Hawaii Health Systems Corporation

Consolidated Financial Statements for the Years Ended June 30, 2003 and 2002, Supplemental Information for the Year Ended June 30, 2003 and Independent Auditors' Reports

HAWAII HEALTH SYSTEMS CORPORATION

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HAWAII HEALTH SYSTEMS CORPORATION

INTRODUCTION

PURPOSE OF THE REPORT

The purpose of this report is to present the consolidated financial statements of Hawaii Health Systems Corporation (HHSC) as of and for the years ended June 30, 2003 and 2002 and the independent auditors' reports thereon.

SCOPE OF THE AUDIT

The audit was required to be performed in accordance with auditing standards generally accepted in the United States of America and *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that the auditors plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the consolidated financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall consolidated financial statement presentation.

ORGANIZATION OF THE REPORT

This report on the consolidated financial statements is divided into three sections:

- The first section presents this introduction.
- The second section presents the consolidated financial statements of HHSC as of and for the years ended June 30, 2003 and 2002 and the independent auditors' report thereon. This section also presents management's discussion and analysis and supplemental financial information.
- The third section presents the independent auditors' report in accordance with *Government Auditing Standards* on HHSC's internal control and compliance with laws and regulations.

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INDEPENDENT AUDITORS' REPORT

Board of Directors of Hawaii Health Systems Corporation:

We have audited the accompanying consolidated statements of net assets of Hawaii Health Systems Corporation (HHSC), a component unit of the State of Hawaii, as of June 30, 2003 and 2002, and the related consolidated statements of revenues, expenses, and changes in net assets and of cash flows for the years then ended. These financial statements are the responsibility of HHSC's management. Our responsibility is to express an opinion on these consolidated 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 of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, such consolidated financial statements present fairly, in all material respects, the financial position of HHSC at June 30, 2003 and 2002 and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

As discussed in Note 1, in fiscal year 1997, the administration of the facilities that comprise HHSC was transferred from the State Department of Health – Division of Community Hospitals (State) to HHSC. As of June 30, 2003, negotiations between the State and HHSC relating to the transfer of assets and liabilities (including amounts due to the State) still had not been finalized. Accordingly, the assets, liabilities and net assets reflected in the accompanying consolidated statements of net assets at June 30, 2003 and 2002 may be significantly different from those eventually included in the final settlement.

The management's discussion and analysis information on pages 4 through 11 is not a required part of the basic financial statements but is supplementary information required by the Governmental Accounting Standards Board. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it.

Our audit was conducted for the purpose of forming an opinion on the basic financial statements taken as a whole. The supplemental schedule on pages 29 and 30 is presented for the purpose of additional analysis and is not a required part of the basic financial statements. The supplemental combining and consolidating schedules on pages 31 through 33 are presented for the purpose of additional analysis of the basic financial statements rather than to present the financial position and results of operations of individual facilities, and are not a required part of the basic financial statements. This supplemental information and the supplemental combining and consolidating schedules are the responsibility of HHSC's management. Such information has been subjected to the auditing procedures applied in our audit of the basic financial statements and, in our opinion, is fairly stated in all material respects when considered in relation to the basic financial statements taken as a whole.

In accordance with *Government Auditing Standards*, we have also issued a report dated November 14, 2003 on our consideration of HHSC's internal control over financial reporting and our tests of its compliance with certain provisions of laws, regulations, contracts and grants. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be read in conjunction with this report in considering the results of our audit.

Deloitte & Touche LLP

November 14, 2003

Overview of the Financial Statements

This discussion and analysis are intended to serve as an introduction to Hawaii Health Systems Corporation's (HHSC's) basic financial statements. In accordance with Statement No. 34 of the Governmental Accounting Standards Board, *Basic Financial Statements – and Management's Discussion and Analysis – for State and Local Governments* (GASB No. 34), a government entity's basic financial statements comprise three components: 1) government-wide financial statements, 2) fund financial statements, and 3) notes to the financial statements.

Government-wide financial statements are designed to provide readers with a broad overview of a government entity's finances, in a manner similar to a private-sector business. The Statement of Net Assets presents information on all of a government entity's assets and liabilities, with the differences between the two reported as net assets. The Statement of Revenues, Expenses, and Changes in Net Assets presents information showing how the government entity's net assets changed during the most recent fiscal year. The Statement of Net Assets and the Statement of Revenues, Expenses, and Changes in Net Assets are prepared using the economic resources measurement focus and the accrual basis of accounting.

Fund financial statements are used to ensure and demonstrate compliance with finance-related legal requirements. A fund is a grouping of related accounts that is used to maintain control over resources that have been segregated for specific activities or objectives. All funds of a government entity can be divided into three categories: governmental funds, proprietary funds, and fiduciary funds. HHSC's funds are categorized as proprietary funds. Proprietary fund reporting focuses on the determination of operating income, changes in net assets, financial position, and cash flows. Proprietary fund financial statements are similar to that of the government-wide financial statements in that they are also prepared using the economic resources measurement focus and the accrual basis of accounting.

Under the provisions of GASB No. 34, HHSC is considered to be a Special Purpose government entity. And, as a Special Purpose government entity engaged only in business-type activities, the only financial statements required to be presented are those for proprietary funds. Accordingly, HHSC's basic financial statements consist of a Consolidated Statement of Net Assets, a Consolidated Statement of Revenues, Expenses, and Changes in Net Assets, a Consolidated Statement of Cash Flows, and Notes to Consolidated Financial Statements.

Financial Analysis

Consolidated Statements of Net Assets

Summarized financial information of HHSC's Consolidated Statements of Net Assets as of June 30, 2003 and 2002 is as follows:

ASSETS	2003	2002
Current assets	$ 74,377,026	$ 67,312,163
Capital assets - net	186,775,282	176,168,634
Other assets	3,284,853	921,797
Total assets	$264,437,161	$244,402,594
LIABILITIES		
Current liabilities	$ 88,000,939	$ 68,915,916
Accrued vacation - less current portion	20,884,868	18,273,984
Capital lease obligations - less current portion	24,367,818	17,049,951
Long-term debt - less current portion	12,594,445	11,423,465
Due to the State of Hawaii	20,122,507	20,122,507
Other liabilities	763,491	914,765
Total liabilities	166,734,068	136,700,588
NET ASSETS		
Invested in capital assets - net of related debt	141,502,484	140,464,914
Unrestricted	(45,929,897)	(33,244,379)
Restricted	2,130,506	481,471
Total net assets	97,703,093	107,702,006
Total liabilities and net assets	$264,437,161	$244,402,594

