

Single Audit Report
Watts Healthcare Corporation
Year ended December 31, 2012
with Report of Independent Auditors

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**Report of Independent Auditors on Internal Control over Financial Reporting
and on Compliance and Other Matters Based on an Audit of Financial
Statements Performed in Accordance with Government Auditing Standards**

**Board of Directors
Watts Healthcare Corporation**

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 Watts Healthcare Corporation, which comprise the statement of financial position as of December 31, 2012, 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 July 19, 2013.

Internal Control Over Financial Reporting

In planning and performing our audit of the financial statements, we considered Watts Healthcare Corporation'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 Watts Healthcare Corporation's internal control. Accordingly, we do not express an opinion on the effectiveness of Watts Healthcare Corporation's internal control.

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

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

Compliance and Other Matters

As part of obtaining reasonable assurance about whether Watts Healthcare Corporation'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 consolidated financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*.

We noted certain matters that we reported to management of Watts Healthcare Corporation in a separate letter dated July 19, 2013.

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.

Vargus + Company LLP

**Los Angeles, California
July 19, 2013**

**Report of Independent Auditors on Compliance with Requirements
That Could Have a Direct and Material Effect on Each Major Program and on Internal Control
Over Compliance in Accordance with OMB Circular A-133**

**To the Board of Directors of
Watts Healthcare Corporation**

Report on Compliance for Each Major Federal Program

We have audited of Watts Healthcare Corporation's compliance with the types of compliance requirements described in the *OMB Circular A-133 Compliance Supplement* that could have a direct and material effect on each of Watts Healthcare Corporation's major federal programs for the year ended December 31, 2012. Watts Healthcare Corporation's major federal programs are 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 the requirements of laws, regulations, contracts, and grants applicable to its federal programs.

Auditor's Responsibility

Our responsibility is to express an opinion on compliance for each of Watts Healthcare Corporation's major federal programs 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 OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*. Those standards and OMB Circular A-133 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 Watts Healthcare Corporation'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 each major federal program. However, our audit does not provide a legal determination of Watts Healthcare Corporation's compliance.

Opinion on Each Major Federal Program

In our opinion, Watts Healthcare Corporation complied, in all material respects, with the types of compliance requirements referred to above that could have a direct and material effect on each of its major federal programs for the year ended December 31, 2012.

Other Matters

The results of our auditing procedures disclosed an instance of noncompliance, which is required to be reported in accordance with OMB Circular A-133 and which is described in the accompanying schedule of findings and questioned costs as Finding 12-01. Our opinion on each major federal program is not modified with respect to these matters

Watts Healthcare Corporation's response to the noncompliance finding identified in our audit is described in the accompanying *schedule of findings and questioned costs*. Watts Healthcare Corporation's response was not subjected to the auditing procedures applied in the audit of compliance and, accordingly, we express no opinion on the response.

Report on Internal Control Over Compliance

Management of Watts Healthcare Corporation 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 Watts Healthcare Corporation's internal control over compliance with the types of requirements that could have a direct and material effect on each major federal program to determine the auditing procedures that are appropriate in the circumstances for the purpose of expressing an opinion on compliance for each major federal program and to test and report on internal control over compliance in accordance with OMB Circular A-133, 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 Watts Healthcare Corporation's internal control over compliance.

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 OMB Circular A-133. Accordingly, this report is not suitable for any other purpose.

Report on Schedule of Expenditures of Federal Awards Required by OMB Circular A-133

We have audited the financial statements of Watts Healthcare Corporation as of and for the year ended December 31, 2012, and have issued our report thereon dated July 19, 2013, which contained an unmodified opinion on those financial statements. Our audit was conducted for the purpose of forming an opinion on the financial statements as a whole. The accompanying schedule of expenditures of federal awards is presented for purposes of additional analysis as required by OMB Circular A-133 and is not a required part of the 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 financial statements. The information has been subjected to the auditing procedures applied in the audit of the financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the financial statements or to the financial statements themselves, and other additional procedures in accordance with auditing standards generally accepted in the United States of America. In our opinion, the schedule of expenditure of federal awards is fairly stated in all material respects in relation to the financial statements as a whole.

Vargus + Company LLP

Los Angeles, California
July 19, 2013

Watts Healthcare Corporation
Schedule of Expenditures of Federal Awards
Year ended December 31, 2012

<u>Federal Grantor / Pass Through Grantor / Program Title</u>	<u>Pass Through Grantor's Number</u>	<u>CFDA Number</u>	<u>Expenditures</u>
MAJOR PROGRAMS			
<u>Department of Agriculture</u>			
Passed-through the State of California			
Women, Infants and Children (WIC)	11-10510		
	08-85487 A01	10.557	\$ <u>3,748,314</u>
<u>Department of Health and Human Services</u>			
Passed-through the County of Los Angeles			
Block Grants for Prevention and Treatment of Substance Abuse			
Residential Drug Free	H801695		
	PH001717-1	93.959	1,425,207
Outpatient Drug Free & Staellite Housing (aka Lumpkin)	PH001510	93.959	130,298
General Program Services (GPS) & Perinatal	PH002269	93.959	479,379
Alcohol & Drug Prevention	PH001509		
	PH001509-1	93.959	<u>207,677</u>
			<u>2,242,561</u>
		Total Major Programs	<u>5,990,875</u>
NONMAJOR PROGRAMS			
<u>Department of Health and Human Services</u>			
Direct Programs:			
Community Health Centers	H80CS00850		
	H80CS00851	93.224	5,682,410
ARRA - Capital Improvement Program	C81CS14200	93.703	<u>93,168</u>
Total Cluster			5,775,578
ACA - School-Based Health Centers Capital Program	C12CS22046	93.501	95,000
Substance Abuse and Mental Health Services Administration	5H79T1019831		
	1H79T11024448	93.243	398,200
Outpatient Early Intervention Services with Respect to HIV Disease	H76HA00832	93.918	402,597
Passed-through the County of Los Angeles			
HIV Emergency Relief Project Grant			
AIDS Outpatient	H209575	93.914	118,276
HIV / AIDS Dental Health	PH002155	93.914	87,932
HIV Care Formula Grants			
HIV / AIDS Case Management	H210822	93.917	77,267
HIV / AIDS Residential Rehabilitation	H701059	93.917	113,935
HIV Prevention Activities			
HIV / AIDS Prevention Case Management	PH001056	93.940	<u>95,766</u>
		Total Nonmajor Programs	<u>7,164,551</u>
		Total Federal Programs	<u>\$ 13,155,426</u>

NOTE 1 GENERAL

The accompanying Schedule of Expenditures of Federal Awards presents the activity of all federal awards programs of Watts Healthcare Corporation (WHCC). WHCC's organization is defined in Note 1 of the WHCC's financial statements. All federal awards, including federal awards passed through intermediate governmental agencies to WHCC, is included in the accompanying schedule.

