

SPECTRUM HEALTH SYSTEMS, INC. AND AFFILIATE

***CONSOLIDATED FINANCIAL STATEMENTS
WITH SUPPLEMENTAL SCHEDULES
AND OTHER REPORTS***

YEAR ENDED JUNE 30, 2018

AND

INDEPENDENT AUDITOR'S REPORT

SPECTRUM HEALTH SYSTEMS, INC. AND AFFILIATE
CONSOLIDATED FINANCIAL STATEMENTS
WITH SUPPLEMENTAL SCHEDULES AND OTHER REPORTS
YEAR ENDED JUNE 30, 2018

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INDEPENDENT AUDITOR'S REPORT

To the Board of Directors
Spectrum Health Systems, Inc. and Affiliate

Report on the Financial Statements

We have audited the accompanying consolidated financial statements of Spectrum Health Systems, Inc. and Affiliate (the "Organization"), which comprise the consolidated statements of financial position as of June 30, 2018, 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 (collectively, the financial statements).

Management's Responsibility for the Consolidated 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.

Auditor's 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 from 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 auditor's 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 consolidated financial position of Spectrum Health Systems, Inc. and Affiliate, as of June 30, 2018, and the changes in its net assets and its cash flows for the year then ended in accordance with accounting principles generally accepted in the United States of America.

INDEPENDENT AUDITOR'S REPORT

(Continued)

Other Matter

Supplementary Information

Our audit was conducted for the purpose of forming an opinion on the consolidated financial statements as a whole. The accompanying Schedule of Expenditures of Federal Awards, as required by Title 2 U.S. *Code of Federal Regulations* Part 200, *Uniform Administrative Requirements, Cost Principles, and Audit Requirements for Federal Awards*, is presented for purposes of additional analysis and is not a required part of the consolidated financial statements. Such information is the responsibility of management and was derived from and relates directly to the underlying accounting and other records used to prepare the consolidated financial statements. The information has been subjected to the auditing procedures applied in the audit of the consolidated financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the consolidated financial statements or to the consolidated financial statements themselves, and other additional procedures in accordance with auditing standards generally accepted in the United States of America. In our opinion, the information is fairly stated, in all material respects, in relation to the consolidated financial statements as a whole.

Other Information

The consolidated financial statements of the Organization, as of and for the year ended June 30, 2017, were audited by other auditors, whose report, dated February 5, 2018, expressed an unmodified opinion on those statements.

Other Reporting Required by *Government Auditing Standards*

In accordance with *Government Auditing Standards*, we have also issued our report dated February 5, 2019, on our consideration of the Organization's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is 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. 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.

Ballus Lynch, LLP

Worcester, Massachusetts
February 5, 2019

SPECTRUM HEALTH SYSTEMS, INC. AND AFFILIATE
CONSOLIDATED STATEMENTS OF FINANCIAL POSITION
JUNE 30, 2018 AND 2017

	2018	2017
Assets		
Current assets		
Cash and cash equivalents	\$ 8,551,197	\$ 5,509,517
Accounts receivable, net of allowance of \$3,740,535 and \$6,249,930 as of June 30, 2018 and 2017, respectively	8,433,761	8,243,292
Prepaid expenses and other current assets	630,909	776,078
Total current assets	17,615,867	14,528,887
Property and equipment, net	23,925,106	25,642,878
Restricted cash	723,044	713,392
Investments	315,163	276,794
Investment in affiliate	355,296	368,244
Other assets	2,375	-
Total assets	\$ 42,936,851	\$ 41,530,195
Liabilities and Net Assets		
Current liabilities		
Accounts payable	\$ 1,258,909	\$ 1,556,228
Accrued expenses and other current liabilities	3,484,995	3,789,384
Current portion of long-term debt	14,472	13,926
Current portion of bonds payable	341,488	329,000
Current portion of capital lease obligations	4,570	120,478
Total current liabilities	5,104,434	5,809,016
Long-term liabilities		
Long-term debt, net of debt issuance costs and current portion	288,959	303,055
Long-term bonds payable, net of debt issuance costs and current portion	6,737,369	7,068,850
Capital lease obligations, net of current portion	-	4,570
Other liabilities	315,163	276,794
Total liabilities	12,445,925	13,462,285
Net assets		
Unrestricted	29,956,702	27,562,408
Temporarily restricted	534,224	505,502
Total net assets	30,490,926	28,067,910
Total liabilities and net assets	\$ 42,936,851	\$ 41,530,195

See accompanying independent auditor's report and notes to consolidated financial statements.

SPECTRUM HEALTH SYSTEMS, INC. AND AFFILIATE

CONSOLIDATED STATEMENTS OF ACTIVITIES

YEARS ENDED JUNE 30, 2018 AND 2017

	2018			2017		
	Unrestricted	Temporarily Restricted	Total	Unrestricted	Temporarily Restricted	Total
Public support and revenues						
Contract revenue	\$ 74,875,395	\$ -	\$ 74,875,395	\$ 73,768,520	\$ -	\$ 73,768,520
Gifts and contributions	7,120	31,462	38,582	59,182	15,301	74,483
Interest income	31,079	-	31,079	23,075	-	23,075
Unrealized gain on investments	25,233	-	25,233	39,396	-	39,396
Other revenue	315,615	5,000	320,615	848,778	70,625	919,403
Releases from restriction	7,740	(7,740)	-	95,144	(95,144)	-
Total public support and revenue	<u>75,262,182</u>	<u>28,722</u>	<u>75,290,904</u>	<u>74,834,095</u>	<u>(9,218)</u>	<u>74,824,877</u>
Expenses						
Program services	65,775,584	-	65,775,584	69,320,563	-	69,320,563
Management and general	6,942,263	-	6,942,263	11,307,517	-	11,307,517
Fundraising	150,041	-	150,041	142,988	-	142,988
Total expenses	<u>72,867,888</u>	<u>-</u>	<u>72,867,888</u>	<u>80,771,068</u>	<u>-</u>	<u>80,771,068</u>
Change in net assets	2,394,294	28,722	2,423,016	(5,936,973)	(9,218)	(5,946,191)
Net assets, beginning of year	<u>27,562,408</u>	<u>505,502</u>	<u>28,067,910</u>	<u>33,499,381</u>	<u>514,720</u>	<u>34,014,101</u>
Net assets, end of year	<u>\$ 29,956,702</u>	<u>\$ 534,224</u>	<u>\$ 30,490,926</u>	<u>\$ 27,562,408</u>	<u>\$ 505,502</u>	<u>\$ 28,067,910</u>

See accompanying independent auditor's report and notes to consolidated financial statements.