At June 30, 2003 and 2002, HHSC's capital assets, net of accumulated depreciation, comprised approximately 71% and 72%, respectively, of its total assets. These assets consist mainly of land, hospital buildings and equipment that are used in HHSC's operations. The fiscal year 2003 increase of approximately $10.6 million is due to capital asset additions of approximately $26.2 million, offset by depreciation expense of approximately $15.5 million. The primary reason for the increase is due to the acquisition of medical equipment and energy saving equipment of $14.4 million funded through HHSC's municipal leasing lines of credit and State-funded capital improvement projects of $6.2 million. The State-funded capital improvement projects consisted primarily of life-safety code improvements at HHSC's critical access hospitals (Kauai Veterans Memorial Hospital, Kohala Hospital, Lanai Community Hospital, and Ka'u Hospital) and a nurse call system installation and electrical upgrades at Maui Memorial Medical Center. The fiscal year 2002 increase of approximately $7.7 million is due to capital asset additions of approximately $21.6 million, offset by depreciation expense of approximately $13.8 million. The primary reason for the increase is the acquisition of medical equipment (primarily the MRI, monitors, and imaging equipment for Maui Memorial Medical Center) and application systems (primarily the Lawson Human Resources application and Laser Arc data storage). The vast majority of these purchases were financed through HHSC's municipal leasing lines of credit (see further explanation below). A summary of HHSC's capital assets as of June 30, 2003 and 2002 is as follows:

	2003	2002
Land and land improvements	$ 5,083,354	$ 4,809,354
Buildings and improvements	205,427,870	193,742,748
Equipment	110,505,091	105,435,204
Construction in progress	22,835,068	14,986,281
	343,851,383	318,973,587
Less accumulated depreciation and amortization	(157,076,101)	(142,804,953)
Capital assets - net	$ 186,775,282	$ 176,168,634

At June 30, 2003, HHSC's current assets approximated 28% of total assets. Current assets increased by approximately $7.1 million from the fiscal year 2002 balance due to the increases in cash and cash equivalents of approximately $8.3 million and in supplies and other current assets of approximately $1.2 million, offset by a decrease in net patient accounts receivable of approximately $2.4 million. The increase in cash and cash equivalents is primarily due to the need to repay $5 million out of operating funds at the end of fiscal year 2002 to the State of Hawaii for an advance given to HHSC to fund its operating deficit for fiscal year 2002. The other reason for the increase in cash and cash equivalents is the increase in cash collections for fiscal year 2003 as compared to the prior year. HHSC collected $277 million in fiscal year 2003 as compared to $247 million in fiscal year 2002 due to an increase in patient services as a result of HHSC's investment in imaging equipment at its three major acute facilities.

At June 30, 2002, HHSC's current assets approximated 28% of total assets. Current assets decreased by approximately $1.2 million from the fiscal year 2001 balance due to three primary factors: increase in net patient accounts receivable of approximately $9 million, decrease in prepaid pension costs of approximately $6.2 million, and decrease in cash and cash equivalents of approximately $4.9 million. The increase in net patient accounts receivable represents an increase of 21% from fiscal year 2001, primarily due to an increase in net patient service revenues of $25.3 million (see further explanation below), offset by an increase of $12.1 million in cash collections. The decrease in prepaid pension costs is due to the amortization of the pension costs into salaries and benefits expense, resulting from HHSC's overpayment into the Employees' Retirement System of the State of Hawaii (ERS) in fiscal year 2000. The decrease in cash and cash equivalents is primarily due to reduced cash flow, as the demands to meet payroll, municipal lease and loan payments, and accounts payable were far greater than the amount of cash collected.

At June 30, 2003, HHSC's other noncurrent assets increased approximately $2.4 million from fiscal year 2002. The primary reasons for the increase are the restricted contribution of $1.5 million received from the Harry & Jeanette Weinberg Foundation to fund the Hawaii Prescription Care Association program, and an increase of approximately $709,000 in HHSC's investment in the Clinical Laboratories of Hawaii LLP joint venture.

At June 30, 2003 and 2002, HHSC's current liabilities approximated 53% and 50%, respectively, of total liabilities. The fiscal year 2003 increase in current liabilities is primarily due to the $14 million advance from the State of Hawaii (see explanation under general fund appropriations below) which is to be repaid in fiscal year 2004. Increases in accounts payable and accrued expenses over fiscal years 2002 and 2001 were caused by a general delay in paying creditors, caused by operating cash flow shortages, resulting in an increase of approximately $4.7 million and $7.3 million as of June 30, 2003 and 2002, respectively. Increases in the current portion of the capital lease obligation over fiscal years 2002 and 2001 of approximately $896,000 and $3.8 million, respectively, are due to the increase in the financing of the majority of HHSC's equipment purchases through municipal leasing lines (see further explanation below).

At June 30, 2003 and 2002, HHSC's total capital lease obligation balance increased approximately $8.2 million and $11.6 million from fiscal years 2002 and 2001, respectively. The primary reason for the increases is the acquisition of fixed equipment, medical equipment, and application systems (see explanation under capital assets above). HHSC has municipal leasing lines of credit with Academic Capital Group, Inc. and Salem Capital Group, which allow HHSC to finance equipment purchases at interest rates below market rates.

At June 30, 2003, HHSC's long-term debt balances represented notes and term loans payable on land, building, and medical equipment previously owned by Hilo Residency Training Program of approximately $11.4 million and a mortgage note payable relating to the acquisition of the nursing cottages on the Maui Memorial Medical Center campus with a remaining balance of approximately $1.6 million. At June 30, 2002, HHSC's long-term debt balances represented notes and term loans payable on land, building, and medical equipment previously owned by Hilo Residency Training Program of approximately $11.6 million and a term loan payable relating to the financing of the balance owing under HHSC's guarantee of an $800,000 loan made by a local bank to West Kauai Community Development Corporation of $375,000.

At June 30, 2003 and 2002, the portion of HHSC's net assets that is reflected as its investment in capital assets, net of related debt, of approximately $142 million and $140 million, respectively, is larger than the total net assets of approximately $98 million and $108 million, respectively. This means that HHSC's net operations since inception have resulted in losses of over $46 million and $33 million, respectively.

Consolidated Statements of Revenues, Expenses, and Changes in Net Assets

Summarized financial information of HHSC's Consolidated Statements of Revenues, Expenses, and Changes in Net Assets for the years ended June 30, 2003 and 2002 is as follows:

	2003	2002
Operating expenses:		
Salaries and benefits	$ 190,429,748	$ 170,747,415
Purchased services and professional fees	39,153,782	34,237,579
Supplies and drugs	45,110,748	42,657,736
Provision for doubtful accounts	16,736,879	12,265,438
Depreciation and amortization	15,493,133	13,835,128
Other	26,518,413	23,900,147
Total operating expenses	333,442,703	297,643,443
Operating revenues	288,410,439	267,296,489
Loss from operations	(45,032,264)	(30,346,954)
Nonoperating revenues:		
General appropriations from State of Hawaii	13,300,000	7,000,000
Collective bargaining pay raise appropriation from State of Hawaii	12,394,468	6,213,838
Restricted contributions	2,447,524	947,032
Other nonoperating revenues - net	662,957	1,381,247
Nonoperating revenues - net	28,804,949	15,542,117
Loss before capital contributions	(16,227,315)	(14,804,837)
Capital assets contributed by State of Hawaii	6,228,402	2,287,258
Decrease in net assets	$ (9,998,913)	$ (12,517,579)

For the years ended June 30, 2003 and 2002, HHSC's operating expenses exceeded its operating revenues by approximately $45 million and $30.3 million, respectively. The collective bargaining pay raise appropriation from the State of Hawaii of approximately $12.4 million and $6.2 million, general fund appropriations from the State of Hawaii of $13.3 million and $7 million, other nonoperating revenues of approximately $3.1 million and $2.3 million, and capital assets contributed by the State of Hawaii of approximately $6.2 million and $2.3 million reduced the decrease in net assets to approximately $10 million and $12.5 million, respectively.