NOTE 2 BASIS OF PRESENTATION

The accompanying Schedule of Expenditures of Federal Awards is presented using the accrual basis of accounting, which is described in Note 2 of the Notes to the Financial Statements of WHCC as of and for the year ended December 31, 2012. The information in this schedule is presented in accordance with the requirements of OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*. Therefore, some amounts presented in this schedule may differ from amounts presented in, or used in the preparation of financial statements

NOTE 3 RELATIONSHIP TO FEDERAL FINANCIAL REPORTS

Amounts reported in the accompanying schedule agree with the amounts reported in the related federal financial reports taken as a whole.

Section I – Summary of Auditors’ Results

Financial Statements

Type of auditors’ report issued on the financial statements:	Unqualified
Internal control over financial reporting:	
• Material weakness(es) identified:	No
• Significant deficiency(ies) identified that are not considered to be material weaknesses?	None reported
Noncompliance material to the financial statements noted:	No

Federal Awards

Internal control over major programs:	
• Material weakness(es) identified:	No
• Significant deficiency(ies) identified that are not considered to be material weaknesses?	None reported
Type of auditors’ report issued on compliance for major programs:	Unqualified
Any audit findings disclosed that are required to be reported in accordance with Section 510(a) of OMB Circular A-133?	Yes (Finding No. 12-01)

Identification of Major Programs:

<u>CFDA Number</u>	<u>Name of Federal Program or Cluster</u>
10.577	Women, Infants and Children (WIC)
93.959	Block Grants for Prevention and Treatment of Substance Abuse

Dollar threshold used to distinguish between Type A and Type B programs:	\$ 394,663
Auditee qualified as a low-risk auditee:	Yes

Section II – Financial Statement Findings

None reported.

Section III – Federal Award Findings

Finding No. 12-01: Allowable Costs
Federal Program: CFDA 93.959 – Residential Drug Free Program #1

Criteria

Per contract agreement with the County of Los Angeles, Watts will be compensated for services provided to participants at the daily rate (either a fee-for service rate, or provisional rate for each resident day or portion thereof). Resident day is defined as twenty four hour (24) period during which a specified licensed bed is assigned to and occupied by a registered participant. Program participants are to be involved in no less than six hours of planned treatment and recovery activities per day under the supervision of trained staff.

Condition

During our review of the program participants' (patients) files and invoices billed to the grantor, we noted that 8 of the 25 patients' files lack documentation showing that the patients were involved in at least 6 hours of planned treatment and recovery activities per day. Majority of the days that the patients did not participate in the 6 hours of daily activities were on weekends. The current activity sheet does not have a section to document the outside activities.

Questioned costs
\$8,071

Possible Asserted Cause and Effect

Patients were given weekend passes as they progress in the program. Weekday passes were also given for patients who need to go to court, receive health services, attend school, go to work, etc. However, these were not documented in the patients' files. Due to lack of adequate documentation of patient activities to support services billed to the grantor, corresponding expenses may be considered unallowable costs.

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Recommendation

We recommend that Watts strengthen controls to ensure that patients' files show they are involved in no less than six hours of planned treatment and recovery activities per day. If patient participates in less than 6 hours of activities, the reason should be valid and properly documented in the patient files.

View of Responsible Officials and Planned Corrective Action

This issue has been resolved by creating a Daily Activity Form which will be used to record clients' activities on and off premises. The form was developed to document individual client's daily activities covering a whole month's period whether receiving direct services on site or out on passes. At the end of each period, the form will be signed by the assigned staff and approved by the appropriate supervisor/manager. The form is user friendly and was implemented May 15, 2013 in response to the finding.

**Watts Healthcare Corporation
Status of Prior Year's Audit Report Findings
Year ended December 31, 2012**

There were no findings noted during the year ended December 31, 2011.

Audited Financial Statements
Watts Healthcare Corporation
Year ended December 31, 2012 and 2011
With Report of Independent Auditors

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Report of Independent Auditors

The Honorable Members of the Board of Directors Watts Healthcare Corporation

We have audited the accompanying financial statements of Watts Healthcare Corporation, a California nonprofit corporation, which comprise the statement of financial position as of December 31, 2012 and 2011, and the related statements of activities and cash flows for the years then ended, and the related notes to the financial statements.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these 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 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 financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the 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 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 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 financial statements referred to above present fairly, in all material respects, the financial position of Watts Healthcare Corporation as of December 31, 2012 and 2011, and the changes in its net assets and its cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

Report on Supplementary Information

Our audit was conducted for the purpose of forming an opinion on the financial statements as a whole. The schedule of functional expenses is presented for purposes of additional analysis and is not a required part of the 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 financial statements. The information has been subjected to the auditing procedures applied in the audit of the financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the financial statements or to the 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 financial statements as a whole.

Other Reporting Required by Government Auditing Standards

In accordance with *Government Auditing Standards*, we have also issued our report dated July 19, 2013 on our consideration of Watts Healthcare Corporation's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering Watts Healthcare Corporation's internal control over financial reporting and compliance.