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

	Substance Abuse Services Inpatient	Substance Abuse Services Outpatient	Corrections Services	Adolescent Services	Other Services	Total Program Services	Management and General	Fundraising	Total
Salaries	\$ 9,936,602	\$ 10,727,799	\$ 13,932,765	\$ 3,834,956	\$ 293,894	\$ 38,726,016	\$ 4,797,162	\$ 61,243	\$ 43,584,421
Employee benefits	1,081,274	1,066,179	1,719,571	484,190	22,051	4,373,265	517,096	536	4,890,897
Payroll taxes	959,480	980,755	1,166,668	358,827	21,933	3,487,663	386,094	5,298	3,879,055
	<u>11,977,356</u>	<u>12,774,733</u>	<u>16,819,004</u>	<u>4,677,973</u>	<u>337,878</u>	<u>46,586,944</u>	<u>5,700,352</u>	<u>67,077</u>	<u>52,354,373</u>
Occupancy	1,790,903	3,593,201	65,654	120,556	1,999	5,572,313	83,913	-	5,656,226
Professional fees	216,621	1,069,023	183,504	15,857	47,579	1,532,584	1,057,455	2,604	2,592,643
Administrative expense	1,156,498	1,483,171	227,191	28,871	28,609	2,924,340	(291,162)	70,470	2,703,648
Food and donations	2,124,785	11,907	2,968	119,453	-	2,259,113	500	9,287	2,268,900
Depreciation	1,325,700	796,012	15,720	59,512	560	2,197,504	220,419	107	2,418,030
Transportation	155,961	136,307	453,507	35,868	27,340	808,983	143,115	-	952,098
Medical service and supply	204,390	1,502,717	22	497	-	1,707,626	-	-	1,707,626
Insurance	208,345	145,165	148,821	59,621	133	562,085	9,360	276	571,721
Education and training	22,844	49,401	77,982	2,243	1,080	153,550	117,837	220	271,607
Bad debt expense	819,717	-	-	-	-	819,717	(100,534)	-	719,183
Program supplies	266,003	35,238	3,274	34,427	11,560	350,502	1,008	-	351,510
Interest	282,964	12,545	125	-	-	295,634	-	-	295,634
Grant expense	-	-	2,045	2,644	-	4,689	-	-	4,689
Total expenses	<u>\$ 20,552,087</u>	<u>\$ 21,609,420</u>	<u>\$ 17,999,817</u>	<u>\$ 5,157,522</u>	<u>\$ 456,738</u>	<u>\$ 65,775,584</u>	<u>\$ 6,942,263</u>	<u>\$ 150,041</u>	<u>\$ 72,867,888</u>

See accompanying independent auditor's report and notes to consolidated financial statements.

SPECTRUM HEALTH SYSTEMS, INC. AND AFFILIATE
CONSOLIDATED STATEMENT OF FUNCTIONAL EXPENSES
YEAR ENDED JUNE 30, 2017

	Substance Abuse Services Inpatient	Substance Abuse Services Outpatient	Corrections Services	Adolescent Services	Other Services	Total Program Services	Management and General	Fundraising	Total
Salaries	\$ 10,228,083	\$ 10,342,449	\$ 16,006,320	\$ 3,748,629	\$ 191,273	\$ 40,516,754	\$ 4,884,913	\$ 42,448	\$ 45,444,115
Employee benefits	963,973	1,136,427	1,902,410	415,982	13,900	4,432,692	660,210	1,831	5,094,733
Payroll taxes	978,013	913,758	1,322,452	344,187	16,385	3,574,795	367,092	2,909	3,944,796
	<u>12,170,069</u>	<u>12,392,634</u>	<u>19,231,182</u>	<u>4,508,798</u>	<u>221,558</u>	<u>48,524,241</u>	<u>5,912,215</u>	<u>47,188</u>	<u>54,483,644</u>
Occupancy	1,328,469	3,196,196	81,790	125,846	-	4,732,301	474,943	-	5,207,244
Professional fees	619,455	1,201,059	417,982	10,378	19,053	2,267,927	897,437	-	3,165,364
Administrative expense	1,704,268	1,405,063	315,825	30,958	26,121	3,482,235	(550,310)	55,249	2,987,174
Food and donations	1,948,727	24,522	214	123,910	-	2,097,373	-	39,627	2,137,000
Depreciation	1,335,590	645,054	23,324	60,080	370	2,064,418	200,781	556	2,265,755
Transportation	115,092	144,653	614,284	37,120	26,612	937,761	124,588	17	1,062,366
Medical service and supply	206,404	1,416,110	476	1,038	-	1,624,028	-	-	1,624,028
Insurance	193,995	139,470	162,496	52,989	1,161	550,111	(166,100)	351	384,362
Education and training	37,276	68,005	98,681	2,030	-	205,992	122,777	-	328,769
Bad debt expense	1,026,559	310,301	-	-	-	1,336,860	5,134,847	-	6,471,707
Program supplies	264,107	30,381	4,063	33,433	-	331,984	570	-	332,554
Interest	304,879	13,068	-	-	-	317,947	105	-	318,052
Grant expense	-	-	3,049	-	-	3,049	-	-	3,049
Total expenses	<u>\$ 21,254,890</u>	<u>\$ 20,986,516</u>	<u>\$ 20,953,366</u>	<u>\$ 4,986,580</u>	<u>\$ 294,875</u>	<u>\$ 68,476,227</u>	<u>\$ 12,151,853</u>	<u>\$ 142,988</u>	<u>\$ 80,771,068</u>

See accompanying independent auditor's report and notes to consolidated financial statements.

SPECTRUM HEALTH SYSTEMS, INC. AND AFFILIATE

CONSOLIDATED STATEMENTS OF CASH FLOWS

YEARS ENDED JUNE 30, 2018 AND 2017

	2018	2017
Cash flows from operating activities:		
Change in net assets	\$ 2,423,016	\$ (5,946,191)
Adjustments to reconcile change in net assets to net cash (used in) provided by operating activities:		
Loss on sale of property and equipment	-	74,439
Depreciation	2,418,030	2,265,759
Amortization of debt issuance costs	10,382	9,119
Uncollectible accounts expense	719,183	6,471,707
Unrealized gain on investments	(23,369)	(39,396)
Increase (decrease) in operating assets:		
Accounts receivable, net	(909,652)	(3,810,387)
Prepaid expenses and other assets	142,794	65,199
Decrease in operating liabilities:		
Accounts payable	(139,656)	(308,171)
Accrued expenses and other liabilities	(266,020)	(321,113)
Total adjustments	1,951,692	4,407,156
Net cash provided by (used in) operating activities	4,374,708	(1,539,035)
Cash flows from investing activities:		
Investment in affiliate	12,948	(188,578)
Purchases of property and equipment	(857,921)	(2,743,272)
Purchase of investments	(15,000)	(25,000)
Net cash used in investing activities	(859,973)	(2,956,850)
Cash flows from financing activities:		
Change in restricted cash	(9,652)	130,035
Payments of long-term debt	(13,926)	(15,084)
Payments of bond payable	(328,999)	(316,969)
Payments of capital lease obligations	(120,478)	(149,729)
Net cash used in financing activities	(473,055)	(351,747)
Net increase (decrease) in cash	3,041,680	(4,847,632)
Cash, beginning of year	5,509,517	10,357,149
Cash, end of year	\$ 8,551,197	\$ 5,509,517
Supplemental disclosure of cash flow information is as follows:		
Cash paid during the year for:		
Interest	\$ 413,514	\$ 309,855
Supplemental disclosure of cash flow information is as follows:		
Purchases of property and equipment	\$ 700,258	\$ 2,936,462
Add: Accrued capital improvements, beginning of year	193,190	-
Less: Accrued capital improvements, end of year	(35,527)	(193,190)
Cash paid during the year for purchases of property and equipment	\$ 857,921	\$ 2,743,272

See accompanying independent auditor's report and notes to consolidated financial statements.