Operating expenses in fiscal year 2003 were approximately 12% higher than fiscal year 2002. The increase was mainly in the categories of salaries and benefits expense, purchased services and professional fees, and the provision for doubtful accounts. Salaries and benefits expense increased 12% from fiscal year 2002, due primarily to an increase in the fringe benefit rate charged to all State agencies from 21.19% to 32.22%. The increase in the fringe benefit rate was due primarily to an increase in the required contribution to the Employee Retirement System (ERS) from 0% to 8.87%. The impact of the fringe benefit increases for the ERS, Retiree Health Insurance, and Employee Health Fund was an additional $14 million in salaries and benefits expense to HHSC in fiscal year 2003. Further, HHSC's union employees received pay raises from the unions' collective bargaining agreements with the State of Hawaii, ranging from 2-5%. These pay raises represented an additional $6.2 million in salaries and benefits expense over fiscal year 2002. Purchased services and professional fees increased 14.4% from fiscal year 2002, primarily due to increased use of registry nurses and clinical laboratory services at Maui Memorial Medical Center, driven by larger than expected patient volume throughout the year. Provision for doubtful accounts increased by approximately $4.5 million from fiscal year 2002, primarily due to an increase of $5.4 million in provision for doubtful accounts at Maui Memorial Medical Center. While the facility's business office was fairly successful in keeping up with billing and collecting the fiscal year 2003 patient accounts, it was unable to maintain its collection efforts on fiscal year 2002 and older patient accounts. As a result, the facility's accounts receivable aging deteriorated substantially in fiscal year 2003. The facility's accounts receivable aged current to 60 days past due decreased 13% from June 30, 2002 to June 30, 2003; while the accounts receivable aged 151 days and older increased 12% from June 30, 2002 to June 30, 2003. Therefore, a substantially higher provision for doubtful accounts was necessary to account for the diminished likelihood of collection on the older patient accounts receivable.

Operating expenses in fiscal year 2002 were approximately 11.4% higher than fiscal year 2001. The increase was primarily in the categories of salaries and supplies and drugs. Salaries and benefits expense increased approximately 20% from fiscal year 2001, due primarily to an increase in full-time equivalent employees (FTEs). The increase in FTEs was primarily due to added personnel for imaging departments at Hilo Medical Center, Maui Memorial Medical Center, and Kona Community Hospital, accounting for approximately 47 FTEs, as well as the conversion of nurses who were previously on contract to full-time employees, accounting for approximately 78 FTEs. In addition, HHSC's union employees received pay raises ranging from 2% to 4% from the unions' collective bargaining agreements with the State of Hawaii. Further, HHSC amortized approximately $6.2 million in prepaid pension costs into salaries and benefits expense during fiscal year 2002, as the amount overpaid by HHSC in fiscal year 2000 was used for the fiscal year 2002 contribution to the ERS. Supplies and drugs expense in fiscal year 2002 increased approximately 19% from fiscal year 2001, primarily due to an increase in patient volume and an average 17% increase in the price of prescription drugs.

Operating revenue in fiscal year 2003 increased by approximately 7.9%, as a result of a 1.3% increase in patient days, a 5% rate increase effective July 1, 2002, and continued revenue enhancements as a result of HHSC's imaging initiatives that began in fiscal year 2002. The increase in revenues primarily came in the areas of major surgery, emergency room, imaging (including MRI, diagnostic radiology services, and CT Scan), clinical laboratory testing, and drugs sold to patients. The primary increase in operating revenues occurred at Maui Memorial Medical Center, primarily due to a 5.3% increase in emergency room visits, a 4.7% increase in newborn patient days, and a 2.3% increase in acute patient days.

The 2002 increase in net patient service revenues was driven by a 6% increase in patient days and a 5% increase in outpatient visits, driven by initiatives such as the purchases of imaging equipment at Hilo Medical Center, Maui Memorial Medical Center, and Kona Community Hospital, as well as the increase in the clinic revenues at Kauai Veterans Memorial Hospital. The increase in patient days is reflected in increases in the long-term care occupancy percentage, from 92% in fiscal year 2001 to 97% in fiscal year 2002, and the acute care occupancy percentage, from 66% in fiscal year 2001 to 70% in fiscal year 2002.

For the year ended June 30, 2003, General Fund Appropriations from the State of Hawaii is comprised of $14 million approved for HHSC's operating purposes by the 2002 Legislature, which was reduced by $700,000 due to a budget restriction imposed by the Governor of the State of Hawaii. During fiscal year 2003, HHSC communicated to the State Department of Budget and Finance and the Governor of the State of Hawaii that due to unanticipated increases in the amounts assessed to HHSC for employee retirement system contributions and other health benefit costs, the level of general fund appropriations HHSC was to receive for fiscal year 2003 would be insufficient to support its operations. The Governor agreed to loan HHSC $14 million, with the understanding that HHSC would seek an emergency appropriation from the 2003 Legislature to repay the loan. The 2003 Legislature did not support HHSC's emergency appropriation request; accordingly, the balance of the $14 million loan from the Governor is reflected as "Advance from the State of Hawaii" on the Statement of Net Assets.

The significant excess of operating expenses over operating revenues in both fiscal years 2003 and 2002, as well as the cumulative net losses, is due to several factors. First, HHSC's payor mix is made up of predominantly government-type payors. For fiscal years 2003 and 2002, 56% and 58%, respectively, of HHSC's total gross revenues were from government-type payors (approximately 21% and 23% from Medicare and approximately 19% and 26% from Medicaid and Med-Quest). In fact, Medicare, Medicaid, and Med-Quest account for over 88% and 80% of HHSC's revenues for its long-term care facilities in 2003 and 2002, respectively. Reimbursements from government-type payors has not kept up with the increasing costs of health care providers since the Balanced Budget Act of 1997 was passed, which dramatically reduced the level of reimbursements from government-type payors.

Second, HHSC's facilities on the neighbor islands suffer from an insufficient supply of long-term care beds. As noted above, HHSC's beds in its long-term care facilities are virtually fully occupied and there are very few other freestanding long-term care facilities on the neighbor islands. As a result, HHSC's acute care facilities, especially Hilo Medical Center and Maui Memorial Medical Center, have numerous patients initially admitted as acute patients, but who continue to occupy acute care beds while awaiting long-term care beds to become available. Such patients are called "wait-list" patients. HHSC receives little to no reimbursement from insurers for such patients, as insurers will not reimburse providers for patients whose required level of care does not coincide with the type of bed the patient is occupying. Hilo Medical Center and Maui Memorial Medical Center both have an average census of approximately 20-40 wait-list patients per day in fiscal year 2003 and 30-50 wait-list patients per day in fiscal year 2002. Management expects the wait-list problem to worsen as Hawaii's population continues to age and the State of Hawaii lags behind on a credible plan to address the long-term care crisis.