Virquy + Company LLP

**Los Angeles, California
July 19, 2013**

Watts Healthcare Corporation
Statements of Financial Position

ASSETS	December 31	
	2012	2011
Current assets		
Cash and cash equivalents	\$ 2,015,040	\$ 1,342,140
Patients receivable, net of allowance for doubtful accounts of \$1,059,504 in 2012 and \$5,313,992 in 2011	6,315,633	6,183,919
Grants and contracts receivable, net of allowance for doubtful accounts of \$226,426 in 2012 and \$94,142 in 2011	1,911,778	1,998,790
Prepaid expenses and other current assets	77,473	48,889
Total current assets	10,319,924	9,573,738
Noncurrent assets		
Property and equipment, net	9,541,430	9,294,450
Restricted cash	222,840	211,518
Other assets	55,471	45,541
Total assets	\$ 20,139,665	\$ 19,125,247
LIABILITIES AND NET ASSETS		
Current liabilities		
Accounts payable	\$ 748,738	\$ 396,480
Accrued expenses	554,695	696,006
Accrued salaries	604,597	416,077
Accrued vacation and sick leave	1,520,917	1,571,238
Claims payable	268,492	340,957
Contract advances	54,635	269,949
Total current liabilities	3,752,074	3,690,707
Noncurrent liabilities		
Notes payable	5,318,548	5,318,548
Total liabilities	9,070,622	9,009,255
Net assets		
Unrestricted	9,069,043	8,115,992
Unrestricted - board-designated	2,000,000	2,000,000
Total net assets	11,069,043	10,115,992
Total liabilities and net assets	\$ 20,139,665	\$ 19,125,247

See notes to financial statements.

Watts Healthcare Corporation
Statements of Activities

	Year ended December 31	
	2012	2011
Revenues and other support		
Patient service revenue (net of contractual allowances) \$	21,530,229	\$ 16,867,863
Provision for bad debts	(2,711,403)	(611,822)
Net patient service revenue	18,818,826	16,256,041
Grants and contracts	13,151,858	14,480,940
Other revenues	950,332	904,683
Total revenues and other support	32,921,016	31,641,664
Expenses		
Program services		
Primary care	12,058,680	11,492,532
Specialty care	5,134,722	4,811,194
Ancillary care	2,598,116	1,957,571
Clinical support	4,543,322	4,536,927
Substance abuse	2,441,946	2,551,821
WIC program	3,922,608	4,561,487
Other programs	1,165,044	1,064,618
Total program services	31,864,439	30,976,150
Supporting services		
Fundraising	103,526	54,625
Total expenses	31,967,965	31,030,775
Change in net assets	953,051	610,889
Net assets - unrestricted		
Beginning of year	10,115,992	9,505,103
End of year	\$ 11,069,043	\$ 10,115,992

See notes to financial statements.

Watts Healthcare Corporation
Statements of Cash Flows

	Year ended December 31	
	2012	2011
Cash flows from operating activities		
Change in net assets	\$ 953,051	\$ 610,889
Adjustments to reconcile change in net assets to net cash provided by (used in) operating activities		
Depreciation and amortization	512,362	341,946
(Increase) decrease in assets:		
Patients receivable, net	(131,714)	(2,791,492)
Grants and contracts receivable, net	87,012	(117,379)
Prepaid expenses and other assets	(38,514)	134,390
Increase (decrease) in liabilities:		
Accounts payable	352,258	(87,486)
Accrued expenses	(141,311)	(504,403)
Accrued salaries	188,520	39,287
Accrued vacation and sick leave	(50,321)	72,327
Claims payable	(72,465)	(178,984)
Contract advances	(215,314)	(389,986)
Net cash provided by (used in) operating activities	1,443,564	(2,870,891)
Cash flows from investing activities		
Acquisition of property and equipment	(759,342)	(885,940)
Net cash used in investing activities	(759,342)	(885,940)
Cash flows from financing activities		
Increase in restricted cash	(11,322)	(10,718)
Net cash used in financing activities	(11,322)	(10,718)
Change in cash and cash equivalents	672,900	(3,767,549)
Cash and cash equivalents at beginning of year	1,342,140	5,109,689
Cash and cash equivalents at end of year	\$ 2,015,040	\$ 1,342,140
Supplemental disclosure of cashflow information		
Interest paid during the year	\$ 337,980	\$ 334,464

See notes to financial statements.

NOTE 1 ORGANIZATION

Watts Healthcare Corporation (WHCC) is a non-profit corporation supported by federal, state and local grants, private foundation grants, and revenues from operations. Organizational activities consist of providing high quality clinical, preventive, behavioral and restorative services to the low-income population of South Central Los Angeles. WHCC operates three (3) primary health care facilities, two (2) located in the Watts district and one in the Crenshaw district of the City of Los Angeles. WHCC provides service delivery sites for substance abuse treatment, HIV, and women, infant and children (WIC) nutrition at six (6) additional locations throughout South Los Angeles County. The Board of Directors governs all of the operations and programs of WHCC through the management team led by the Chief Executive Officer. The underlying philosophy and objective of the organization is to provide high quality comprehensive health services to the communities it serves, regardless of the patient's ability to pay.

During the years ended December 31, 2012 and 2011, WHCC received the following mix of revenues from grantors, patients and third-party payors:

	2012	2011
Patient fees (primarily Medi-Cal and Medicare)	42%	36%
Managed care contracts	15%	15%
Grants and other contracts	40%	46%
Other revenues	3%	3%
	100%	100%

NOTE 2 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Accounting

WHCC prepares its financial statements on the accrual basis of accounting. WHCC classifies revenue, gains, expenses, and losses into three net asset categories according to the existence or absence of donor-imposed restrictions. Accordingly, net assets of WHCC and changes therein are classified and reported as follows:

- Unrestricted net assets - Net assets that are not subject to donor-imposed stipulations.
- Unrestricted – Board-designated net assets – Unrestricted net assets set aside by the Board of Directors for future financial and property and equipment improvement programs.
- Temporarily restricted net assets - Net assets subject to donor-imposed stipulations that may or will be met by either actions of WHCC and/or the passage of time.
- Permanently restricted net assets - Net assets subject to donor-imposed stipulations that must be maintained in perpetuity. Generally, the donors of these assets permit WHCC to use all or part of the income earned on the related investments for general or specific purposes.