SPECTRUM HEALTH SYSTEMS, INC. AND AFFILIATE
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Nature of activities

Spectrum Health Systems, Inc. and Affiliate (the “Organization”) includes Spectrum Health Systems, Inc. (“Spectrum”) and NE Behavioral Health, Inc. (“NEBH”). Spectrum is a not-for-profit organization that provides residential and outpatient substance abuse treatment and rehabilitation, conducts related research and provides mental health counseling and treatment.

NEBH was incorporated on February 11, 2015 and commenced operations in June 2015. NEBH is a not-for-profit organization that shares the same mission as Spectrum and provides residential and outpatient substance abuse treatment and rehabilitation, conducts related reach and provides mental health counseling and treatment. Spectrum is the sole member of NEBH.

A Summary of the Organizations significant accounting policies follows:

Principles of consolidations

The consolidated financial statements of the Organization include the accounts of Spectrum and NEBH. All significant intercompany accounts and transactions have been eliminated in consolidation.

Classification and reporting of net assets

The consolidated financial statements of the Organization have been prepared using the accrual basis of accounting in accordance with accounting principles generally accepted in the United States of America (“GAAP”) applicable to not-for-profit organizations under Financial Accounting Standards Board (“FASB”) Accounting Standards Codification (“ASC”) 958, *Financial Statements of Not-For-Profit Organizations*. These standards require the Organization to report information regarding its financial position and activities according to three classes of net assets: unrestricted net assets, temporarily restricted net assets, and permanently restricted net assets. A description of the three net assets classes follows:

Unrestricted - All resources over which the governing board has discretionary control. The governing board of the Organization may elect to designate such resources for specific purposes. This designation may be removed at the board's discretion.

Temporarily Restricted - Resources accumulated through donations or grants for specific operating or capital purposes. Such resources will become unrestricted when the requirements of the donor or grantee have been satisfied through expenditure for the specified purpose or program or through the passage of time.

Permanently Restricted - Resources accumulated through donations or grants that are subject to the restriction in perpetuity that the principal be invested. Investment income may be either an unrestricted or temporarily restricted resource when earned, determined according to the gift instruments. As of June 30, 2018 and 2017, the Organization did not have any permanently restricted net assets.

Use of estimates

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenue and expenses during the reporting period. Actual results could differ from those estimates.

SPECTRUM HEALTH SYSTEMS, INC. AND AFFILIATE
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Continued)

1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Cash and cash equivalents

The Organization defines cash and equivalents as short-term, highly liquid investments with original maturities of three months or less.

Concentration of credit risk

The Organization maintains its cash in bank deposit accounts, which at times, may exceed federally insured limits. The Organization has not experienced any losses in such accounts and believes it is not exposed to significant credit risk on cash and cash equivalents.

Accounts receivable

Accounts receivable are stated at the amount management expects to collect from outstanding balances. Management provides for probable uncollectible amounts through a provision for bad debt expense and an adjustment to a valuation allowance based on its assessment of the current status of individual accounts. Balances that are still outstanding after management has used reasonable collection efforts are written off through a charge to the valuation allowance and a credit to accounts receivable. Recoveries of accounts receivable previously written off are recorded when received.

Property and equipment

Property and equipment is recorded at cost or, if received by donation, at fair value at the time such properties were received. Depreciation and amortization is provided on a straight-line basis over the estimated useful lives of the respective assets.

Leasehold improvements are amortized over the terms of the underlying lease.

Expenditures for major renewals and improvements are capitalized, while expenditures for maintenance and repairs are expensed as incurred.

Construction in progress

Costs associated with on-going projects are accumulated until completion. The completed asset is then depreciated over its estimated useful life once placed in service.

Impairment of long-lived assets

The Organization has given consideration to FASB ASC 360, Property and Equipment as it relates to the accounting for the impairment or disposal of long-lived assets in its presentation of the consolidated financial statements. As of June 30, 2018 and 2017, the Organization did not recognize any reduction in the carrying value of its property and equipment when considering this standard.

Debt issuance costs

Debt issuance costs consisting of deferred financing costs related to the bonds payable and mortgage note payable are being amortized over the life of the respective debt agreements. Debt issuance costs are classified as a reduction of debt on the accompanying consolidated statements of financial position.

SPECTRUM HEALTH SYSTEMS, INC. AND AFFILIATE
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Continued)

1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Fair value measurements

Under the FASB's authoritative guidance on fair value measurements, fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. In determining fair value, the Organization uses various methods including market, income and cost approaches. Based on these approaches, the Organization often utilizes certain assumptions that market participants would use in pricing the asset or liability, including assumptions about risk and or the risks inherent in the inputs to the valuation technique. These inputs can be readily observable, market corroborated, or generally unobservable inputs. The Organization utilizes valuation techniques that maximize the use of observable inputs and minimize the use of unobservable inputs.

Based on the observability of the inputs used in the valuation techniques, the Organization is required to provide the following information according to the fair value hierarchy. The fair value hierarchy ranks the quality and reliability of the information used to determine fair values. Financial assets and liabilities carried at fair value will be classified and disclosed in one of the following three categories:

Level 1 - Quoted prices for identical assets and liabilities traded in active exchange markets, such as the New York Stock Exchange.

Level 2 - Observable inputs other than Level 1 including quoted prices for similar assets or liabilities, quoted prices in less active markets, or other observable inputs that can be corroborated by observable market data. Level 2 also includes derivative contracts whose value is determined using a pricing model with observable market inputs or can be derived principally from or corroborated by observable market data.

Level 3 - Unobservable inputs supported by little or no market activity for financial instruments whose value is determined using pricing models, discounted cash flow methodologies, or similar techniques, as well as instruments for which the determination of fair value requires significant management judgment or estimation; also includes observable inputs for nonbinding single dealer quotes not corroborated by observable market data.

The Organization has various processes and controls in place to ensure fair value is reasonably stated. While the Organization believes its valuation methods are appropriate and consistent with other market participants, the use of different methodologies or assumptions to determine the fair value of certain financial instruments could result in a different estimate of fair value at the reporting date.