Third, HHSC is bound by the collective bargaining agreements negotiated by the State of Hawaii and the public employee unions (Hawaii Government Employees Association and United Public Workers). The collective bargaining agreements not only bind HHSC to the negotiated pay raises, but also to the union work regulations and benefit packages. Management believes that such arrangements do not allow HHSC to manage its resources as effectively as other health-care systems.

Fourth, HHSC inherited aging facilities upon the formation of the Corporation in 1996. These aging facilities require substantial improvements and maintenance before they can be brought up to par with other health care facilities in the State of Hawaii. While the State of Hawaii has provided annual funding for capital improvement projects, that funding has been primarily used to correct life-safety code concerns. Funding for medical equipment, application systems, and routine repair and maintenance is funded from HHSC's operational cash flow. Given HHSC's payor mix and cost burdens, HHSC's operational cash flows are inadequate to fully fund the capital acquisitions that are necessary to keep up with the advances in health care technology that allow hospitals to improve the quality of care for their patients.

Finally, HHSC serves as the "safety-net" provider of health care in the State of Hawaii. HHSC is the sole source of health care for several isolated neighbor island communities (e.g., Ka'u, Kohala, Lanai, etc.). Further, Maui Memorial Medical Center is the primary acute care facility on the island of Maui, and Hilo Medical Center and Kona Community Hospital are the only acute care facilities with more than 50 acute beds on the island of Hawaii. In addition, Leahi Hospital functions as the primary tuberculosis hospital for the State of Hawaii. Also, HHSC's long-term care facilities provide the primary source of long-term care services for elderly people who cannot afford private care or nursing homes and do not have family that can care for them. Given all of the above, management believes that HHSC has a vital role in ensuring that the people of the State of Hawaii have access to quality health care.

Further, management believes that there are two Medicaid reimbursement issues that will have a significant negative impact on the financial performance of HHSC: the implementation of Act 294 and the lack of Medicaid Disproportionate Share Hospital (DSH) provider reimbursements in the State of Hawaii. Act 294 was passed by the State Legislature in 1998, and requires that no later than June 30, 2003, there be no distinction in reimbursement rates between hospital-based and non-hospital based long-term care facilities under the Medicaid program. Prior to the passage of Act 294, hospital-based long-term care facilities received a higher reimbursement than freestanding long-term care facilities under the Medicaid program, primarily due to the recognition that hospital-based long-term care facilities are subject to the compliance with EMTALA (Emergency Medical Treatment and Labor Act) requirements, which requires hospitals to accept all patients who come through an emergency room, regardless of the patient's ability to pay. Freestanding long-term care facilities are not subject to EMTALA requirements. Compliance with EMTALA requirements imposes additional costs on hospital-based long-term care facilities, primarily in staffing requirements and in bad debt expense. Six HHSC facilities would be negatively impacted by the implementation of Act 294, while one facility (Maluhia Hospital) would be positively impacted. Understanding the dramatic impact that implementation of Act 294 would have on HHSC, the Department of Human Services has authorized a phased implementation of Act 294 over six years. However, management estimates that even with a phased implementation, the cost to HHSC will be approximately $38 million over the six-year phase-in period. Once Act 294 is fully implemented, management estimates that the cost to HHSC will be approximately $13 million per year. Management believes that such large annual costs will simply serve to increase the amount of general fund appropriations that HHSC will be seeking from the State of Hawaii each year as the amount of cost reductions and revenue enhancements that can be reasonably explored will not be enough to absorb such costs.

When the State of Hawaii implemented the Med-QUEST (QUEST) program in 1994, the federal funds provided to the State of Hawaii for Medicaid DSH payments to hospitals were eliminated. DSH payments are additional reimbursements that attempt to reflect additional costs incurred by providers who serve a significantly disproportionate number of low-income patients and/or significant number of Medicaid patients. HHSC's patient mix is such that it would have qualified for Medicaid DSH payments had the State of Hawaii not eliminated such payments. Such additional reimbursements would have reduced the amount of State subsidies needed to finance the operations of HHSC. Management estimates that if the State of Hawaii had maintained Medicaid DSH payments, HHSC would be receiving approximately $7 million more in reimbursements than it currently does. To illustrate the importance of Medicaid DSH payments to public hospital systems, the National Association of Public Hospitals' report on "America's Safety Net Hospitals and Health Systems, 2001" states that in 2001, "Medicaid DSH once again proved to be a critical funding source, financing 25 percent of unreimbursed costs." The 2003 Legislature passed a resolution requesting the State Department of Human Services to work with Hawaii's congressional delegation to aggressively advocate for the restoration of DSH payments from the Centers for Medicare and Medicaid Services to compensate Hawaii hospitals for care provided to the uninsured.

HAWAII HEALTH SYSTEMS CORPORATION

CONSOLIDATED STATEMENTS OF NET ASSETS
JUNE 30, 2003 AND 2002

ASSETS	2003	2002
CURRENT ASSETS:		
Cash and cash equivalents:		
On deposit with the State of Hawaii	$ 8,158,638	$ 514,684
On deposit with banks and on hand (Note 3)	7,112,264	6,454,896
Patient accounts receivable - less allowances of $108,887,907 and $95,553,804 for contractual adjustments and doubtful accounts	50,479,290	52,914,430
Supplies and other current assets	8,626,834	7,428,153
Total current assets	74,377,026	67,312,163
CAPITAL ASSETS - Net (Notes 4, 6 and 7)	186,775,282	176,168,634
ASSETS LIMITED AS TO USE	2,517,281	862,830
OTHER ASSETS (Note 11)	767,572	58,967
TOTAL	$264,437,161	$244,402,594

(Continued)

HAWAII HEALTH SYSTEMS CORPORATION

CONSOLIDATED STATEMENTS OF NET ASSETS (Continued)
JUNE 30, 2003 AND 2002

LIABILITIES AND NET ASSETS	2003	2002
CURRENT LIABILITIES:		
Accounts payable and accrued expenses (Note 11)	$ 44,160,581	$ 39,436,774
Accrued workers' compensation liability (Note 10)	18,500,000	18,500,000
Advance from the State of Hawaii (Note 5)	14,000,000	
Current portion of capital lease obligations (Note 6)	7,933,202	7,036,881
Estimated third-party payor settlements	1,565,986	1,978,549
Current portion of accrued vacation (Note 6)	840,270	719,154
Current portion of long-term debt (Note 7)	377,333	568,423
Other current liabilities	623,567	676,135
Total current liabilities	88,000,939	68,915,916
CAPITAL LEASE OBLIGATIONS - Less current portion (Note 6)	24,367,818	17,049,951
LONG-TERM DEBT - Less current portion (Note 7)	12,594,445	11,423,465
ACCRUED VACATION - Less current portion (Note 6)	20,884,868	18,273,984
DUE TO THE STATE OF HAWAII	20,122,507	20,122,507
PATIENTS' SAFEKEEPING DEPOSITS	386,775	381,359
OTHER LIABILITIES	376,716	533,406
Total liabilities	166,734,068	136,700,588
NET ASSETS:		
Invested in capital assets - net of related debt	141,502,484	140,464,914
Unrestricted (Note 3)	(45,929,897)	(33,244,379)
Restricted	2,130,506	481,471
Total net assets	97,703,093	107,702,006
TOTAL	$264,437,161	$244,402,594

See notes to consolidated financial statements.