NOTE 2 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

Cash and Cash Equivalents

For purposes of the statements of cash flows, cash and cash equivalents have been defined as deposits and highly liquid investments with maturity of 90 days or less at the date of purchase.

Patient Accounts Receivable

Accounts receivable are reduced by an allowance for doubtful accounts. In evaluating the collectibility of accounts receivable, the Organization analyzes its past history and identifies trends for each of its major payer sources of revenue to estimate the appropriate allowance for doubtful accounts and provision for uncollectible accounts. Management regularly reviews data about these major payer sources of revenue in evaluating the sufficiency of the allowance for doubtful accounts.

For receivables associated with services provided to patients who have third-party coverage, the Organization analyzes contractually due amounts and provides an allowance for doubtful accounts and a provision for uncollectible accounts, if necessary (for example, for expected uncollectible deductibles and copayments on accounts for which the third-party payer has not yet paid, or for payers who are known to be having financial difficulties that make the realization of amounts due unlikely). For receivables associated with self-pay patients (which includes both patients without insurance and patients with deductible and copayment balances due for which third-party coverage exists for part of the bill), the Organization records a provision for uncollectible accounts in the period of services on the basis of its past experience. The difference between the standard rates (or the discounted rates if negotiated or provided by the sliding fee or other policy) and the amounts actually collected after all reasonable collection efforts have been exhausted is charged off against the allowance for doubtful accounts.

The Organization's allowance for doubtful accounts for self-pay patients did not significantly change from the previous year.

Property and Equipment

Property and equipment are recorded at cost if purchased or, if contributed, at fair value at date of contribution. WHCC capitalizes all expenditures for property and equipment in excess of \$2,000; the fair value of contributed property, plant, and equipment is similarly capitalized.

Provision for depreciation of property and equipment is calculated using the straight-line method over the estimated useful lives of the assets, which range from 3 to 10 years. The American Hospital Association Estimated Useful Lives of Depreciable Hospital Assets is used as the guidelines for determining useful lives of assets.

NOTE 2 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

Property acquired with certain federal funds is considered to be owned by WHCC while used in the program for which it was purchased or in other future authorized programs. The disposition as well as the ownership of any proceeds therefrom, is subject to federal regulations.

WHCC reviews property and equipment for impairment whenever events or changes in circumstances indicate that the carrying value of the property and equipment may not be recoverable. Recoverability is measured by a comparison of the carrying amount of the asset to future net cash flows, undiscounted and without interest, expected to be generated by the asset. If such asset is considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the asset exceeds the fair value of the asset. During 2012, there were no events or changes in circumstances indicating that the carrying amount of the property and equipment may not be recoverable.

Accrued Vacation and Sick Leave

WHCC employees may accumulate vacation during their employment with the corporation and redeem unused vacation time in cash upon termination of employment subject to certain limitations. The estimated amounts of accrued vacation pay and sick leave at December 31, 2012 and 2011 are as follows:

	2012	2011
Accrued sick leave	\$ 631,536	\$ 642,193
Accrued vacation leave	889,381	929,045
Total \$	1,520,917	1,571,238

Leases

Leases, which in substance transfer all the benefits and risks equivalent to ownership of the property, are classified as capital leases. The related assets and liabilities are recorded, at amounts equal to the lesser of the present value of the minimum lease payments or the fair value of the leased property, at the beginning of the respective lease terms. Generally, such assets are amortized over their economic lives. All other leases are classified as operating leases and related rentals are charged to expense as incurred.

Revenue Recognition

Net patient service revenue

The Organization has agreements with third-party payers that provide for payments to the Organization at amounts different from its established rates. Net patient service revenue is reported at the estimated net realizable amounts from patients, third-party payers and others for services rendered and includes estimated retroactive adjustments. Retroactive adjustments are considered in recognition of revenue on an estimated basis in the period the related services are rendered and such estimated amounts are revised in future periods as adjustments become known.

NOTE 2 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

Revenue Recognition (Continued)

Grants and Contracts

WHCC recognizes revenues from federal grants and state contracts when eligible costs are incurred for cost-reimbursement grants and when the contracted services are performed for performance based grants. Revenue is recognized to the extent of expenditures incurred not to exceed grant and contract awards for cost-reimbursement grants. When grants and contracts budget periods do not coincide with WHCC's reporting period, revenues are recognized on a pro-rata basis.

Contributions

WHCC reports gifts of cash and other assets as restricted contributions if they are received with donor stipulations limiting the use of the donated assets and if the restrictions are not met in the period of receipt. When a donor restriction expires, that is, when a stipulated time restriction ends or a purpose restriction is accomplished, temporarily restricted net assets are reclassified to unrestricted net assets. If a stipulated time restriction ends or a purpose restriction is accomplished during the year the donation is received, the donation is recognized as unrestricted revenue.

Functional Expenses Allocation

The costs of providing programs and other activities have been summarized on a functional basis in the Statement of Activities. Accordingly, certain costs have been allocated among the programs and supporting services benefited.

Fair Value Measurements

Fair value is defined as the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants at the measurement date. WHCC reports its assets and liabilities that are measured at fair value using a three-level fair value hierarchy that prioritizes the inputs used to measure fair value. This hierarchy maximizes the use of observable inputs and minimizes the use of unobservable inputs. The three levels of inputs used to measure fair value are as follows:

- Level 1 Quoted prices in active markets for identical assets or liabilities.
- Level 2 Observable inputs other than quoted prices included in Level 1, such as quoted prices for similar assets and liabilities in active markets; quoted prices for identical or similar assets and liabilities in markets that are not active; or other inputs that are observable or can be corroborated by observable market data.
- Level 3 Unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities. This includes certain pricing models, discounted cash flow methodologies and similar techniques that use significant unobservable inputs.

NOTE 2 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

Fair Value Measurements (Continued)

An asset's or liability's level within the fair value hierarchy is based on the lowest level of any input that is significant to the fair value measurement. At each reporting period, we perform a detailed analysis of our assets and liabilities that are measured at fair value. All assets and liabilities for which the fair value measurement is based on significant unobservable inputs or instruments which trade infrequently and therefore have little or no price transparency are classified as Level 3.

