

**MENTAL HEALTH SYSTEMS, INC. AND SUBSIDIARIES**

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

**JUNE 30, 2017 and 2016**

MENTAL HEALTH SYSTEMS, INC. AND SUBSIDIARIES  
CONSOLIDATED FINANCIAL STATEMENTS  
JUNE 30, 2017 and 2016

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## INDEPENDENT AUDITORS' REPORT

December 27, 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, 2017 and 2016, 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.

## INDEPENDENT AUDITORS' REPORT (CONT.)

### Opinion

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Mental Health Systems, Inc. and subsidiaries as of June 30, 2017 and 2016, 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 27, 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, 2017 and 2016

	<u>2017</u>	<u>2016</u>
<b>ASSETS</b>		
Cash and cash equivalents	\$ 3,542,357	\$ 2,210,912
Restricted cash	546,335	-
Contracts and grants receivable, net	9,645,674	13,217,836
Prepaid expenses	764,040	820,706
Deposits	868,668	898,989
Property and equipment, net	11,038,250	12,410,630
Intangible assets	<u>-</u>	<u>6,944</u>
<b>TOTAL ASSETS</b>	<b>\$ <u>26,405,324</u></b>	<b>\$ <u>29,566,017</u></b>
<b>LIABILITIES</b>		
Accounts payable	\$ 3,728,056	\$ 2,787,857
Accrued liabilities	8,824,972	9,035,235
Deferred revenue	230,421	269,435
Line of credit	3,662,290	4,970,642
Notes payable	<u>8,807,929</u>	<u>9,255,285</u>
<b>TOTAL LIABILITIES</b>	<b>25,253,668</b>	<b>26,318,454</b>
<b>NET ASSETS</b>		
Unrestricted	1,062,175	3,161,967
Temporarily restricted	<u>89,481</u>	<u>85,596</u>
<b>TOTAL NET ASSETS</b>	<b><u>1,151,656</u></b>	<b><u>3,247,563</u></b>
<b>TOTAL LIABILITIES AND NET ASSETS</b>	<b>\$ <u>26,405,324</u></b>	<b>\$ <u>29,566,017</u></b>

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

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

	2017			Total
	Unrestricted	Temporarily Restricted	Permanently Restricted	
<b>REVENUES AND OTHER SUPPORT</b>				
Mental Health Systems - Contract revenue	\$ 63,227,617	\$ -	\$ -	\$ 63,227,617
Mental Health Systems - Other revenue	1,288,980	-	-	1,288,980
Mental Health Systems - Donations	-	79,552	-	79,552
Gain on sale of assets	1,028,050	-	-	1,028,050
Net assets released from restrictions:				
Restriction satisfied by program expenditures	75,667	(75,667)	-	-
Novata Behavioral Health - Revenues	1,471,309	-	-	1,471,309
<b>TOTAL REVENUES AND OTHER SUPPORT</b>	<b>67,091,623</b>	<b>3,885</b>	<b>-</b>	<b>67,095,508</b>
<b>EXPENSES</b>				
Mental Health Systems - Program services	56,598,380	-	-	56,598,380
Mental Health Systems - Management and general	9,793,060	-	-	9,793,060
Novata Behavioral Health - Expenses	1,891,869	-	-	1,891,869
Sportfisher - Expenses	160,079	-	-	160,079
<b>TOTAL EXPENSES</b>	<b>68,443,388</b>	<b>-</b>	<b>-</b>	<b>68,443,388</b>
<b>OTHER CHANGES</b>				
Contract settlements	(748,027)	-	-	(748,027)
<b>CHANGE IN NET ASSETS</b>	<b>(2,099,792)</b>	<b>3,885</b>	<b>-</b>	<b>(2,095,907)</b>
<b>NET ASSETS AT BEGINNING OF YEAR</b>	<b>3,161,967</b>	<b>85,596</b>	<b>-</b>	<b>3,247,563</b>
<b>NET ASSETS, END OF YEAR</b>	<b>\$ 1,062,175</b>	<b>\$ 89,481</b>	<b>\$ -</b>	<b>\$ 1,151,656</b>