HAWAII HEALTH SYSTEMS CORPORATION

CONSOLIDATED STATEMENTS OF REVENUES, EXPENSES, AND CHANGES IN NET ASSETS
YEARS ENDED JUNE 30, 2003 AND 2002

	2003	2002
OPERATING REVENUES:		
Net patient service revenues (Note 8)	$283,900,663	$263,466,300
Other operating revenues (Notes 8 and 11)	4,509,776	3,830,189
Total operating revenues	288,410,439	267,296,489
OPERATING EXPENSES:		
Salaries and benefits (Notes 8 and 9)	190,429,748	170,747,415
Medical supplies and drugs	32,525,872	31,628,897
Professional fees (Notes 8 and 11)	20,459,213	16,912,677
Purchased services (Notes 8 and 11)	18,694,569	17,324,902
Provision for doubtful accounts	16,736,879	12,265,438
Depreciation and amortization	15,493,133	13,835,128
Other supplies	12,584,876	11,028,839
Utilities	7,302,695	7,168,591
Repairs and maintenance	5,453,900	5,122,963
Rent and lease	3,505,118	2,874,317
Insurance	3,328,280	1,909,978
Interest (net of capitalized interest) (Note 6)	2,373,961	1,910,873
Other	4,554,459	4,913,425
Total operating expenses	333,442,703	297,643,443
LOSS FROM OPERATIONS	(45,032,264)	(30,346,954)
NONOPERATING REVENUES:		
General appropriations from State of Hawaii	13,300,000	7,000,000
Collective bargaining pay raise appropriation from State of Hawaii	12,394,468	6,213,838
Restricted contributions	2,447,524	947,032
Interest and dividend income	221,292	235,836
Other nonoperating revenues - net	441,665	1,145,411
Nonoperating revenues - net	28,804,949	15,542,117
LOSS BEFORE CAPITAL CONTRIBUTIONS	(16,227,315)	(14,804,837)
CAPITAL ASSETS CONTRIBUTED BY STATE OF HAWAII (Note 4)	6,228,402	2,287,258
DECREASE IN NET ASSETS	(9,998,913)	(12,517,579)
NET ASSETS, BEGINNING OF YEAR	107,702,006	120,219,585
NET ASSETS, END OF YEAR	$ 97,703,093	$107,702,006

See notes to consolidated financial statements.

HAWAII HEALTH SYSTEMS CORPORATION

CONSOLIDATED STATEMENTS OF CASH FLOWS
YEARS ENDED JUNE 30, 2003 AND 2002

	2003	2002
OPERATING ACTIVITIES:		
Payments from government, insurance and patients	$ 269,186,361	$ 240,123,598
Payments to employees	(185,974,391)	(163,340,414)
Payments to suppliers and others	(109,274,264)	(92,848,049)
Other receipts - net	3,400,979	3,453,886
Net cash used in operating activities	(22,661,315)	(12,610,979)
NONCAPITAL FINANCING ACTIVITIES:		
Appropriations from State of Hawaii	25,694,468	13,213,838
Advances from the State of Hawaii	14,000,000	
Other nonoperating revenues - net	371,234	757,421
Net cash provided by noncapital financing activities	40,065,702	13,971,259
CAPITAL AND RELATED FINANCING ACTIVITIES:		
Repayments on capital lease obligations	(6,288,048)	(3,879,484)
Capital expenditures	(2,106,622)	(1,900,616)
Payments on long-term debt	(711,010)	(523,176)
Proceeds from sale of capital assets	2,615	227
Net cash used in capital and related financing activities	(9,103,065)	(6,303,049)
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	8,301,322	(4,942,769)
CASH AND CASH EQUIVALENTS, BEGINNING OF YEAR	6,969,580	11,912,349
CASH AND CASH EQUIVALENTS, END OF YEAR	$ 15,270,902	$ 6,969,580

HAWAII HEALTH SYSTEMS CORPORATION

CONSOLIDATED STATEMENTS OF CASH FLOWS (Continued)
YEARS ENDED JUNE 30, 2003 AND 2002

	2003	2002
RECONCILIATION OF LOSS FROM OPERATIONS TO NET CASH USED IN OPERATING ACTIVITIES:		
Loss from operations	$ (45,032,264)	$ (30,346,954)
Adjustments to reconcile loss from operations to net cash used in operating activities:		
Provision for doubtful accounts	16,736,879	12,265,438
Depreciation and amortization	15,493,133	13,835,128
Amounts released from restrictions	798,489	1,413,001
Amortization of prepaid pension costs		6,206,461
Change in operating assets and liabilities:		
Receivables	(14,301,739)	(21,276,875)
Supplies and other assets	(1,907,286)	(1,620,328)
Accounts payable, accrued expenses, and other liabilities	3,232,036	6,687,948
Accrued workers' compensation liability		1,516,063
Estimated third-party payor settlements	(412,563)	(2,065,827)
Accrued vacation	2,732,000	774,966
Net cash used in operating activities	$ (22,661,315)	$ (12,610,979)
SUPPLEMENTAL CASH FLOW INFORMATION:		
Interest paid, primarily on capital lease obligations	$ 3,077,856	$ 2,312,522
Non-cash financing and investing activities:		
• Capital assets acquired under capital leases	14,502,236	15,445,269
• Capital assets contributed by State of Hawaii	6,228,402	2,287,258
• Capital asset purchases included in accounts payable	1,838,295	555,782
• Capital assets acquired through long-term debt financing	1,690,900	
• Capital assets acquired through grants	423,238	585,084
• Reclassification of deposits to capital assets		750,000
• Contribution of capital assets		59,000

See notes to consolidated financial statements.

1. ORGANIZATION

Hawaii Health Systems Corporation (HHSC) is a public body corporate and politic and an instrumentality and agency of the State of Hawaii (State). HHSC is managed by a chief executive officer under the control of a 13-member board of directors.

In June 1996, the Legislature of the State passed Act 262, S.B. 2522. The Act, which became effective in fiscal year 1997, transferred all facilities under the administration of the Department of Health - Division of Community Hospitals to HHSC. The facilities are as follows:

Hawaii County:
- Hilo Medical Center
- Hale Ho'ola Hamakua
- Ka'u Hospital
- Kohala Hospital
- Kona Community Hospital

City and County of Honolulu:
- Leahi Hospital
- Maluhia

Maui County:
- Maui Memorial Medical Center
- Kula Hospital
- Lanai Community Hospital

Kauai County:
- Kauai Veterans Memorial Hospital
- Samuel Mahelona Memorial Hospital

Act 262 also amended a previous act to exempt all facilities from the obligation to pay previously allocated central service and departmental administration expenses by the State.