During the years ended June 30, 2018 and 2017, there were no changes to the Organization's valuation techniques that had, or are expected to have, a material impact on its consolidated statements of financial position or activities.

Following is a description of the valuation methodologies used for assets measured at fair value.

Mutual funds (non-privately managed): Valued at the daily closing price as reported by the fund. Mutual funds held by the Organization are open-ended mutual funds that are registered with the SEC. These funds are required to publish their daily net asset value (NAV) and to transact at that price. The mutual funds held by the Organization are deemed to be actively traded.

SPECTRUM HEALTH SYSTEMS, INC. AND AFFILIATE
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Continued)

1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Investments

Investments represent portfolio shares in registered investment companies and are carried at fair value. By Board of Trustees' resolution, these investments were designated as an offset against deferred compensation. Investment income and realized and unrealized gains or losses are recorded as increases or decreases in unrestricted net assets.

Investment in affiliate

Investment in affiliate represents the Organization's portion of its investment in a captive insurance company and is accounted for under the equity method.

Revenue recognition

The Organization recognizes revenue when there is persuasive evidence of an arrangement, services have been rendered, the fee is fixed or determinable, and collectability is reasonably assured. Amounts billed or collected prior to satisfying the Organization's revenue recognition policy are reflected as deferred revenue.

The programs of the Organization are principally supported by the Massachusetts Department of Public Health, the Massachusetts Department of Youth Services, and the Massachusetts Department of Corrections. The Organization also contracts with non-Massachusetts agencies in the states of Georgia, Tennessee, Rhode Island, and Virginia. Revenue is recorded as services are provided in individual programs at the rates approved by the Massachusetts Operational Services Division for Massachusetts programs, and as negotiated for out-of-state contracts. Additionally, the Organization derives service revenue and client service fees through third party billing and Medicaid.

Certain third party payors reimburse the Organization based on a unit rate reimbursement formula. The Organization estimates and excludes from revenue the difference, if any, between full charge and third party defined costs in the period services are rendered. Differences, if any, between the Organization's estimate of the contractual allowance and the final settlement by the third party payor are recognized as an adjustment to revenue in the period of final settlement.

The Organization is also subject to the regulations of the Massachusetts Executive Office for Administration and Finance Operational Services Division ("OSD"). Excess of revenue over expenses from the Commonwealth of Massachusetts supported programs, up to certain defined limits, can be utilized by the Organization for expenditures in accordance with its exempt purposes provided such expenditures are reimbursable under OSD regulations.

Contributions

Contributions, including unconditional promises to give, are initially recognized at fair value as revenues in the period the promise is received. Conditional promises to give are not recognized until they become unconditional, that is, at the time when the conditions on which they depend are substantially met. Contributions of assets other than cash are recorded at fair value.

Contributions to be received after one year are discounted using a rate commensurate with the risk involved. An allowance for uncollectible contributions receivable is provided based upon management's judgment of potential defaults. The determination includes such factors as prior collection history, type of contribution, and nature of fund raising activity. Amortization of discounts is recorded as additional contribution revenue in accordance with donor-imposed restrictions, if any, on the contributions.

SPECTRUM HEALTH SYSTEMS, INC. AND AFFILIATE
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Continued)

1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Contributions (continued)

Contributions received with donor-imposed restrictions that are met in the same year as received are reported as revenues of the temporarily restricted net asset class. A reclassification from temporarily restricted net assets to unrestricted net assets is made to reflect the expiration of such restrictions.

Contributions of property and equipment without donor stipulations concerning the use of such long-lived assets are reported as revenues of the unrestricted net asset class. Contributions of cash or other assets with donor stipulations that such assets are to be used to acquire property and equipment are reported as revenues of the temporarily restricted net asset class; the restrictions are considered to be released at the time of acquisition of such long-lived assets.

Contributions of services are reported as revenues and expenses of the unrestricted net asset class at the fair value of the services received only if the services create or enhance a non-financial asset or would typically need to be purchased by the Organization if they had not been provided by individuals with those skills. Contributions of goods and space to be used in program operations are reported as revenues and expenses of the unrestricted net asset class at the time the goods or space are received.

Advertising

The Organization expenses advertising costs as incurred. For the years ended June 30, 2018 and 2017, advertising expenses were \$344,216 and \$189,853, respectively.

Functional expenses

The costs of providing the various programs and other activities of the Organization have been summarized on a functional basis in the consolidated statements of activities. Accordingly, certain costs have been allocated between the programs and supporting services.

Income taxes

The Organization is a not-for-profit organization, which is qualified under Section 501 (c)(3) of the Internal Revenue Code, though it would be subject to tax on income unrelated to its exempt purposes (unless that income is otherwise excluded by the IRC).

The Organization follows FASB ASC 740, Income Taxes, which clarifies the accounting for uncertainty in income taxes by prescribing the recognition threshold a tax position is required to meet before being recognized in the consolidated financial statements. It also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition. Management believes that the Organization has no material uncertainties in income taxes. The Organization will account for interest and penalties related to uncertain tax positions, if any, as part of tax expense.

The Organization is no longer subject to income tax examinations by the U.S. federal, state, or local tax authorities for fiscal years before 2015.

SPECTRUM HEALTH SYSTEMS, INC. AND AFFILIATE
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Continued)

1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Recently Adopted Accounting Standards

In May 2015, the FASB issued ASU No. 2015-07, Fair Value Measurement (Topic 820): Disclosures for Investments in Certain Entities That Calculate Net Asset Value per Share (or Its Equivalent). The amendments apply to reporting entities that elect to measure the fair value of an investment using the NAV per share (or its equivalent) practical expedient. The amendments remove the requirement to categorize within the fair value hierarchy all investments for which fair value is measured using the net asset value per share practical expedient. The amendments also remove the requirement to make certain disclosures for all investments that are eligible to be measured at fair value using the net asset value per share practical expedient. Rather, those disclosures are limited to investments for which the entity has elected to measure the fair value using that practical expedient. The Organization has adopted ASU 2015-07 for the year ended June 30, 2018, as well as retrospectively for 2017. The Organization does not measure the fair value of its investment securities using the NAV per share (or its equivalent) practical expedient. Therefore, the adoption did not have any impact on the Organization's consolidated financial statements.

Recently issued accounting pronouncements

In May 2014, the FASB issued ASU 2014-09, Revenue from Contracts with Customers (Topic 606), which stipulates that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. To achieve this core principle, an entity should apply the following steps: (1) identify the contract(s) with a customer; (2) identify the performance obligations in the contract; (3) determine the transaction price; (4) allocate the transaction price to the performance obligations in the contract; and (5) recognize revenue when (or as) the entity satisfies a performance obligation. In August 2015, the FASB issued ASU 2015-14, which deferred the effective date of ASU 2014-09. The ASU is now effective for annual reporting periods beginning after December 15, 2018, and early adoption is permitted for years beginning after December 15, 2016. The Organization has not yet selected a transition method and is currently evaluating the effect that the updated standard will have on the consolidated financial statements.