WHCC's financial assets and liabilities include primarily cash and cash equivalents, patients receivable, grants and contracts receivable, and accounts payable and accrued liabilities. Because of the short-term nature of the cash, receivables, accounts payable and accrued liabilities, the carrying amounts of these assets and liabilities approximate their fair value.

Concentrations of Credit Risk

Financial instruments that potentially subject WHCC to concentrations of credit risk consist principally of receivables and cash accounts in financial institutions. Effective December 31, 2010 until January 1, 2013, all noninterest-bearing transaction accounts are fully insured without limit by the Federal Deposit Insurance Corporation (FDIC). As of December 31, 2012, WHCC's bank deposits were not exposed to the custodial credit risk.

Use of Estimates

The preparation of 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 and disclosure 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 these estimates.

Non-Profit Status

WHCC (tax identification number 75-3046480) is a tax-exempt organization under Internal Revenue Code Section 501(c) (3) and California Revenue and Taxation Code Section 23701(d). Accordingly, no provision has been made for income taxes.

Uncertainty in Income Taxes

WHCC recognizes the effect of income tax positions only if those positions are more likely than not of being sustained. WHCC does not believe its financial statements as of and for the years ended December 31, 2012 and 2011 include any uncertain tax positions.

The Organization's income tax returns remain subject to examination for all tax years ended on or after December 31, 2008 with regard to all tax positions and results reported.

NOTE 3 CASH AND CASH EQUIVALENTS

Cash and cash equivalents balance at December 31, 2012 and 2011 consist of the following:

	2012	2011
Cash on hand	\$ 1,350	\$ 1,850
Operating accounts	2,013,690	281,056
Money market accounts	-	1,059,234
	\$ 2,015,040	\$ 1,342,140

NOTE 4 PATIENT ACCOUNTS RECEIVABLE AND REVENUE

As at December 31, patient accounts receivable consists of the following:

	2012	2011
Medi-Cal/Managed care	\$ 15,440,585	\$ 15,615,504
FQHC reconciliation/PPS cost report settlement/rate differential	2,235,915	5,623,180
Clinic fees	9,225,175	14,642,852
Gross patient accounts receivable	26,901,675	35,881,536
Less allowance for contractual accounts	(19,526,538)	(24,383,625)
Patient accounts receivable, net of contractual allowances	7,375,137	11,497,911
Less allowance for uncollectible accounts	(1,059,504)	(5,313,992)
Net \$	6,315,633	\$ 6,183,919

Patient revenue is recorded at WHCC's established rates. Contractual adjustments and deductions from patient revenue represent the difference between charges for the services provided calculated based on established rates and anticipated reimbursement for such services.

NOTE 5 PROPERTY AND EQUIPMENT

As at December 31, property and equipment consists of the following:

	2012	2011
Land	\$ 5,386,653	\$ 5,386,653
Building and improvements	2,974,035	2,896,535
Leasehold improvements	31,626	31,626
Furniture and equipment	1,410,187	1,035,823
Transportation equipment	183,967	182,827
Computer systems	1,509,508	1,203,170
Total	11,495,976	10,736,634
Less accumulated depreciation	1,954,546	1,442,184
	Net \$ 9,541,430	\$ 9,294,450

For the years ended December 31, 2012 and 2011, provision for depreciation expense amounted to \$512,362 and \$341,946, respectively. The land and building and improvements were used as collateral to secure two promissory notes (see Note 6).

NOTE 6 NOTES PAYABLE

On August 20, 2007, WHCC made an agreement with NCBDC CDE 22, LLC (NCBDC), a Delaware limited liability company, for two notes in the amounts of \$3,969,668 (Note A) and \$1,348,880 (Note B), which totaled \$5,318,548 with a fixed per annum interest rate of 6%. WHCC is required to open an interest reserve bank account under the name of WHCC for the debt service fund. As of December 31, 2012 and 2011, the balance in the interest reserve bank account amounted to \$222,840 and \$211,518, respectively. The interest reserve bank account is reported as restricted cash in the Statement of Financial Position.

The maturity dates of Note A and Note B are August 20, 2014 and August 20, 2037, respectively. The notes are interest only until August 20, 2014. Interest is payable in quarterly installments on the first day of each subsequent quarter. The entire outstanding Note A principal amount is due on August 20, 2014. As for Note B, during the period commencing on August 20, 2014 and ending on the Note B maturity date, interest and principal shall be payable in successive quarterly installments until the entire outstanding Note B principal amount is paid on August 20, 2037. These loans are collateralized by WHCC's land and building and improvements.

NOTE 6 NOTES PAYABLE (CONTINUED)

The scheduled principal repayments on the notes payable are as follows:

Year	Amount
2013	\$ -
2014	3,984,330
2015	58,647
2016	58,647
2017	58,647
Thereafter	1,158,277
	\$ 5,318,548

NOTE 7 UNRESTRICTED BOARD-DESIGNATED NET ASSETS

In December 2010, the Board of Directors set aside \$1,000,000 to fund future debt refinancing plan and another \$1,000,000 for major property and equipment purchase and maintenance expenditures.

NOTE 8 LINE OF CREDIT

On August 17, 2012, WHCC entered into a revolving line of credit with Citibank, N.A. in the amount of \$1,500,000 with a variable interest rate term. The interest rate is subject to change from time to time based on changes in an independent index which is the greater of its prime rate or minimum interest rate set by the bank. At December 31, 2012, WHCC had no outstanding loan balance from the line of credit. This line of credit is renewable every year.

NOTE 9 RETIREMENT PLAN

WHCC contributes 5%-8% of eligible employees' gross salaries to an approved defined contribution plan. After one year of employment, eligible employees who have worked 1,000 hours are enrolled and are 20% vested for their first year of participation. Thereafter they are 20% vested for each subsequent year until they are 100% vested at the fifth year of participation. WHCC's contributions amounted to \$738,410 and \$731,014 for 2012 and 2011, respectively.

