPERATING ACTIVITIES	(1,072,629)	(287,410)
CASH FLOWS FROM INVESTING ACTIVITIES		
Collection on short-term note receivable	31,614	30,000
Disposal of property and equipment	639,955	219,128
Purchase of property and equipment	(54,586)	(1,133,269)
NET CASH PROVIDED BY (USED IN) INVESTING ACTIVITIES	616,983	(884,141)
CASH FLOWS FROM FINANCING ACTIVITIES		
Borrowings on line of credit	710,000	8,281,530
Borrowings on notes payable	3,300,192	-
Payments made on line of credit	(847,945)	(5,350,000)
Payments made on notes payable	(5,875,410)	(788,623)
NET CASH PROVIDED BY (USED IN) FINANCING ACTIVITIES	(2,713,163)	2,142,907
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	(3,168,809)	971,356
CASH AND CASH EQUIVALENTS, BEGINNING OF YEAR	5,379,721	4,408,365
CASH AND CASH EQUIVALENTS, END OF YEAR	$ 2,210,912	$ 5,379,721
SUPPLEMENTAL CASH FLOW INFORMATION		
CASH PAID DURING THE YEAR:		
Interest	$ 891,960	$ 851,145
Taxes	$ 12,300	$ 10,900

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

NOTE 1 ORGANIZATION

Mission and History

Mental Health Systems, Inc. and subsidiaries (collectively, the "Organization" or “MHS”) was organized June 2, 1978 pursuant to the General Nonprofit Corporation Law of the State of California and does not contemplate pecuniary gain or profit to the members thereof and it is organized for nonprofit purposes. The Organization was founded to provide mental health, drug and alcohol rehabilitation services in an innovative and cost effective manner primarily via government contracts. The mission of the Organization is to improve lives and instill hope by using new creative treatments strategies while respecting time proven methods of intervention.

Nature of Activities

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

The Organization is supported primarily through government contracts, donor contributions, and grants. Approximately 88% and 90% of the Organization's support for the years ended June 30, 2016 and 2015, respectively, came from government contracts.

NOTE 2 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Principles of Consolidation

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

Basis of Accounting

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

Basis of Presentation

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

NOTE 2 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

Unrestricted Net Assets

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

Temporarily Restricted Net Assets

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

Permanently Restricted Net Assets

The permanently restricted class is the portion used to record resources received that are permanently restricted as to use by the donor or grantor. There are no permanently restricted net assets at June 30, 2016 and 2015.

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.

Cash in Bank – 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, 2016 and 2015.

Certificates of Deposit

Certificates of deposit at June 30, 2016 and 2015 totaling $201,052 and $200,900 bear interest ranging from 2% to 2.75% and 3.5% to 3.75%, respectively, and have maturities ranging from three to nine months, with penalties for early withdrawal. Any penalties for early withdrawal would not have a material effect on the financial statements.

NOTE 2 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

Contracts and Grants Receivable

Contracts receivable consists of balances due for services provided pursuant to written and verbal contracts with various public and private agencies. Generally accepted accounting principles in the United States of America require that an allowance for doubtful accounts be established for accounts receivable. It is the Organization’s policy to evaluate the collectability of receivables on a regular and ongoing basis, if deemed necessary, an adjustment to the allowance for bad debt is recorded. Accordingly, contracts and accounts receivable are shown net of an allowance for doubtful accounts.

Contributions and Pledges Receivable

As required by accounting principles generally accepted in the United States of America, contributions received are recorded as unrestricted, temporarily restricted, or permanently restricted depending on the existence and/or nature of any donor restrictions. When a restriction expires (that is, when a stipulated time restriction ends or purpose restriction is accomplished), temporarily restricted net assets are reclassified to unrestricted net assets and reported in the statement of activities as net assets released from restrictions.

Donated Services and Materials

No amounts have been reflected in the financial statements for donated services. The Organization generally pays for services requiring specific expertise. 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 expensed. These funds must be expensed in accordance with the provisions of the contract to which they apply, or if not expensed in the current period, are carried over into the subsequent year.

NOTE 2 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

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.