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			Total
	Unrestricted	Temporarily Restricted	Permanently Restricted	
<b>REVENUES AND SUPPORT</b>				
Mental Health Systems - Contract revenue	\$ 67,885,390	\$ -	\$ -	\$ 67,885,390
Mental Health Systems - Other revenue	3,704,982	-	-	3,704,982
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
<b>TOTAL REVENUES AND SUPPORT</b>	<b>77,320,900</b>	<b>33,314</b>	<b>-</b>	<b>77,354,214</b>
<b>EXPENSES</b>				
Mental Health Systems - Program services	61,037,376	-	-	61,037,376
Mental Health Systems - Management and general	11,907,817	-	-	11,907,817
Novata Behavioral Health - Expenses	6,733,497	-	-	6,733,497
Sportfisher - Expenses	64,960	-	-	64,960
<b>TOTAL EXPENSES</b>	<b>79,743,650</b>	<b>-</b>	<b>-</b>	<b>79,743,650</b>
<b>OTHER CHANGES</b>				
Contract settlements	(273,405)	-	-	(273,405)
<b>CHANGE IN NET ASSETS</b>	<b>(2,696,155)</b>	<b>33,314</b>	<b>-</b>	<b>(2,662,841)</b>
<b>NET ASSETS, BEGINNING OF YEAR,</b>	<b>5,858,122</b>	<b>52,282</b>	<b>-</b>	<b>5,910,404</b>
<b>NET ASSETS, END OF YEAR</b>	<b>\$ 3,161,967</b>	<b>\$ 85,596</b>	<b>\$ -</b>	<b>\$ 3,247,563</b>

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

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

	Mental Health Systems			Novata Behavioral Health	Sportfisher	Total
	Program Services	Management and General	Total			
Salaries	\$ 26,970,491	\$ 2,913,990	\$ 29,884,481	\$ 1,001,388	\$ -	\$ 30,885,869
Employee benefits	3,686,246	436,147	4,122,393	47,464	-	4,169,857
Payroll taxes	1,999,337	224,322	2,223,659	110,483	-	2,334,142
Total salary related expenses	<u>32,656,074</u>	<u>3,574,459</u>	<u>36,230,533</u>	<u>1,159,335</u>	<u>-</u>	<u>37,389,868</u>
Purchased services	3,876,354	-	3,876,354	-	-	3,876,354
Professional fees and outside services	3,328,428	2,897,297	6,225,725	15,158	131	6,241,014
Occupancy	4,278,167	523,436	4,801,603	133,100	19,365	4,954,068
Consulting fees	4,794,649	396,161	5,190,810	67,358	-	5,258,168
Utilities and telephone	1,653,836	148,831	1,802,667	54,715	-	1,857,382
Insurance	898,405	143,349	1,041,754	59,486	8,363	1,109,603
Travel	796,001	54,890	850,891	57,891	-	908,782
Interest and bank charges	154,508	675,272	829,780	8,647	132,064	970,491
Taxes and licenses	495,910	47,064	542,974	2,421	156	545,551
Equipment purchase	629,691	48,855	678,546	-	-	678,546
Program expense	781,661	20,434	802,095	-	-	802,095
Laboratory fees	527,965	2,200	530,165	-	-	530,165
Office supplies	556,448	72,575	629,023	9,272	-	638,295
Computer	67,472	60,245	127,717	40,514	-	168,231
Miscellaneous expense	82,977	82,336	165,313	-	-	165,313
Equipment and maintenance	288,127	153,832	441,959	11,633	-	453,592
Staff development	240,416	25,053	265,469	3,462	-	268,931
Printing and postage	125,622	27,500	153,122	1,174	-	154,296
Equipment rental	150,657	35,270	185,927	1,899	-	187,826
Bad debt expense	45,214	156,698	201,912	140,881	-	342,793
Donated property	-	-	-	95,510	-	95,510
Dues and subscriptions	5,249	12,712	17,961	2,765	-	20,726
Expenses before depreciation and amortization	<u>56,433,831</u>	<u>9,158,469</u>	<u>65,592,300</u>	<u>1,865,221</u>	<u>160,079</u>	<u>67,617,600</u>
Depreciation and amortization	<u>164,549</u>	<u>634,591</u>	<u>799,140</u>	<u>26,648</u>	<u>-</u>	<u>825,788</u>
Total expenses	<u>\$ 56,598,380</u>	<u>\$ 9,793,060</u>	<u>\$ 66,391,440</u>	<u>\$ 1,891,869</u>	<u>\$ 160,079</u>	<u>\$ 68,443,388</u>