HHSC is considered to be administratively attached to the Department of Health of the State of Hawaii, and is a component unit of the State of Hawaii. The accompanying consolidated financial statements relate only to HHSC and the facilities and are not intended to present the financial position, results of operations, or cash flows of the Department of Health.

Negotiations between HHSC and the State relating to the transfer of assets and assumption of liabilities pursuant to Act 262 had not been finalized as of June 30, 2003. Accordingly, the assets, liabilities and net assets of HHSC reflected in the accompanying consolidated statements of net assets may be significantly different from those eventually included in the final settlement.

The consolidated financial statements are being presented for HHSC, Hawaii Health Systems Foundation (HHSF), and Alii Community Care, Inc. (Alii). HHSF and Alii are non-profit organizations of which HHSC is the sole member. The purpose of HHSF is to raise funds and obtain gifts and grants on behalf of HHSC. The purpose of Alii is to own, manage, and operate assisted living and other health care facilities in the State of Hawaii.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Accounting - HHSC prepares its financial statements using the economic resources measurement focus and the accrual basis of accounting.

HHSC's financial statements are presented in accordance with the pronouncements of the Governmental Accounting Standards Board (GASB) and the American Institute of Certified Public Accountants audit guide for health care organizations. Pursuant to GASB Statement No. 20, *Accounting and Financial Reporting for Proprietary Funds and Other Governmental Entities that Use Proprietary Fund Accounting*, HHSC has elected not to apply the provisions of relevant pronouncements of the Financial Accounting Standards Board issued after November 30, 1989.

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

Cash and Cash Equivalents - Cash and cash equivalents include short-term investments with original maturities of three months or less. It also includes amounts held in the State Treasury. The State Director of Finance is responsible for the safekeeping of all moneys paid into the State Treasury (cash pool). HHSC's portion of this cash pool at June 30, 2003 and 2002 is indicated in the accompanying consolidated statements of net assets as "Cash and cash equivalents on deposit with the State of Hawaii." The Hawaii Revised Statutes authorize the Director of Finance to invest in obligations of, or guaranteed by, the U.S. Government, obligations of the State, federally-insured savings and checking accounts, time certificates of deposit, and repurchase agreements with federally-insured financial institutions. Cash and deposits with financial institutions are collateralized in accordance with State Statutes. All securities pledged as collateral are held either by the State Treasury or by the State's fiscal agents in the name of the State.

HHSC has cash in financial institutions that is in excess of available depository insurance coverage.

Supplies - Supplies consist principally of medical and other supplies and are valued at the lower of first-in, first-out cost, or market.

Capital Assets - Capital assets assumed from the State at inception are recorded at cost less accumulated depreciation. Other capital assets are recorded at cost or estimated fair market value at the date of donation. Donated buildings, equipment and land are recognized as revenue when all eligibility requirements have been met, generally at the date of donation. Equipment under capital leases is recorded at the present value of future payments. Buildings, equipment and improvements are depreciated by the straight-line method over their estimated useful lives. Gains or losses on the sale of capital assets are reflected in other nonoperating revenues. Normal repairs and maintenance expenses are charged to operations as incurred.

Certain of HHSC's capital improvement projects are managed by the State Department of Accounting and General Services. The related costs for these projects are transferred to HHSC's capital assets accounts and are reflected as revenue below the nonoperating revenues category on the consolidated statement of revenues, expenses, and changes in net assets.

Assets Limited as to Use - Assets limited as to use are restricted net assets and patients' safekeeping deposits. Such restrictions have been externally imposed by contributors. Restricted resources are applied before unrestricted resources when an expense is incurred for purposes for which both restricted and unrestricted net assets are available. Patients' safekeeping deposits represent funds received or property belonging to the patients that are held by HHSC in a fiduciary capacity as custodian. Receipts and disbursements of these funds are not reflected in HHSC's operations.

Accrued Vacation and Compensatory Pay - HHSC accrues all vacation and compensatory pay at current salary rates, including additional amounts for certain salary-related expenses associated with the payment of compensated absences (such as employer payroll taxes and fringe benefits), in accordance with GASB Statement No. 16, *Accounting for Compensated Absences*. For employees first employed on or before July 1, 2001, vacation is earned at a rate of one and three-quarters working days for each month of service. For employees first employed on or after July 2, 2001, vacation is earned at a rate of one working day for each month of service. Vacation days may be accumulated to a maximum of 90 days.

Operating Revenues and Expenses - HHSC has defined its operating revenues and expenses as those relating to the provision of health care services. Those revenues and expenses relating to capital and related financing activities, noncapital financing activities, and investing activities are excluded from that definition.

Net Patient Service Revenues - Net patient service revenues are recorded on an accrual basis in the period in which the related services are provided at established rates, less contractual adjustments. HHSC, as a safety net provider, provides charity care to certain patients; the specific cost of such care is not determinable for the years ended June 30, 2003 and 2002.

HHSC has agreements with third-party payors that provide for payments at amounts different from their established rates. Payment arrangements include prospectively determined rates per discharge, reimbursed costs, discounted charges, and per diem payments. Net patient service revenues are reported at the estimated net realizable amounts from patients, third-party payors, and others for services rendered, including estimated retroactive adjustments under reimbursement agreements with third-party payors. Retroactive adjustments are recorded on an estimated basis in the period the related services are rendered and adjusted in future periods as final settlements are determined.

The estimated third-party payor settlement accrual of approximately $1,566,000 and $1,979,000, as of June 30, 2003 and 2002, respectively, is based on estimates, because complete information is not currently available to determine the final settlement amounts for certain cost report years. Management has used its best efforts, judgment, and certain methodologies to estimate the anticipated final outcome.

A summary of the payment arrangements with major third-party payors follows:

- ***Medicare*** - Inpatient acute services rendered to Medicare program beneficiaries are paid at prospectively determined rates per discharge. Effective August 1, 2000, certain inpatient services and all hospital outpatient services rendered to Medicare beneficiaries are paid at prospectively determined rates per discharge. These rates vary according to a patient classification system that is based on clinical, diagnostic and other factors. Inpatient non-acute services and defined capital and medical education costs related to Medicare beneficiaries were paid based upon a cost reimbursement methodology. HHSC was reimbursed at a tentative rate with final settlement determined after submission of annual cost reports and audits thereof by the Medicare fiscal intermediary. The appropriateness of admissions is subject to an independent review by peer review organizations under contract with HHSC. HHSC's Medicare cost reports have been audited by the Medicare fiscal intermediary through fiscal year 2000.

- ***Medicaid*** - Inpatient and outpatient services rendered to Medicaid program beneficiaries are reimbursed under a cost reimbursement methodology. HHSC is reimbursed at a tentative rate with final settlement determined after submission of annual cost reports and audits thereof by the Medicaid fiscal intermediary.

- ***Hawaii Medical Service Association (HMSA)*** - Inpatient services rendered to HMSA subscribers are reimbursed at prospectively determined case rates for hospitalization or procedures performed. The prospectively determined case rates are not subject to retroactive adjustment. In addition, outpatient services and certain contracts are reimbursed on a discounted charges method basis.