In January 2016, the FASB issued ASU 2016-01, Financial Instruments-Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities, which updates certain aspects of recognition, measurement, presentation and disclosure of financial instruments. ASU 2016-01 will be effective for the Organization for fiscal years beginning after December 15, 2018. The Organization has not yet selected a transition method and is currently evaluating the effect that the updated standard will have on the consolidated financial statements.

In February 2016, the FASB issued ASU 2016-02, Leases (Topic 842). The guidance in this ASU supersedes the leasing guidance in Topic 840, Leases. Under the new guidance, lessees are required to recognize lease assets and lease liabilities on the statement of financial position for all leases with terms longer than twelve months. Leases will be classified as either finance or operating, with classification affecting the pattern of expense recognition in the consolidated statement of activities. The new standard is effective for annual reporting periods beginning after December 15, 2019. The Organization has not yet selected a transition method and is currently evaluating the effect that the updated standard will have on the consolidated financial statements.

SPECTRUM HEALTH SYSTEMS, INC. AND AFFILIATE
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Continued)

1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Recently issued accounting pronouncements (continued)

In August 2016, the FASB issued ASU 2016-14, Not-for-Profit Entities (Topic 958): Presentation of Financial Statements of Not-for-Profit Entities. The ASU simplifies and improves how a not-for profit organization classifies its net assets, as well as the information it presents in financial statements and notes about its liquidity, financial performance, and cash flows. The ASU is effective for fiscal years beginning after December 15, 2017. Early adoption is permitted. The Organization has not yet selected a transition method and is currently evaluating the effect that the updated standard will have on the consolidated financial statements.

In August 2016, the FASB issued ASU 2016-15, Statement of Cash Flows (Topic 230): Classification of Certain Cash Receipts and Cash Payments (A Consensus of the FASB Emerging Issues Task Force). To reduce diversity in practice, the ASU provides solutions for eight specific statement of cash flow classification issues. The ASU is effective for fiscal years beginning after December 15, 2018, and interim periods within fiscal years beginning after December 15, 2019. Early adoption is permitted. The Organization has not yet selected a transition method and is currently evaluating the effect that the updated standard will have on the consolidated financial statements.

In November 2016, the FASB issued ASU No. 2016-18, Statement of Cash Flows (Topic 230): Restricted Cash, a consensus of the FASB's Emerging Issues Task Force. The new standard requires that the statement of cash flows explain the change during the period in the total of cash, cash equivalents and amounts generally described as restricted cash or restricted cash equivalents. Therefore, amounts generally described as restricted cash and restricted cash equivalents should be included with cash and cash equivalents when reconciling the beginning-of-period and end-of-period total amounts shown on the statement of cash flows. A reconciliation to the amounts on the statement of financial position and disclosure of the nature of the restrictions is also required. The ASU is effective for fiscal years beginning after December 15, 2018. Early adoption is permitted. The Organization has not yet selected a transition method and is currently evaluating the effect that the updated standard will have on the consolidated financial statements.

FASB Accounting Standards Update No. 2018-08, Not-for-Profit Entities (Topic 958) – Clarifying the Scope and Accounting Guidance for Contributions Received and Contributions Made was issued in June 2018 to clarify and improve the scope and the accounting guidance for contributions received and contributions made. The amendments in this update should assist entities in (1) evaluating whether transactions should be accounted for as contributions (nonreciprocal transactions) within the scope of Topic 958, Not-for-Profit Entities, or as exchange (reciprocal) transactions subject to other guidance and (2) determining whether a contribution is conditional. The provisions of ASU 2018-08 will be effective for the Organization's fiscal year ended June 30, 2020.

Reclassifications

Certain reclassifications have been made to the 2017 consolidated financial statements to conform to the 2018 presentation, with no effect on change in net assets.

Subsequent events

The Organization has evaluated subsequent events through February 5, 2019 the date the consolidated financial statements were available to be issued.

SPECTRUM HEALTH SYSTEMS, INC. AND AFFILIATE
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Continued)

2 - RELATED PARTY TRANSACTIONS

A board member of the Organization is an employee and partial owner of a construction company contracted for the construction of the new Westborough facility. During the year ended June 30, 2017, the Organization made payments totaling \$3,861 to this company. No payments were made to this company in 2018 and no amount was owed to the company as of June 30, 2018 and 2017.

In addition, a board member of the Organization is a partner in a law firm, which provides legal services to the Organization. During the years ended June 30, 2018 and 2017, legal fees incurred to this law firm totaled \$125,808 and \$129,788, respectively. As of June 30, 2018 and 2017, \$29,806 and \$13,688, respectively, was owed to the law firm and included in accounts payable for the Organization.

The Organization is affiliated with 585 Lincoln Street Condominium Trust (the "Trust") by virtue of one of the Organization's board members being the sole trustee of the Trust. Some of the Organization's programs are the sole tenant of the Trust's property and pay all of the costs incurred in occupying that property. During the years ended June 30, 2018 and 2017, no amounts were paid or owed to the Trust.

During the year ended June 30, 2017, \$3,226 was paid to board members for reimbursable expenses. No amount was owed to board members as of June 30, 2018 and 2017.

3 - RESTRICTED CASH

Restricted cash totaling \$723,044 and \$713,392 as of June 30, 2018 and 2017, respectively, consists of a collateral deposit plus interest for the Organization's bonds payable (see Note 7), as well as proceeds from the sale of the Marston Way property, as agreed upon with the Organization's lender.

4 - PROPERTY AND EQUIPMENT

Property, plant, and equipment, together with estimated useful lives, consist of the following:

	Estimated Useful Lives	2018	2017
Land		\$ 1,664,403	\$ 1,664,403
Buildings and building improvements	28 - 40 years	21,954,776	21,641,570
Leasehold improvements	2 - 30 years	6,418,912	6,399,153
Furniture and equipment	3 - 10 years	12,069,823	11,690,747
Motor vehicles	5 - 7 years	346,287	345,207
Construction in progress		431,671	479,309
		42,885,872	42,220,389
Accumulated depreciation and amortization		18,960,766	16,577,511
		<u>\$ 23,925,106</u>	<u>\$ 25,642,878</u>

Depreciation expense for property, plant, and equipment was \$2,418,030 and \$2,265,759 in 2018 and 2017, respectively.

SPECTRUM HEALTH SYSTEMS, INC. AND AFFILIATE
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
 (Continued)

5 - CONSTRUCTION IN PROGRESS

As of June 30, 2018 and 2017, the construction in progress balance of \$431,671 and \$479,309, respectively, relates primarily to the construction of the new Healing Gardens facility. This project will cost approximately \$300,000 to complete.