Concentration of Contributions or Grants

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

Tax Status

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

The Organization files IRS Form 990 and State Forms 199 and RRF-1. Generally accepted accounting principles provide accounting and disclosure guidance about positions taken by an organization in its tax returns that might be uncertain. The Organization recognizes the effect of income tax positions only if those positions are more likely than not of being sustained. Management of the Organization does not believe the financial statements include any uncertain tax positions. With few exceptions, The Organization is not subject to U.S. federal and state examinations by tax authorities for the years before 2013 and 2012, respectively.

Functional Allocation of Expenses

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

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

Subsequent Events

Management has evaluated subsequent events through February 28, 2017, the date the financial statements were available to be issued. Boston Villas, a building owned by the Organization was sold in October 2016 for which the proceeds were used to pay down the line of credit. The line of credit and a judgment against the Organization were renegotiated and the terms are reflected in the notes. Additionally, the business operations of CARES, operated through Novata Behavioral Health, Inc., was acquired by a third party in November 2016, which included the transfer of all assets and liabilities.

NOTE 3 CONTRACTS AND GRANTS RECEIVABLE

Contracts, grants and other receivable are balances due to the Organization for services provided and expenses incurred prior to June 30, 2016 and 2015, 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, 2016 and 2015:

	2016	2015
Contracts Receivable	$ 14,080,681	$ 14,937,852
Less allowance for doubtful accounts	(862,845)	(859,649)
Total due in one year or less	$ 13,217,836	$14,078,203

NOTE 4 PROPERTY AND EQUIPMENT

Property and equipment as of June 30, 2016 and 2015 consists of the following:

	2016	2015
Land	$ 3,539,328	$ 3,539,328
Building and facilities	$11,072,655	11,043,234
Vehicles	$722,015	857,235
Furniture, fixtures, equipment	655,280	1,418,911
Leasehold improvements	549,156	950,008
Software	2,522,831	3,194,713
Construction in progress	-	7,957
Total property and equipment	19,061,265	21,011,386
Less accumulated depreciation	(6,650,635)	(7,040,392)
Property and equipment, net	$ 12,410,630	$ 13,970,994

Depreciation expense for the fiscal years ended June 30, 2016 and 2015 was $974,995 and $524,101, respectively.

NOTE 5 INTANGIBLE ASSETS

The accounting for the acquisition of Center for Autism Research Evaluation and Services resulted in recognizing a non-compete agreement with the seller in the amount of $50,000. Under accounting principles generally accepted in the United States of America, the carrying amount of the non-compete is amortized over the term of the contract. At June 30, 2016 and 2015, the unamortized balances were $6,944 and $23,611, respectively.

NOTE 6 JUDGEMENT

The Organization was involved in a legal dispute during 2015 and went to arbitration with regard to a disputed lease agreement. The Organization received an adverse judgment in February 2016 in the amount of $2,242,263, which is included in liabilities at June 30, 2016.

NOTE 7 LINE OF CREDIT

The Organization had available an $8,000,000 line of credit with a bank. The line of credit had an interest rate of 4.5%. The balance as of June 30, 2016 and 2015 was $4,970,642 and $5,108,587, respectively.

The Organization was in technical default of the terms of its line of credit as of September 30, 2015 as it was unable to reduce the outstanding balance to zero for a period of thirty (30) consecutive days during the previous twelve (12) month period as required by the line of credit terms. The lender and the Organization are in negotiations to execute a forbearance agreement by March 15, 2017.

NOTE 8 NOTES PAYABLE

Notes payable as of June 30, 2016 and 2015 consists of the following:

	2016	2015
Boston Villas	$ 195,509	$ 190,634
Hacienda	4,952,500	6,930,000
Vermont	232,957	265,865
Sportfisher	3,262,788	582,415
CARES	-	3,238,406
Clementine	611,531	623,183
Total Notes Payable	$ 9,255,285	$ 11,830,503
Due in one year	$ 270,549	$ 5,700,280
Due in two to five years	1,294,563	2,978,200
Thereafter	7,690,173	3,152,023
	$ 9,255,285	$ 11,830,503

NOTE 8 NOTES PAYABLE (CONTINUED)

Boston Villas Housing Project has a thirty year deed of trust held by the California Department of Housing and Community Development bearing interest at 3% through June 29, 2019, with principal and interest to be forgiven at maturity provided that the Organization meets all requirements during the term of the loan. The principal balance at June 30, 2016 and 2015 was $162,500 with accrued interest of $33,009 and $28,134, respectively.