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



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

	Mental Health Systems			Novata Behavioral Health	Sportfisher	Total
	Program Services	Management and General	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	<u>33,680,002</u>	<u>4,260,491</u>	<u>37,940,493</u>	<u>4,352,970</u>	<u>-</u>	<u>42,293,463</u>
Purchased services	7,546,087	-	7,546,087	-	-	7,546,087
Professional fees and outside services	2,552,992	3,684,333	6,237,325	139,977	-	6,377,302
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 and amortization	<u>60,871,010</u>	<u>11,168,789</u>	<u>72,039,799</u>	<u>6,663,896</u>	<u>64,960</u>	<u>78,768,655</u>
Depreciation and amortization	<u>166,366</u>	<u>739,028</u>	<u>905,394</u>	<u>69,601</u>	<u>-</u>	<u>974,995</u>
Total expenses	<u>\$61,037,376</u>	<u>\$11,907,817</u>	<u>\$72,945,193</u>	<u>\$ 6,733,497</u>	<u>\$ 64,960</u>	<u>\$79,743,650</u>

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

MENTAL HEALTH SYSTEMS, INC. AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF CASH FLOWS  
FOR THE YEAR ENDED JUNE 30, 2017 and 2016

	2017	2016
<b>CASH FLOWS FROM OPERATING ACTIVITIES</b>		
Change in net assets	\$ (2,095,907)	\$ (2,662,841)
Adjustments to reconcile change in net assets to net cash provided by (used in) operating activities:		
Depreciation	818,844	958,328
Amortization	6,944	16,667
Gain on sale of fixed assets	(1,028,050)	-
(Increase) decrease in assets:		
Contracts and grants receivable, net	3,572,162	860,367
Prepaid expenses	56,666	332,896
Deposits	30,321	23,739
Increase (decrease) in liabilities:		
Accounts payable	940,199	(537,065)
Accrued liabilities	(210,263)	186,043
Deferred revenue	(39,014)	(267,430)
<b>NET CASH PROVIDED BY (USED IN) OPERATING ACTIVITIES</b>	<b>2,051,902</b>	<b>(1,089,296)</b>
<b>CASH FLOWS FROM INVESTING ACTIVITIES</b>		
Collection on short-term note receivable	-	31,614
Sale of property and equipment	1,650,197	-
Disposal of property and equipment	-	656,622
Purchase of property and equipment	(68,611)	(54,586)
<b>NET CASH PROVIDED BY INVESTING ACTIVITIES</b>	<b>1,581,586</b>	<b>633,650</b>
<b>CASH FLOWS FROM FINANCING ACTIVITIES</b>		
Borrowings on line of credit	-	710,000
Borrowings on notes payable	-	3,300,192
Payments made on line of credit	(1,308,352)	(847,945)
Payments made on notes payable	(447,356)	(5,875,410)
<b>NET CASH PROVIDED BY (USED IN) FINANCING ACTIVITIES</b>	<b>(1,755,708)</b>	<b>(2,713,163)</b>
<b>NET INCREASE (DECREASE) IN CASH, CASH EQUIVALENTS AND RESTRICTED CASH</b>	<b>1,877,780</b>	<b>(3,168,809)</b>
<b>CASH, CASH EQUIVALENTS AND RESTRICTED CASH BEGINNING OF YEAR</b>	<b>2,210,912</b>	<b>5,379,721</b>
<b>CASH, CASH EQUIVALENTS AND RESTRICTED CASH END OF YEAR</b>	<b>\$ 4,088,692</b>	<b>\$ 2,210,912</b>
<b>SUPPLEMENTAL CASH FLOW INFORMATION</b>		
<b>CASH PAID DURING THE YEAR:</b>		
Interest	\$ 936,394	\$ 891,960
Taxes	\$ -	\$ 12,300

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

MENTAL HEALTH SYSTEMS, INC. AND SUBSIDIARIES  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
JUNE 30, 2017 and 2016

**NOTE 1 ORGANIZATION**

**Mission and History**

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

**Nature of Activities**

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

The Organization is supported primarily through government contracts, donor contributions, and grants. Approximately 93% and 88% of the Organization's support for the years ended June 30, 2017 and 2016, respectively, came from government contracts.