6 - LINE OF CREDIT

The Organization has a \$1,000,000 demand line of credit agreement with TD Bank. Under the agreement, the creditor provides for borrowings at the Wall Street Journal Prime variable rate (5.00% and 4.25% as of June 30, 2018 and 2017, respectively). Borrowings are secured by accounts receivable. The line is also subject to the financial and non-financial covenants imposed on long-term debt with the same lender (see Note 7). The line remains in effect as long as the Organization has other obligations outstanding with TD Bank (including the long-term debt described in Note 8). There was no amount outstanding on the line of credit as of June 30, 2018 and 2017.

7 - BOND PAYABLE

On December 18, 2013, the Organization entered into a tax exempt bond agreement funded by the Massachusetts Development Finance Agency ("MDFA"). The Series 2013 revenue bonds, financed through TD Bank, the bond owner, aggregates \$8,500,000 and has a fixed interest rate of 3.68%. The bonds were issued on a draw-down basis through June 18, 2015 with monthly payments of principal and interest beginning at that time, with a maturity date of June 18, 2030. The outstanding balance on the bonds payable as of June 30, 2018 and 2017 was \$7,188,540 and \$7,517,539, respectively.

Maturities of the bonds payable are as follows for the years ended June 30:

2019	\$ 341,488
2020	353,767
2021	367,877
2022	381,840
2023	396,333
Thereafter	<u>5,347,235</u>
	7,188,540
Less: Unamortized bond issuance costs	<u>(109,683)</u>
	<u>\$ 7,078,857</u>

The Organization's performance on repaying the bonds' principal and interest is secured by an initial cash deposit to TD Bank of \$428,000. The initial deposit plus interest of \$898 and \$1,461 as of June 30, 2018 and 2017, respectively, is recorded as restricted cash on the consolidated statements of financial position. The bonds are secured by a mortgage on the property. The bonds are also subject to certain financial covenants, including a minimum debt service coverage ratio, a minimum fixed charge coverage ratio and a leverage ratio.

The Organization incurred fees and related costs in connection with the bond agreement, which are being amortized over the term of the bond and included in bonds payable on the consolidated statements of financial position. Included in debt issuance costs as of June 30, 2018 and 2017 are \$137,463 of debt issuance costs, net of accumulated amortization of \$27,780 and \$17,774 as of June 30, 2018 and 2017, respectively.

SPECTRUM HEALTH SYSTEMS, INC. AND AFFILIATE
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Continued)

8 - LONG-TERM DEBT

Long-term debt consists of the following:

	2018	2017
Term note payable to TD Bank with a fixed interest rate of 3.80% for the first five years (through April 2019), then the TD Bank internal cost of funds rate plus 175 basis points for the remainder of the note. The note is payable in monthly installments of \$2,178 through April 2024 with a balloon payment in full at that time. The note is secured by the Sanford, Maine real estate.	\$ 309,389	\$ 323,315
Less: Current maturities of long-term debt	14,472	13,926
	\$ 294,917	\$ 309,389

Maturities of long-term debt in subsequent years are as follows:

2019	\$ 14,472
2020	15,009
2021	15,628
2022	16,241
2023	16,878
Thereafter	231,161
	309,389
Less: Unamortized bond issuance costs	(5,958)
	\$ 303,431

The above term note payable and the line of credit are subject to various financial and non-financial covenants, including restrictions on maintenance of key management positions and additional indebtedness, and require the Organization to meet certain financial ratios including a minimum debt service coverage ratio, a minimum fixed charge coverage ratio and a leverage ratio.

The Organization incurred fees and related costs in connection with the note payable, which are being amortized over the term of the note and included in long term debt on the consolidated statements of financial position. Included in debt issuance costs as of June 30, 2018 and 2017 are \$7,525 of debt issuance costs, net of accumulated amortization of \$1,567 and \$1,191 as of June 30, 2018 and 2017, respectively.

9 - CAPITAL LEASE OBLIGATIONS

The Organization leases computer equipment, vehicles and furniture under capital lease obligations. The leases require both monthly and quarterly payments ranging from \$928 to \$26,323 commencing in November 2013 through January 2019. The assets and liabilities under the capital lease obligations were recorded at the fair value of the assets. The assets are amortized over their estimated useful life and had an amortized cost of \$7,752 and \$134,323 as of June 30, 2018 and 2017, respectively. As of June 30, 2018 and 2017, \$4,570 and \$125,048, respectively was outstanding under the capital lease obligations.

SPECTRUM HEALTH SYSTEMS, INC. AND AFFILIATE
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
 (Continued)

9 - CAPITAL LEASE OBLIGATIONS (Continued)

Minimum and present value of future lease payments as of June 30, 2018 under the capital lease agreements are as follows for the years ending June 30:

2019	\$ 5,301
Total minimum lease payments	5,301
Less: Amount representing interest	731
Present value of future minimum lease payments	\$ 4,570

10 - OPERATING LEASES

The Organization rents program locations, vehicles and office equipment under cancelable and noncancelable operating leases through November 2023, the expenses for which were \$1,474,906 and \$1,590,110 for the years ended June 30, 2018 and 2017, respectively.

Future minimum lease payments on noncancelable operating leases as of June 30, 2018 are as follows for the years ending June 30:

2019	\$ 1,139,349
2020	802,357
2021	654,939
2022	221,048
2023	90,687
	\$ 2,908,380

11 - TEMPORARILY RESTRICTED NET ASSETS

As of June 30, 2018 and 2017, temporarily restricted net assets totaling \$533,924 and \$505,502 were available for use in several of the Organization's programs.

The Organization met the restrictions set forth by various donors by spending the funds on the various programs operated by the Organization during the years ended June 30, 2018 and 2017 and released a total of \$7,740 and \$95,144 during those years, respectively.

12 - BENEFIT PLANS

The Organization has a 403(b) plan for highly compensated individuals to which no employer contributions are made. The Organization also has a qualified contributory 401 (k) profit sharing plan. This plan covers substantially all eligible employees meeting certain age and service requirements. Employee contributions are voluntary and are based on specific percentages of compensation. The plan also provides for contributions by the Organization in such amounts as the Board of Trustees may determine annually. Employee and employer contributions may not exceed maximum amounts established by the Internal Revenue Code. The Organization made contributions of \$176,317 and \$164,892 to the 401 (k) profit sharing plan for the years ended June 30, 2018 and 2017, respectively.

SPECTRUM HEALTH SYSTEMS, INC. AND AFFILIATE
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Continued)

12 - BENEFIT PLANS (Continued)

In addition, the Organization has a 457(b) deferred compensation plan for key individuals, which was established during the year ended June 30, 2007. Benefits are accrued by the Organization annually up to a maximum contribution of \$15,000 and \$25,000 for the years ended June 30, 2018 and 2017, respectively. The Organization's related liability of \$315,163 and \$276,794 as of June 30, 2018 and 2017, respectively, is included in other liabilities. The Organization had contributed a total of \$190,000 and \$175,000 as of June 30, 2018 and 2017, respectively, which is included in investments on the consolidated statements of financial position, plus cumulative unrealized gains of \$125,163 and \$101,794 as of June 30, 2018 and 2017, respectively.