NOTE 10 COMMITMENTS AND CONTINGENCIES

Operating Leases

WHCC occupies certain facilities under both month-to-month and long-term lease agreements expiring through April 2015. Future minimum rental payments under these non-cancelable lease terms in excess of one year at December 31, 2012 are as follows:

Year ending December 31,		
2013	\$	140,712
2014		140,712
2015		73,901
Total future minimum lease payments		355,326

Total rent expense amounted to \$572,261 and \$564,492 for the years ended December 31, 2012 and 2011, respectively, under such operating leases.

Federal and State Grants

Continuing program funding from federal and state sources is contingent upon availability of funds and project performance. The funds are awarded on a yearly basis upon receipt and approval of program applications. In addition, expenses made under federal and state grants are subject to review and audit by the grantor agencies.

Medicare/Medi-Cal Cost Report

WHCC elected to participate in the FQHC Medicare/Medi-Cal reimbursement program administered by the California Department of Health Care Services (DHCS), formerly California Department of Health Services. Under the reimbursement program, WHCC is reimbursed on a per-visit basis. WHCC filed the cost reports for the year ended December 31, 2004 to establish the prospective payment reimbursement rate (PPS). On April 2, 2009, DHCS completed its review of the WHCC's cost reports under the authority of Section 14170 of the Welfare and Institutions Code, and determined the PPS rates as follow:

Effective Dates*	Sites		
	WHC	CCHC	MJSB
4/1/03 - 9/30/05	\$ 210.26	\$ 246.20	\$ 187.72
10/1/05 - 9/30/06	216.78	253.83	193.54
10/1/06 - 9/30/07	222.85	260.94	198.96
10/1/07 - 9/30/08	227.53	266.42	203.14
10/1/08 - forward	231.62	271.21	206.79

*The PPS rates reflect the Medicare Economic Index increases of 3.1%, 2.8%, 2.1%, and 1.8% effective October 1 of 2005, 2006, 2007, and 2008, respectively.

NOTE 10 COMMITMENTS AND CONTINGENCIES (CONTINUED)

Medicare/Medi-Cal Cost Report (Continued)

Prior to the completion of the review of the cost reports, the WHCC was reimbursed at interim reimbursement rates of \$100.57, \$205.13, and \$220.27, as of April 1, 2003, June 1, 2004, and August 1, 2006, respectively.

WHCC started receiving the new PPS rates in June 2009, and will be retroactively paid for patient visits beginning April 1, 2003 through December 31, 2008. WHCC submitted the rate settlement on August 31, 2009 amounting to \$753,475.

In June 2009, WHCC filed an appeal disputing some of the findings contained in the audit report of the DHCS. In February 2010, a decision was made on the appeal by the Administrative Appeals of DHCS effectively increasing the PPS rate. WHCC estimated that the approved PPS rate would be higher by at least \$14.05 per visit since 2003 and recorded an estimated receivable from this decision of \$1,924,194, net of allowance for possible error in calculation.

In August 2010, WHCC received a notice of tentative settlement from DHCS based on the audited Medi-Cal PPS and paid 60% of the amount in October 2010. The settled PPS rate showed a much higher rate of \$27.48 per visit since 2003 resulting to additional revenue of about \$4 million in 2010 calculated at 60% settlement rate.

In July 2012 and April 2013, DHCS issued final determination letters for the years 2003 through 2010 resulting to additional revenue of \$5 million.

The audited and current PPS rates are as follows:

Effective Dates	Sites		
	WHC	CCHC	MJSB
4/1/03 - 9/30/05	\$ 253.44	\$ 205.33	\$ 156.42
10/1/05 - 9/30/06	268.61	211.70	161.27
10/1/06 - 9/30/07	274.25	222.19	165.78
10/1/07 - 9/30/08	279.19	226.19	169.27
10/1/08 - 9/30/09	283.66	228.81	172.31
10/1/09 - 9/30/10	285.19	229.81	175.07
10/1/10 - 9/30/11	287.06	231.68	177.17
10/1/11 - 9/30/12	288.21	232.61	177.88
10/1/12 - 9/30/13	289.94	234.62	179.00

NOTE 11 MANAGED CARE CONTRACTS

Payment agreements have been established with certain commercial insurance carriers, health maintenance organizations, and preferred provider organizations. Premiums are due monthly (calculated on a prospectively determined capitated rate) and are recognized as revenue during the period in which WHCC is obligated to provide services to its members.

NOTE 11 MANAGED CARE CONTRACTS (CONTINUED)

Operating expenses incurred in the provision of health services are accrued in the period in which services are provided to patients based in part on estimates, including accrual for medical services provided but not yet reported to WHCC. Incurred but not reported (IBNR) costs are costs associated with health care services incurred during a financial reporting period but not reported to the health care organization until after the financial reporting date. WHCC's estimated IBNR claims are determined based on claim lag studies that track and measure date of service against date of payment. The claim lag reports are also adjusted to reflect the current month because these reports are mathematically sensitive to prior history. Estimated IBNR of \$268 thousand and \$341 thousand are presented as claims payable as of December 31, 2012 and 2011, respectively.

NOTE 12 SUBSEQUENT EVENTS

WHCC has evaluated events subsequent to December 31, 2012 to assess the need for potential recognition or disclosure in the financial statements. Such events were evaluated through July 19, 2013, the date the financial statements were available to be issued. Based upon this evaluation, it was determined that no subsequent events occurred that require recognition or additional disclosure in the financial statements.