**NOTE 2 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

**Principles of Consolidation**

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

**Basis of Accounting**

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

**Basis of Presentation**

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

MENTAL HEALTH SYSTEMS, INC. AND SUBSIDIARIES  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
JUNE 30, 2017 and 2016

**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, 2017 and 2016.

**Cash and Cash Equivalents**

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

**Restricted Cash**

Under the terms of the State of California Department of Transportation Right of Way Contract-State Highway, the Organization is required to escrow funds for curative improvements to the Hacienda property. Any improvements made to the Hacienda property will draw against this balance. Restricted cash balances at June 30, 2017 and 2016 totaled \$546,335 and \$0, 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, 2017 and 2016.

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

MENTAL HEALTH SYSTEMS, INC. AND SUBSIDIARIES  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
JUNE 30, 2017 and 2016

**NOTE 2 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)**

**Certificates of Deposit**

Certificates of deposit at June 30, 2017 and 2016 totaling \$43 and \$201,052 bear interest at .05%, and ranging from 2% to 2.75%, 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.

**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.

MENTAL HEALTH SYSTEMS, INC. AND SUBSIDIARIES  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
JUNE 30, 2017 and 2016

**NOTE 2 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)**

**Deferred Revenue**

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

**Use of Estimates**

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

**Reclassifications**

Certain 2016 financial information has been reclassified to conform to the 2017 presentation. The reclassifications have no impact on the previously reported changes in net assets.

**Tax Status**

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

The Organization files IRS Form 990 and State Forms 199 and RRF-1. Generally accepted accounting principles provide accounting and disclosure guidance about positions taken by an organization in its tax returns that might be uncertain. The Organization recognizes the effect of income tax positions only if those positions are more likely than not of being sustained. Management of the Organization does not believe the financial statements include any uncertain tax positions. With few exceptions, The Organization is not subject to U.S. federal and state examinations by tax authorities for the years before 2014 and 2013, respectively.

**Functional Allocation of Expenses**

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

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

MENTAL HEALTH SYSTEMS, INC. AND SUBSIDIARIES  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
JUNE 30, 2017 and 2016

**NOTE 2 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)**

**Subsequent Events**

Management has evaluated subsequent events through December 27, 2017, the date the financial statements were available to be issued.

The Sportfisher property in Oceanside CA was sold in September 2017. Proceeds from the sale was used to pay down the Line of Credit with NCB.

The County of San Diego issued a resolution of cure notice on December 1, 2017.

**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, 2017 and 2016, 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, 2017 and 2016:

	<u>2017</u>	<u>2016</u>
Contracts Receivable	\$ 9,839,942	\$ 14,080,681
Less allowance for doubtful accounts	<u>(194,268)</u>	<u>(862,845)</u>
Total due in one year or less	<u><u>\$ 9,645,674</u></u>	<u><u>\$13,217,836</u></u>

**NOTE 4 PROPERTY AND EQUIPMENT**

Property and equipment as of June 30, 2017 and 2016 consists of the following:

	<u>2017</u>	<u>2016</u>
Land	\$3,099,503	\$ 3,539,328
Building and facilities	10,926,250	11,072,655
Vehicles	722,015	722,015
Furniture, fixtures, equipment	489,133	655,280
Leasehold improvements	530,953	549,156
Software	2,463,832	2,522,831
Construction in progress	<u>-</u>	<u>-</u>
Total property and equipment	18,231,686	19,061,265
Less accumulated depreciation	<u>(7,193,436)</u>	<u>(6,650,635)</u>
Property and equipment, net	<u><u>\$ 11,038,250</u></u>	<u><u>\$ 12,410,630</u></u>

MENTAL HEALTH SYSTEMS, INC. AND SUBSIDIARIES  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
JUNE 30, 2017 and 2016

**NOTE 4 PROPERTY AND EQUIPMENT (CONTINUED)**

Depreciation expense for the fiscal years ended June 30, 2017 and 2016 was \$818,844 and \$958,328, 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, 2017 and 2016, the unamortized balances were \$0 and \$6,944, respectively.

**NOTE 6 JUDGEMENT**

The Organization was involved in arbitration with regard to a disputed lease agreement and received an adverse judgment. The balance due as of June 30, 2017 and 2016 was \$2,085,460 and \$2,242,263, respectively, and is included with accrued liabilities.

**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, 2017 and 2016 was \$3,662,290 and \$4,970,642, 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.