13 - FAIR VALUE MEASUREMENTS

The Organization's financial assets that are measured at fair value on a recurring basis were recorded using the fair value hierarchy at June 30, 2018 as follows:

Description	Level 1	Level 2	Level 3	Total
Stock fund	\$ -	\$ 112,091	\$ -	\$ 112,091
International fund	-	54,509	-	54,509
Small growth fund	-	137,883	-	137,883
Retirement fund	-	10,680	-	10,680
	<u>\$ -</u>	<u>\$ 315,163</u>	<u>\$ -</u>	<u>\$ 315,163</u>

The Organization's financial assets that are measured at fair value on a recurring basis were recorded using the fair value hierarchy at June 30, 2017 as follows:

Description	Level 1	Level 2	Level 3	Total
Stock fund	\$ -	\$ 94,543	\$ -	\$ 94,543
International fund	-	44,959	-	44,959
Small growth fund	-	133,052	-	133,052
Retirement fund	-	4,240	-	4,240
	<u>\$ -</u>	<u>\$ 276,794</u>	<u>\$ -</u>	<u>\$ 276,794</u>

14 - INVESTMENT IN AFFILIATE

The Organization's investment in affiliate represents a one-twelfth membership interest in The Captive Advantage, LLC, a Delaware Limited Liability Company (the "LLC"). The LLC was founded for the principal purpose of participating in a segregated account captive insurance company in an attempt to provide human service provider organizations with significantly lower insurance costs. The LLC insures claims relating to professional liability, general liability and auto liability. The Organization deposited \$300,582 and \$290,244 with the LLC during the years ended June 30, 2018 and 2017, respectively. The Organization has a stop loss policy, which limits their maximum loss in the investment for any single claim to \$250,000. The deposits are reduced by any claims and expenses incurred to date.

SPECTRUM HEALTH SYSTEMS, INC. AND AFFILIATE
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Continued)

14 - INVESTMENT IN AFFILIATE (Continued)

The Organization has accounted for its investment under the equity method of accounting. The carrying value of the investment is recorded based on the Organization's initial investment and then adjusted for the Organization's pro-rated share of the LLC's net earnings. The carrying value of the investment totaled \$355,296 and \$368,244 as of June 30, 2018 and 2017, respectively. The carrying value is the net of the cumulative deposits made and the Organization's share of cumulative expenses incurred of \$704,529 and \$574,407 as of June 30, 2018 and 2017, respectively.

SUPPLEMENTAL SCHEDULE PURSUANT
TO UNIFORM GUIDANCE

SPECTRUM HEALTH SYSTEMS, INC. AND AFFILIATE

CONSOLIDATED SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS

YEAR ENDED JUNE 30, 2018

Federal Grantor/Pass-Through Grantor/ Program or Cluster Title	Federal CFDA Number	Pass-Through Entity Identifying Number	Passed Through to Subrecipients	Total Federal Expenditures
U.S. Department of Health and Human Services:				
Passed through the Massachusetts Department of Public Health				
Block Grants for Prevention and Treatment of Substance Abuse	93.959	INTF2301MM3160524176	N/A	\$ 10,272
		INTF2303MM3182026080	N/A	142,755
		INTF2304M03171125217	N/A	68,813
		INTF2304M03171125291	N/A	43,053
		INTF2318MM3160424036	N/A	174,615
		INTF2320MM3400421022	N/A	37,820
		INTF2324MM3200420003	N/A	22,349
		INTF2350M03184319050	N/A	8,663
		INTF2350MM3W16083020	N/A	<u>20,566</u>
				<u>528,906</u>
Passed through the Massachusetts Department of Public Health				
State Targeted Response to the Opioid Crisis Grant	93.788	INTF2330MM3W17040120	N/A	<u>461,832</u>
<i>Total Department of Health and Human Services</i>				
				<u>990,738</u>
U.S. Department of Justice:				
Passed through Massachusetts Department of Corrections				
Residential Substance Abuse Treatment for State Prisoners	16.593	1000M03SPECTRUMHSYST	N/A	<u>17,936</u>
Passed through Massachusetts Department of Corrections				
Edward Byrne Memorial Justice Assistance Grant Program	16.738	1000M03SPECTRUMHSYST	N/A	<u>103,074</u>
<i>Total Department of Justice</i>				
				<u>121,010</u>
U.S. Department of Homeland Security:				
Passed through Massachusetts Department of Corrections				
Financial Assistance for Countering Violent Extremism	97.132	1000M03SPECTRUMHSYST	N/A	<u>165,293</u>
U.S. Department of Agriculture:				
Passed through the Massachusetts Department of Education				
National School Lunch Program	10.555	SCDOE18758A70532112A	N/A	9,142
		SCDOE18758G70532112A	N/A	2,855
		SCDOE18758G70532112A	N/A	<u>4,488</u>
				<u>16,485</u>
<i>Total Expenditures of Federal Awards</i>				
				<u>\$ 1,293,526</u>

See accompanying independent auditor's report and notes to consolidated schedule.

SPECTRUM HEALTH SYSTEMS, INC. AND AFFILIATE

NOTES TO CONSOLIDATED SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS

1 - BASIS OF PRESENTATION

The accompanying Schedule of Expenditures of Federal Awards (the "Schedule") includes the federal award activity of Spectrum Health Systems, Inc. and Affiliate under programs of the federal government for the year ended June 30, 2018. The information in this Schedule is presented in accordance with the requirements of Title 2 U.S. Code of Federal Regulations Part 200, *Uniform Administrative Requirements, Cost Principles, and Audit Requirements for Federal Awards* (Uniform Guidance). Because the Schedule presents only a selected portion of the operations of Spectrum Health Systems, Inc. and Affiliate, it is not intended to and does not present the consolidated financial position, changes in net assets, or cash flows of Spectrum Health Systems, Inc and Affiliate.

For the purposes of the Schedule, federal awards include all federal financial assistance received directly or received indirectly through contracts executed with the Commonwealth of Massachusetts.

2 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of accounting

Expenditures reported on the Schedule are reported on the accrual basis of accounting. Such expenditures are recognized following the cost principles contained in the Uniform Guidance, wherein certain types of expenditures are not allowable or are limited as to reimbursement. Negative amounts shown on the Schedule represent adjustments or credits made in the normal course of business to amounts reported as expenditures in prior years.

Indirect cost rate

Spectrum Health Systems, Inc. and Affiliate have elected not to use the 10-percent de minimis indirect cost rate as allowed under the Uniform Guidance.

Major program determination

The Organization considers programs with expenditures that exceed \$750,000 to be Type A programs. Type A programs with expenditures that, in the aggregate, encompass at least twenty percent of total federal awards are designated as major programs. Smaller programs are designated as Type B programs. Type A programs assessed as "low risk" that have been audited as a major program within the last two years with no audit findings are not designated as major programs, provided the Organization has Type B programs that have federal expenditures exceeding twenty percent of total expenditures. Accordingly, certain Type B programs may be identified as major programs.