HHSC has also entered into payment agreements with certain commercial insurance carriers, health maintenance organizations, and preferred provider organizations. The basis for payment under these agreements includes prospectively determined rates per discharge, discounts from established rates, and prospectively determined daily rates.

Contributed Services - Volunteers have made contributions of their time in furtherance of HHSC's mission. The value of such contributed services is not reflected in the accompanying financial statements since it is not susceptible to objective measurement or valuation.

Bond Interest - HHSC reports as nonoperating expense the interest paid by the State for general obligation bonds whose proceeds were used for hospital construction. A corresponding contribution from the State is reported as nonoperating revenues. The bonds are obligations of the State, to be paid by the State's general fund, and are not reported as liabilities of HHSC. For the years ended June 30, 2003 and 2002, the amount of bond interest allocated to HHSC was $2,443,000 and $2,381,000, respectively.

Bond interest costs incurred on construction projects funded with State general obligation bonds are capitalized during the construction period.

Risk Management - HHSC is exposed to various risks of loss from torts; theft of, damage to and destruction of assets; business interruption; errors and omissions; employee injuries and illnesses; natural disasters; and employee health, dental and accident benefits. Commercial insurance coverage is purchased for claims arising from such matters. Settled claims have not exceeded this commercial coverage in any of the three preceding years. The facilities are self-insured for workers' compensation and disability claims and judgments as discussed in Note 10.

Concentration of Credit Risk - Patient accounts receivable consists of amounts due from insurance companies and patients for services rendered by facilities. The facilities grant credit without collateral to their patients, most of whom are local residents and are insured under third-party payor arrangements. The mix of receivables from patients and third-party payors at June 30, 2003 and 2002 was as follows:

	2003	2002
Medicare	14%	13%
Medicaid	24	24
HMSA	12	15
Other third-party payors	22	22
Patients and other	28	26
	100%	100%

Reclassifications - Certain amounts in the 2002 financial statements have been reclassified to conform to the 2003 presentation.

3. BOARD-DESIGNATED FUNDS

As of June 30, 2002, HHSC's Board of Directors had designated cash reserves as follows:

For capital equipment acquisitions and/or equity investments for growth initiatives	$5,000
For settlement and extinguishment of residual workers' compensation claims	500
Total	$ 5,500

During the years ended June 30, 2003 and 2002, HHSC's Board of Directors did not release any of the designated cash reserves for use in operations.

The designated funds are included in cash on deposit with banks and the unrestricted net assets balance.

4. CAPITAL ASSETS

Transactions in the capital assets accounts for the years ended June 30, 2003 and 2002 were as follows:

2003	Beginning of Year	Additions	Retirements	Transfers	End of Year
Assets Not Subject to Depreciation:					
Land and land improvements	$ 4,809,354			$ 274,000	$ 5,083,354
Construction in progress	14,986,281	$ 16,541,247		(8,692,460)	22,835,068
Assets Subject to Depreciation:					
Buildings and improvements	193,742,748	4,156,964	$ (63,668)	7,591,826	205,427,870
Major moveable equipment	69,150,419	4,833,773	(1,030,996)	370,627	73,323,823
Fixed equipment	36,284,785	699,312	(243,706)	440,877	37,181,268
	318,973,587	26,231,296	(1,338,370)	(15,130)	343,851,383
Less accumulated deprecia- tion and amortization	(142,804,953)	(15,493,133)	1,206,855	15,130	(157,076,101)
Capital assets - net	$ 176,168,634	$ 10,738,163	$ (131,515)	$ -	$ 186,775,282

2002	Beginning of Year	Additions	Retirements	Transfers	End of Year
Assets Not Subject to Depreciation:					
Land and land improvements	$ 4,744,929	$ 64,425			$ 4,809,354
Construction in progress	13,798,590	10,081,311		$(8,893,620)	14,986,281
Assets Subject to Depreciation:					
Buildings and improvements	192,495,936	190,273		1,056,539	193,742,748
Major moveable equipment	61,127,964	9,088,953	$(1,071,556)	5,058	69,150,419
Fixed equipment	26,365,598	2,158,047	(70,883)	7,832,023	36,284,785
	298,533,017	21,583,009	(1,142,439)		318,973,587
Less accumulated deprecia- tion and amortization	(130,092,006)	(13,835,128)	1,122,181		(142,804,953)
Capital assets - net	$ 168,441,011	$ 7,747,881	$ (20,258)	$ -	$ 176,168,634

In 2003 and 2002, the State Department of Accounting and General Services transferred capital assets, including construction in progress, aggregating $6,228,402 and $2,287,258, respectively, to HHSC as a contribution of capital.

5. ADVANCE FROM THE STATE OF HAWAII

In fiscal year 2003, HHSC received a $14,000,000 advance from the State of Hawaii to relieve its cash flow shortfall. The advance is to be repaid in fiscal year 2004.

6. LONG-TERM LIABILITIES

Among HHSC's long-term liabilities are accrued vacation and capital lease obligations. Transactions in these accounts during the years ended June 30, 2003 and 2002 were as follows:

2003	Beginning of Year	Additions	Reductions	End of Year	Current Portion	Noncurrent Portion
Accrued vacation	$ 18,993,138	$ 3,572,270	$ (840,270)	$ 21,725,138	$ 840,270	$ 20,884,868
Capital lease obligations	24,086,832	14,502,236	(6,288,048)	32,301,020	7,933,202	24,367,818
Long-term liabilities	$ 43,079,970	$ 18,074,506	$(7,128,318)	$ 54,026,158	$ 8,773,472	$ 45,252,686
2002						
Accrued vacation	$ 18,229,714	$ 1,482,578	$ (719,154)	$ 18,993,138	$ 719,154	$ 18,273,984
Capital lease obligations	12,521,047	15,445,269	(3,879,484)	24,086,832	7,036,881	17,049,951
Long-term liabilities	$ 30,750,761	$ 16,927,847	$(4,598,638)	$ 43,079,970	$ 7,756,035	$ 35,323,935

Future capital lease payments were as follows:

Year ended June 30:	
2004	$ 10,414,130
2005	9,129,782
2006	7,286,328
2007	4,443,941
2008	2,727,820
Thereafter	9,064,189
Total future minimum payments	43,066,190
Less amount representing interest	(10,765,170)
Total capital lease obligations	32,301,020
Current portion	(7,933,202)
Noncurrent portion	$ 24,367,818

HHSC has an arrangement with lessors whereby HHSC enters into capital leases on behalf of the facilities. The capital lease obligation is recorded on HHSC-Corporate's (Corporate) financial statements. While the assets are being constructed, the amounts are recorded as construction in progress on the financial statements of either Corporate or the facilities. Corporate makes the capital lease payments and incurs the interest expense, while the facilities record depreciation on the capital asset. Corporate also computes capitalized interest on construction in progress and transfers the capitalized interest asset to the facilities. The facilities reimburse Corporate through the due from affiliates account for the capital lease payments, interest expense, and capitalized interest. For the year ended June 30, 2003, interest capitalized for Corporate and all facilities was approximately $779,000.