**NOTE 8 NOTES PAYABLE**

Notes payable as of June 30, 2017 and 2016 consists of the following:

	2017	2016
Boston Villas	\$ -	\$ 195,509
Hacienda	4,952,500	4,952,500
Vermont	199,049	232,957
Sportfisher	3,057,067	3,262,788
Clementine	599,313	611,531
Total Notes Payable	\$ 8,807,929	\$ 9,255,285



MENTAL HEALTH SYSTEMS, INC. AND SUBSIDIARIES  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
JUNE 30, 2017 and 2016

**NOTE 8 NOTES PAYABLE (CONTINUED)**

Due in one year	\$ 272,174	\$ 270,549
Due in two to five years	3,054,525	1,294,563
Thereafter	5,481,230	7,690,173
	\$ 8,807,929	\$ 9,255,285

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, 2017 and 2016 was \$0 and \$162,500, with accrued interest of \$0 and \$33,009, respectively. The Organization was required to maintain a reserve for capital improvements and an operating reserve. There is \$0 and \$ 93,471 on reserve as of June 30, 2017 and 2016, respectively. The reserve was used to improve the property when it was sold in October 2016.

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, 2016 and 2017. At June 30, 2017, 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, 2017 and 2016 was \$4,952,500 and \$4,952,500, 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, 2017 and 2016 was \$199,049 and \$232,957, respectively.

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

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, 2017 and 2016 was \$599,313 and \$611,531, respectively.

MENTAL HEALTH SYSTEMS, INC. AND SUBSIDIARIES  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
JUNE 30, 2017 and 2016

**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
2018	\$ 2,598,401
2019	1,948,059
2020	2,140,821
2021	878,055
2022	683,467
Thereafter	1,819,102
Totals	\$ 10,067,905

During the year ended June 30, 2017 and 2016, the Organization incurred expenses of \$4,084,544 and \$4,570,099, 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 \$4,954,068 and \$5,430,214, respectively.

**Contingencies**

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

MENTAL HEALTH SYSTEMS, INC. AND SUBSIDIARIES  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
JUNE 30, 2017 and 2016

**NOTE 9 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, 2017 and 2016 of \$748,027 and \$273,405, respectively, shown on the Statement of Activities represents known adjustments for prior year settlements. Liabilities, if any, which may result from any other governmental audits cannot be reasonably estimated and, accordingly, the Organization has no provisions for the possible disallowance of any other program costs on its financial statements.

**NOTE 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 \$89,481 and \$85,596 as of June 30, 2017 and 2016, 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 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 \$0 and \$63,006 for the years ended June 30, 2017 and 2016, respectively. There were no amounts outstanding at June 30, 2017 and 2016.

Behavioral Healthcare Solutions, Inc. ("BHS") was a for-profit company and was 100% owned by the Organization. BHS was incorporated during the year ended June 30, 2010 to administer certain government contracts. On November 23, 2013, BHS acquired the stock of Center for Autism Research Evaluation and Services ("CARES") for \$4,000,000. BHS obtained a \$4,000,000 loan with a 7 year repayment term for the purchase. The loan agreement required the Organization to sign a guarantor agreement for BHS, whereby the Organization agrees to provide cash as needed for the ongoing operations of BHS/CARES. On January 1, 2014, BHS was merged into CARES. Simultaneously, the name of the corporation was changed to Novata Behavioral Health, Inc., a California corporation. All intercompany transactions were eliminated in the consolidation. The seller of CARES owns the building leased by Novata Behavioral Health and is an employee of Novata Behavioral Health. The amount paid to the employee for rent was \$0 and \$212,544 for the years ended June 30, 2017 and 2016, respectively. There were no amounts outstanding at June 30, 2017 and 2016.

MENTAL HEALTH SYSTEMS, INC. AND SUBSIDIARIES  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
JUNE 30, 2017 and 2016

**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, 2017 and 2016, total expense was \$1,489,741 and \$1,302,303, 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**

December 27, 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, 2017, 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 December 27, 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.

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

**Compliance and Other Matters**

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

**Purpose of this Report**

The purpose of this report is solely to describe the scope of our testing of internal control and compliance and the results of that testing, and not to provide an opinion on the effectiveness of the organization's internal control or on compliance. This report is an integral part of an audit performed in accordance with Government Auditing Standards in considering the organization's internal control and compliance. Accordingly, this communication is not suitable for any other purpose.

*NSBN LLP*

NSBN LLP  
Los Angeles, California