OTHER REPORTS PURSUANT
TO UNIFORM GUIDANCE

INDEPENDENT AUDITOR'S 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

To the Board of Directors
Spectrum Health Systems, Inc. and Affiliate

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 Spectrum Health Systems, Inc. and Affiliate (the "Organization") which comprise the consolidated statement of financial position as of June 30, 2018, 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 (collectively, the financial statements), and have issued our report thereon dated February 5, 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 opinions 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 consolidated 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 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*.

INDEPENDENT AUDITOR'S 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
(Continued)

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 entity'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 entity's internal control and compliance. Accordingly, this communication is not suitable for any other purpose.

Ballus Lynch, LLP

Worcester, Massachusetts
February 5, 2019

INDEPENDENT AUDITOR'S REPORT ON COMPLIANCE FOR EACH MAJOR FEDERAL PROGRAM
AND ON INTERNAL CONTROL OVER COMPLIANCE REQUIRED BY THE UNIFORM GUIDANCE

To the Board of Directors
Spectrum Health Systems, Inc. and Affiliate

Report on Compliance for Each Major Federal Program

We have audited Spectrum Health Systems, Inc. and Affiliate (the "Organization") compliance with the types of compliance requirements described in the *OMB Compliance Supplement* that could have a direct and material effect on the Organization's major federal program for the year ended June 30, 2018. The Organization's major federal program is identified in the summary of auditor's results section of the accompanying Schedule of Findings and Questioned Costs.

Management's Responsibility

Management is responsible for compliance with federal statutes, regulations, and the terms and conditions of its federal awards applicable to its federal programs.

Auditor's Responsibility

Our responsibility is to express an opinion on compliance for the Organization's major federal program based on our audit of the types of compliance requirements referred to above. We conducted our audit of compliance in accordance with auditing standards generally accepted in the United States of America; the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; and the audit requirements of Title 2 U.S. *Code of Federal Regulations* Part 200, *Uniform Administrative Requirements, Cost Principles, and Audit Requirements for Federal Awards* (Uniform Guidance). Those standards and the Uniform Guidance require that we plan and perform the audit to obtain reasonable assurance about whether noncompliance with the types of compliance requirements referred to above that could have a direct and material effect on a major federal program occurred. An audit includes examining, on a test basis, evidence about the Organization's compliance with those requirements and performing such other procedures as we considered necessary in the circumstances.

We believe that our audit provides a reasonable basis for our opinion on compliance for the major federal program. However, our audit does not provide a legal determination of the Organization's compliance.

Opinion on Each Major Federal Program

In our opinion, the Organization complied, in all material respects, with the types of compliance requirements referred to above that could have a direct and material effect on its major federal program for the year ended June 30, 2018.

Report on Internal Control Over Compliance

Management of the Organization is responsible for establishing and maintaining effective internal control over compliance with the types of compliance requirements referred to above. In planning and performing our audit of compliance, we considered the Organization's internal control over compliance with the types of requirements that could have a direct and material effect on the major federal program to determine the auditing procedures that are appropriate in the circumstances for the purpose of expressing an opinion on compliance for the major federal program and to test and report on internal control over compliance in accordance with the Uniform Guidance, but not for the purpose of expressing an opinion on the effectiveness of internal control over compliance. Accordingly, we do not express an opinion on the effectiveness of the Organization's internal control over compliance.

INDEPENDENT AUDITOR'S REPORT ON COMPLIANCE FOR EACH MAJOR FEDERAL PROGRAM
AND ON INTERNAL CONTROL OVER COMPLIANCE REQUIRED BY THE UNIFORM GUIDANCE

(Continued)

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

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

The purpose of this report on internal control over compliance is solely to describe the scope of our testing of internal control over compliance and the results of that testing based on the requirements of the Uniform Guidance. Accordingly, this report is not suitable for any other purpose.

Ballus Lynch, LLP

Worcester, Massachusetts
February 5, 2019

SPECTRUM HEALTH SYSTEMS, INC. AND AFFILIATE
CONSOLIDATED SCHEDULE OF FINDINGS AND QUESTIONED COSTS
YEAR ENDED JUNE 30, 2018

I. SUMMARY OF AUDITOR'S RESULTS

Financial Statements

Type of report the auditor issued on whether the consolidated financial statements audited were prepared in accordance with GAAP:

Unmodified

Internal control over financial reporting:

- Material weakness(es) identified? Yes X No
- Significant deficiency(ies) identified? Yes X None Reported

Noncompliance material to consolidated financial statements noted?

Yes X No

Federal Awards

Internal control over major programs:

- Material weakness(es) identified? Yes X No
- Significant deficiency(ies) identified? Yes X None Reported

Type of auditor's report issued on compliance for major federal programs:

Unmodified

Any audit findings disclosed that are required to be reported in accordance with section 2 CFR 200.516(a)?

Yes X No

Identification of major programs:

CFDA Number(s)

93.788

Name of Federal Program or Cluster

State Targeted Response to the Opioid Crisis Grant

Dollar threshold used to distinguish between type A and type B programs

\$750,000

Auditee qualified as low-risk auditee?

X Yes No

SPECTRUM HEALTH SYSTEMS, INC. AND AFFILIATE
CONSOLIDATED SCHEDULE OF FINDINGS AND QUESTIONED COSTS
YEAR ENDED JUNE 30, 2018
(Continued)

II. FINANCIAL STATEMENT FINDINGS

Reportable Conditions in Internal Control

As disclosed in Section I, the audit of the consolidated financial statements of Spectrum Health Systems, Inc. and Affiliate as of and for the year ended June 30, 2018, disclosed no matters involving the internal control over financial reporting and its operation that are considered to be material weaknesses.

Compliance Findings

As disclosed in Section I, the audit disclosed no instances of noncompliance which are material to the consolidated financial statements of Spectrum Health Systems, Inc. and Affiliate as of and for the year ended June 30, 2018.

III. FINDINGS AND QUESTIONED COSTS FOR FEDERAL AWARDS

Internal Control Over Compliance

No findings noted as of June 30, 2018.

Compliance Findings

No findings noted as of June 30, 2018.

SPECTRUM HEALTH SYSTEMS, INC. AND AFFILIATE
SUMMARY SCHEDULE OF PRIOR AUDIT FINDINGS
YEAR ENDED JUNE 30, 2018

Finding 2017.001 - Allowance for Doubtful Accounts

Management did not have procedures in place consistent with industry standard measurements of collection potential for proper valuation allowance of uncollectible accounts throughout the course of the year. As a result, management determined that the valuation allowance was inadequate and resulted in the allowance being understated by approximately \$5,800,000.

Status:

Corrective actions were taken during the year ended June 30, 2018. No further findings were noted.