Hacienda, a Fresno property, was acquired and renovated by the Organization through notes payable to U.S. Bancorp in the amount of $4,952,500 (Note A) and 1,977,500 (Note B). Interest for both loans is 5.923% per year. Maturity on Note A and B was December 17, 2015 and is December 17, 2038, respectively. Note A was refinanced by National Cooperative Bank at a rate of 7.25% and is secured by the deed of trust and contains certain financial covenants and ratio requirements, with which the Organization was compliant at June 30, 2015 and 2016. At June 30, 2016, the annual interest rate was 7.25% and with interest only payments due monthly. Note B was forgiven on December 31, 2015 in the amount of $1,977,500. The principal balance of the notes at June 30, 2016 and 2015 was $4,952,500 and $6,930,000, respectively.

Vermont, an Escondido property, has a deed of trust to California Health Facilities Financing Authority secured by a Deed of Trust, for the acquisition and renovation of the property, and has monthly installments of $3,969, including interest at 3.00%, due October 1, 2022. The principal balance at June 30, 2016 and 2015 was $232,957 and $265,865, respectively.

The Organization had a note payable to National Cooperative Bank for the purchase of the facility located at 1100 Sportfisher Drive, Oceanside, California. The face amount of the note was $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 was fully collateralized by the deed of trust to the properly and contains certain financial covenants and ratio requirements, with which the Organization was in compliance at June 30, 2015. The annual interest rate and minimum monthly payment at June 30, 2015, was 7.80% and $21,383, respectively. The principal balance at June 30, 2015, was $582,415. The property was then placed into a special interest entity on December 31, 2015 and refinanced with a note due to National Cooperative Bank in the amount of $3,375,000. At June 30, 2016, the interest rate was 4.47% and the principal balance as was $3,262,788. The proceeds of the refinance were used to extinguish the debt incurred to acquire CARES.

Clementine, an Oceanside property, has a note payable to the City of Oceanside secured by a Deed of Trust, bearing Interest at 4.75% through January 2042. The principal balance at June 30, 2016 and 2015 was $611,531 and $623,183, respectively.

NOTE 9 COMMITMENTS AND CONTINGENCIES

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 June 2025. Aggregate future minimum operating lease commitments are as follows:

Year Ending June 30,	Total
2017	$ 2,544,693
2018	2,220,874
2019	1,722,837
2020	1,499,734
2021	921,285
Thereafter	2,425,469
Totals	$ 11,334,892

During the year ended June 30, 2016 and 2015, the Organization incurred expenses of $4,570,099 and $4,565,470, 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 $5,430,214 and $5,197,549, respectively.

Contingencies

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

NOTE 10 TEMPORARILY RESTRICTED NET ASSETS

Temporarily restricted net assets have been restricted by donors for specific programs within the Organization. Temporarily restricted net assets were $85,596 and $52,282 as of June 30, 2016 and 2015, respectively.

NOTE 11 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 12 BOSTON VILLAS

Boston Villas (the "Project") is a rental housing development occupied by mentally disabled persons of low income. The Organization administers the program and provides supportive services for the residents. Boston Villas was sold in October 2016 to a third party. MHS master leased the property from the third party while maintaining the programs in the facility.

The Organization is required to maintain a reserve for capital improvements and an operating reserve. The capital improvements include replacing structural elements, furniture, fixtures or equipment at the project. There is $93,471 and $ 97,993 on reserve as of June 30, 2016 and 2015, respectively. This operating reserve can be used for cash shortages that may be the result of unusually high maintenance expenses, seasonal fluctuations in utility costs, abnormally high vacancies, and other expenses that vary seasonally from month-to-month. The reserve was used to improve the property when it was sold in October 2016.

NOTE 13 RELATED PARTY TRANSACTIONS

One member of the Board of Directors provides leased facilities for one of the Organization's programs at fair market value. The amount paid to the board member for rent was $63,006 and $244,167 for the years ended June 30, 2016 and 2015, respectively. There were no amounts outstanding at June 30, 2016 and 2015.