Watts Healthcare Corporation
Schedule of Functional Expenses
Year ended December 31, 2012
(With Comparative Totals for 2011)

	2012												2011	
	Program Services							Total	Support Services				Total Expenses	Total Expenses
	Primary Care Services	Specialty Services	Ancillary Services	Clinical Support Services	Substance Abuse Programs	WIC Program Services	Other Programs		General and Administrative Services	Elimination	Fund Raising	Total		
Salaries and wages	\$ 6,741,767	\$ 1,704,635	\$ 1,535,659	\$ 1,667,660	\$ 1,149,462	\$ 2,068,522	\$ 647,014	\$ 15,514,720	\$ 2,241,798	\$ (2,241,798)	\$ -	\$ -	\$ 15,514,720	\$ 15,486,614
Fringe benefits	2,532,519	652,738	586,871	674,355	473,987	804,246	243,831	5,968,547	837,211	(837,211)	-	-	5,968,547	5,746,116
Total salaries & fringe benefits	9,274,286	2,357,373	2,122,530	2,342,016	1,623,450	2,872,768	890,846	21,483,267	3,079,009	(3,079,009)	-	-	21,483,267	21,232,730
Other operating expenses:														
Healthcare claims	-	1,059,881	-	-	-	-	-	1,059,881	-	-	-	-	1,059,881	1,015,793
Consulting & contracted services	616,725	740,055	219,565	364,661	92,421	70,685	76,451	2,180,563	469,988	(469,988)	103,526	103,526	2,284,089	2,051,700
Supplies	1,566,517	476,752	95,353	135,611	246,400	20,770	53,595	2,594,997	238,690	(238,690)	-	-	2,594,997	2,350,755
Space costs	198,297	10,342	1,437	863,728	187,734	608,805	3,884	1,874,227	16,531	(16,531)	3,884	-	1,874,227	1,871,254
Equipment rentals & leases	93,396	79,865	48,025	70,986	24,147	57,091	7,349	380,860	66,658	(66,658)	-	-	380,860	319,648
Insurance	10,951	105,592	-	71,363	24,687	3,687	6,486	222,767	87,312	(87,312)	-	-	222,767	226,727
Dues & subscriptions	63,674	56,851	14,684	49,472	20,511	15,724	6,675	227,591	147,709	(147,709)	-	-	227,591	201,781
Recruitment	-	-	-	-	-	-	63,246	63,246	62,820	(62,820)	-	-	63,246	61,711
Telephone	36,638	8,470	3,334	134,210	19,114	76,484	3,410	281,660	23,402	(23,402)	-	-	281,660	341,337
Travel, conferences & training	102,155	20,451	31,487	56,587	22,384	70,078	24,103	327,244	176,879	(176,879)	-	-	327,244	368,750
Interest expense	-	-	25	234,749	103,206	-	-	337,980	9,498	(9,498)	-	-	337,980	334,464
Printing, postage & public.	18,453	17,707	13,478	28,257	10,106	24,943	3,391	116,334	45,459	(45,459)	-	-	116,334	127,210
Data processing	33,855	57,924	6,341	94,494	2,349	5,546	897	201,405	77,431	(77,431)	-	-	201,405	183,641
Bad debt	55	-	-	-	-	-	-	55	-	-	-	-	55	125
Other operating expenses before depreciation:	2,740,715	2,633,890	433,728	2,104,117	753,059	953,813	249,488	9,868,810	1,422,377	(1,422,377)	103,526	103,526	9,972,336	9,454,896
Depreciation	43,679	143,459	41,859	97,190	65,437	96,027	24,711	512,362	228,657	(228,657)	-	-	512,362	343,149
Total expenses	\$ 12,058,680	\$ 5,134,722	\$ 2,598,116	\$ 4,543,322	\$ 2,441,946	\$ 3,922,608	\$ 1,165,044	\$ 31,864,439	\$ 4,730,043	\$ (4,730,043)	\$ 103,526	\$ 103,526	\$ 31,967,965	\$ 31,030,775

Watts Healthcare Corporation
Schedule of Functional Expenses
Year ended December 31, 2011
(With Comparative Totals for 2010)

	2011								2010					
	Program Services							Total	Support Services			Total Expenses	Total Expenses	
	Primary Care Services	Specialty Services	Ancillary Services	Clinical Support Services	Substance Abuse Programs	WIC Program Services	Other Programs		General and Administrative Services	Elimination	Fund-raising			
Salaries and wages	\$ 6,655,557	\$ 1,698,220	\$ 1,201,726	\$ 1,617,298	\$ 1,245,329	\$ 2,481,628	\$ 586,856	\$ 15,486,614	\$ 2,200,325	\$ (2,200,325)	\$ -	\$ -	\$ 15,486,614	\$ 14,746,369
Fringe benefits	2,449,490	623,486	437,888	586,652	464,328	965,456	218,816	5,746,116	810,807	(810,807)	-	-	5,746,116	5,232,846
Total salaries & fringe benefits	9,105,047	2,321,706	1,639,614	2,203,950	1,709,657	3,447,084	805,672	21,232,730	3,011,132	(3,011,132)	-	-	21,232,730	19,979,215
Other operating expenses:														
Healthcare claims	-	1,015,493	-	300	-	-	-	1,015,793	-	-	-	-	1,015,793	1,326,863
Consulting & contracted services	605,526	643,022	148,594	344,683	78,902	88,701	87,647	1,997,075	443,864	(443,864)	54,625	54,625	2,051,700	1,996,989
Supplies	1,316,696	473,079	75,832	141,486	270,164	15,662	57,834	2,350,753	227,374	(227,374)	-	-	2,350,753	2,055,652
Space costs	198,923	9,673	1,090	866,842	177,103	614,328	3,295	1,871,254	9,618	(9,618)	-	-	1,871,254	1,739,957
Equipment rentals & leases	45,423	76,876	24,930	76,691	21,814	46,788	28,329	320,851	74,998	(74,998)	-	-	320,851	275,709
Insurance	5,261	107,722	-	73,510	26,902	3,363	9,970	226,728	85,549	(85,549)	-	-	226,728	207,995
Dues & subscriptions	18,097	23,151	8,524	62,949	54,438	18,973	15,651	201,783	137,745	(137,745)	-	-	201,783	149,596
Recruitment	-	-	-	61,711	-	-	-	61,711	61,371	(61,371)	-	-	61,711	69,791
Telephone	40,370	9,411	2,797	163,140	23,668	96,978	4,973	341,337	20,908	(20,908)	-	-	341,337	251,892
Travel, conferences & training	91,302	18,826	17,895	37,549	40,854	140,755	21,569	368,750	172,037	(172,037)	-	-	368,750	296,023
Interest expense	142	-	-	233,847	100,475	-	-	334,464	1,575	(1,575)	-	-	334,464	431,295
Printing, postage & public	41,659	14,718	7,848	24,512	5,326	23,640	9,506	127,209	34,756	(34,756)	-	-	127,209	97,531
Data processing	4,554	1,401	711	173,433	133	1,566	1,843	183,641	74,354	(74,354)	-	-	183,641	181,591
Bad debt	125	-	-	-	-	-	-	125	-	-	-	-	125	462
General & administrative	-	-	-	-	-	-	-	-	(8,192)	8,192	-	-	-	-
Other operating expenses before depreciation:	2,368,078	2,393,372	288,221	2,260,653	799,779	1,050,754	240,617	9,401,474	1,335,957	(1,335,957)	54,625	54,625	9,456,099	9,081,346
Depreciation	19,407	96,116	29,736	72,324	42,385	63,649	18,329	341,946	94,099	(94,099)	-	-	341,946	232,839
Total expenses	\$ 11,492,532	\$ 4,811,194	\$ 1,957,571	\$ 4,536,927	\$ 2,551,821	\$ 4,561,487	\$ 1,064,618	\$ 30,976,150	\$ 4,441,188	\$ (4,441,188)	\$ 54,625	\$ 54,625	\$ 31,030,775	\$ 29,293,400

**Report of Independent Auditors on Internal Control over Financial Reporting
and on Compliance and Other Matters Based on an Audit of Financial Statements
Performed in Accordance with Government Auditing Standards**

**Board of Directors
Watts Healthcare Corporation**

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 Watts Healthcare Corporation, which comprise the statement of financial position as of December 31, 2012, 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 July 19, 2013.

Internal Control Over Financial Reporting

In planning and performing our audit of the financial statements, we considered Watts Healthcare Corporation'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 Watts Healthcare Corporation's internal control. Accordingly, we do not express an opinion on the effectiveness of Watts Healthcare Corporation's internal control.

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

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

Compliance and Other Matters

As part of obtaining reasonable assurance about whether Watts Healthcare Corporation'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 consolidated financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*.

We noted certain matters that we reported to management of Watts Healthcare Corporation in a separate letter dated July 19, 2013.

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.

Vargus + Company LLP

**Los Angeles, California
July 19, 2013**

Letter of Comments to Management
Watts Healthcare Corporation
Year ended December 31, 2012

**To the Board of Directors
Watts Healthcare Corporation
Los Angeles, California**

In planning and performing our audit of the financial statements of Watts Healthcare Corporation (WHCC) as of and for the year ended December 31, 2012, in accordance with auditing standards generally accepted in the United States of America, we considered WHCC's internal control over financial reporting (internal control) as a basis for designing our auditing procedures for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of WHCC's internal control. Accordingly, we do not express an opinion on the effectiveness of WHCC's internal control.

Our consideration of internal control was for the limited purpose described in the preceding paragraph and was not designed to identify all deficiencies in internal control that might be material weakness or significant deficiencies and, therefore, material weaknesses or significant deficiencies may exist that were not identified.

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 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. We did not identify any deficiencies in internal control that we consider to be significant deficiencies or immaterial weaknesses.

During our audit, we became aware of a certain matter that we believe represents an opportunity for the Organization to further improve its accounting practices. This matter does not represent a significant deficiency, material weakness in internal control, or material instance of noncompliance.

We have previously discussed our observation and recommendation with the appropriate members of WHCC's management. The management's response to the observation identified herein has not been subjected to our audit procedures, and, accordingly, we express no opinion to it.

This communication is intended solely for the information and use of the board of directors, audit committee, management, the Department of Health and Human Services, State of California Department of Health Services, County of Los Angeles Department of Human Services, and others within the entity, and is not intended to be and should not be used by anyone other than these specified parties.

Vasquez + Company LLP

**Los Angeles, California
July 19, 2013**

Watts Healthcare Corporation
Observations and Recommendations
Year ended December 31, 2012

1. Generate Journal Entry from eClinical Works Billing System

Observation

During our audit, we noticed that WHCC generates the journal entry to record the monthly patient service revenue transactions and receivable balances based on the calculations from the patient service revenue analysis worksheets. We believe these transactions can be generated from the recently implemented eClinical Works billing system. This billing system was purchased principally to automate WHCC reporting of these transactions.

Recommendation:

We suggest that WHCC maximize the use of the new billing system by processing the reports it needs to record the patient service revenue transactions and receivable balances. If errors are noted, these should be promptly addressed to make this information system reliable and useful. If implemented, the Billing Manager will have more time to improve the billing process and collection rate.

Management Response

Effective July 1, 2013, WHCC adopted its Electronic Health Records (EHR) eClinical Works financial reporting for booking to the general ledger gross revenue, contractual adjustment and accounts receivable. The EHR system was implemented in July 2011 and with a history of more than 24 months WHCC Billing Manager has obtained sufficient analytical knowledge to agree that information generated by eClinical Works Financial Reporting module is accurate.

The Account Aging Summary displays WHCC accounts receivables as a snapshot in time (based on when the report is run) by comparing the beginning and ending accounts receivable for the specified period. The report shows what the beginning Accounts Receivable was to start the reporting period, and what the calculated ending Accounts Receivable is, based on the financial transactions that were posted that month. This is used as the basis for booking the monthly patient revenue accruals.

No manual calculations are performed on the report to produce an Accounts Receivable. Accounts Receivables are formulated automatically posting gross charges reduced by payments and calculated established contractual adjustments at claim Level or contractual adjustments at CPT Level based on payer types (i.e. Medi-Cal/Managed Care charges are contractually adjusted at the claim level as it is a PPS/wrap-around all-inclusive billing as opposed to Family Pact which is a fee-for-service line item payer; hence its account receivables are calculated at the CPT level).

Effective July 2013 WHCC will post activity from the Account Aging Summary which will support the general ledger posting accurately and timely.