Behavioral Healthcare Solutions, Inc. ("BHS") was a for-profit company and was 100% owned by the Organization. BHS was incorporated during the year ended June 30, 2010 to administer certain government contracts. On November 23, 2013, BHS acquired the stock of Center for Autism Research Evaluation and Services ("CARES") for $4,000,000. BHS obtained a $4,000,000 loan with a 7 year repayment term for the purchase. The loan agreement required the Organization to sign a guarantor agreement for BHS, whereby the Organization agrees to provide cash as needed for the ongoing operations of BHS/CARES. On January 1, 2014, BHS was merged into CARES. Simultaneously, the name of the corporation was changed to Novata Behavioral Health, Inc., a California corporation. All intercompany transactions were eliminated in the consolidation. The seller of CARES owns the building leased by Novata Behavioral Health and is an employee of Novata Behavioral Health. The amount paid to the employee for rent was $212,544 and $313,440 for the years ended June 30, 2016 and 2015, respectively. There were no amounts outstanding at June 30, 2016 and 2015.

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NOTE 14 RETIREMENT PLAN

The Organization maintains a 401(A) and Section 501 (A) plan for the benefit of all eligible employees. The plan provides a 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 year ended June 30, 2016 and 2015, total expense was $1,302,303 and $1,610,826, 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.

NOTE 15 PRIOR PERIOD ADJUSTMENT

Net assets as of June 30, 2014 have been restated to correct reporting errors, including consolidating a wholly owned subsidiary. The effect of the restatement for assets were increases in assets of cash and cash equivalents, contracts receivable, prepaid expenses, fixed assets, and deposits as well as decreases in other receivables, and investments. Additionally, for liabilities, there were increases in accounts payable, accrued payroll and notes payable, along with a decrease in other liabilities. Had these items been properly recorded, the net assets would have decreased by $4,184,135 for the year ended June 30, 2014. The restatement for June 30, 2014 is as follows:

	As previously reported	Adjustments	As restated
Statement of Financial Position			
Cash and cash equivalents	$ 2,683,248	$ 1,725,117	$ 4,408,365
Contracts receivables, net	12,354,099	479,923	12,834,021
Other receivables	2,583,148	(2,490,875)	92,273
Prepaid expenses	790,864	574,366	1,365,229
Property and equipment, net	13,374,341	246,889	13,621,230
Investment	5,000	(5,000)	-
Deposits	867,592	4,304	871,896
Total Assets	$32,719,904	$ 534,723	$33,254,627
Accounts payable	$ 2,571,329	$ 67,568	$ 2,638,896
Accrued payroll and related taxes	1,265,210	1,151,029	2,416,238
Accrued employee benefits	4,384,254	225,512	4,609,766
Other liabilities	1,102,681	(482,496)	620,185
Notes payable	8,861,881	3,757,245	12,619,126
Total Liabilities	$20,876,408	$ 4,718,858	$25,595,266
Net Assets	$11,843,496	$(4,184,135)	$ 7,659,361

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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

February 28, 2017

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

We have audited, in accordance with the auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States, the financial statements of Mental Health Systems, Inc. and subsidiaries (collectively, the "Organization"), which comprise the statement of financial position as of June 30, 2016, and the related statements of activities, and cash flows for the year then ended, and the related notes to the financial statements, and have issued our report thereon dated February 28, 2017.

Internal Control Over Financial Reporting

In planning and performing our audit of the financial statements, we considered the Organization's internal control over financial reporting (internal control) to determine the audit procedures that are appropriate in the circumstances for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Organization’s internal control. Accordingly, we do not express an opinion on the effectiveness of the Organization’s internal control.

A *deficiency in internal control* exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, misstatements on a timely basis. A *material weakness* is a deficiency, or a combination of deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of the entity’s financial statements will not be prevented, or detected and corrected on a timely basis. A *significant deficiency* is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

Our consideration of internal control was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies. Given these limitations, during our audit we did not identify any deficiencies in internal control that we consider to be material weaknesses. However, material weaknesses may exist that have not been identified.

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INDEPENDENT AUDITORS' REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING AND ON COMPLIANCE AND OTHER MATTERS BASED ON AN AUDIT OF FINANCIAL STATEMENTS PERFORMED IN ACCORDANCE WITH GOVERNMENT AUDITING STANDARDS (CONT.)

Compliance and Other Matters

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

Purpose of this Report

The purpose of this report is solely to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the effectiveness of the organization's internal control over financial reporting 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.

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