7. LONG-TERM DEBT

Hilo Residency Training Program - In June 2001, HHSC acquired land, building, and medical equipment of $11,893,162 from Hilo Residency Training Program, Inc. (HRTP) to ensure the uninterrupted operation of the Hilo Medical Center Cancer Treatment Center and its radiation and medical oncology services. As part of the acquisition, HHSC assumed HRTP's outstanding balances on the loans and notes payable of $11,893,162. (The assets and related liabilities have been recorded in the Facility's accounting records.) The loans and notes payable are collateralized by a security interest in the capital assets acquired from HRTP, as well as any rights, interest, and other tangible assets relating to such property.

West Kauai Community Development Corporation - In June 2001, HHSC entered into a $700,000 Term Loan Agreement (Loan Agreement) with a local bank to finance the balance of the amount owing under HHSC's guarantee of an $800,000 loan made by the local bank to West Kauai Community Development Corporation (WKCDC). WKCDC had obtained the loan to fund Ohana Physicians Group's (Ohana) operating deficits during the time that Ohana provided physician services to Kauai Veterans Memorial Hospital. WKCDC's loan was collateralized by certain real property and improvements located in Waimea, Kauai. Under the terms of the Loan Agreement, HHSC does not stand to receive any interest in such property nor any rights to the proceeds from the sale of the property. In June 2001, WKCDC executed a promissory note to HHSC for $800,000, representing the outstanding balance WKCDC owed the local bank on its loan. Due to uncertainty as to the realization of any proceeds from the promissory note, HHSC has recorded an allowance for doubtful notes receivable of $800,000 against the note receivable balance. In December 2002, HHSC repaid the loan.

Maui Memorial Medical Center Nurses' Cottages - During fiscal year 2003, HHSC acquired buildings for $1,670,000 on behalf of Maui Memorial Medical Center (MMMC) for use in its operations. During fiscal year 2003, Corporate transferred the buildings to MMMC, but retained the loan payable in its accounting records. The note payable is collateralized by the buildings.

Long-term debt as of June 30, 2003 and 2002 consisted of the following:

	2003	2002
Loan payable to Central Pacific Bank; $9,500,000; interest at 7.1% at June 30, 2003, thereafter, interest at weekly average of 5-year U.S. Treasury Securities rate plus 250 basis points; monthly principal and interest payments of $64,975; due December 1, 2027	$ 9,103,432	$ 9,243,754
Loan payable to Central Pacific Bank; $319,000; interest at 9% until June 8, 2004, thereafter, interest at weekly average of 3-year U.S. Treasury Securities rate plus 275 basis points; monthly principal and interest payments of $3,500; due June 8, 2007	237,000	256,859
Loan payable to Academic Capital; $1,690,900; interest at 6.3%; monthly principal and interest payments of $19,028; due November 4, 2012	1,608,131	
Note payable to United States Department of Agriculture (USDA); $1,250,000; interest at 4.75%; monthly principal and interest payments of $6,188; due June 24, 2034	1,188,111	1,217,480
Note payable to USDA; $1,000,000; interest at 4.75%; monthly principal and interest payments of $8,170; due August 13, 2014	835,104	898,795
Term loan agreement payable to bank (WKCDC); $700,000; interest at the bank's prime rate; interest payments monthly with additional payments of principal commencing on January 15, 2002 of $200,000, followed by equal quarterly payments of $125,000 commencing on April 15, 2002; paid December 17, 2002		375,000
Total	12,971,778	11,991,888
Less current portion	(377,333)	(568,423)
Noncurrent portion	$12,594,445	$11,423,465

Transactions in long-term debt during the years ended June 30, 2003 and 2002 were as follows:

2003	**Beginning of Year**	**Additions**	**Reductions**	**End of Year**
Long-term debt	$ 11,991,888	$ 1,690,900	$ (711,010)	$ 12,971,778
2002				
Long-term debt	$ 12,515,064	$ -	$ (523,176)	$ 11,991,888

Maturities of long-term debt are as follows:

Year ending June 30:	
2004	$ 377,333
2005	444,247
2006	474,797
2007	507,271
2008	456,800
Thereafter	10,711,330
Total	$12,971,778

8. FACILITY-BASED TECHNICAL SERVICE AGREEMENTS

HHSC has facility-based technical service agreements relating to certain ancillary services. These arrangements are generally related to administrative services, clinical personnel, space rental, and clinical services. Reimbursement arrangements vary by contractor and range from fixed amounts per month to 100% reimbursements of charges. Amounts charged by the contractors are included in operating expenses in purchased services and professional fees, and aggregated approximately $10,782,000 (excluding Clinical Laboratories of Hawaii Joint Venture fees of $11,884,000 as disclosed in Note 11) and $16,619,000 during fiscal years 2003 and 2002, respectively.

In compliance with Medicare and Medicaid regulations, HHSC bills third-party payors for the services provided to patients by the contractors. These billings are included in net patient service revenues.

HHSC charges the contractors for use of the premises, supplies and laundry. These amounts are included in other operating revenues and aggregated approximately $871,000 and $790,000 during fiscal years 2003 and 2002, respectively. In addition, HHSC charges the contractors for the use of clinical personnel employed in the facilities. These amounts are netted against salaries and benefits expense and totaled $946,000 and $910,000 during fiscal years 2003 and 2002, respectively.

9. EMPLOYEE BENEFITS

Defined Benefit Pension Plans

All full-time employees of HHSC are eligible to participate in the Employees' Retirement System of the State of Hawaii (ERS), a cost sharing, multiple-employer public employee retirement system covering eligible employees of the State and counties.

The ERS is composed of a contributory retirement plan and a noncontributory retirement plan. Eligible employees who were in service and a member of the existing contributory plan on June 30, 1984, were given an option to remain in the existing plan or join the noncontributory plan, effective January 1, 1985. All new eligible employees hired after June 30, 1984, automatically become members of the noncontributory plan. Both plans provide death and disability benefits and cost of living increases. Benefits are established by State statute. In the contributory plan, employees may elect normal retirement at age 55 with 5 years of credited service or elect early retirement at any age with 25 years of credited service. Such employees are entitled to retirement benefits, payable monthly for life, of 2% of their average final salary, as defined, for each year of credited service. Benefits fully vest on reaching five years of service; retirement benefits are actuarially reduced for early retirement. Covered contributory plan employees are required by State statute to contribute 7.8% of their salary to the plan; HHSC is required by State statute to contribute the remaining amounts necessary to pay contributory plan benefits when due. In the noncontributory plan, employees may elect normal retirement at age 62 with 10 years of credited service or at age 55 with 30 years of credited service, or elect early retirement at age 55 with 20 years of credited service. Such employees are entitled to retirement benefits, payable monthly for life, of 1.25% of their average final salary, as defined, for each year of credited service. Benefits fully vest on reaching ten years of service; retirement benefits are actuarially reduced for early retirement. HHSC is required by State statute to contribute all amounts necessary to pay noncontributory plan benefits when due.

In July 2001, the State notified HHSC that the amounts overpaid by HHSC during the fiscal years ended June 30, 2000 would be applied toward HHSC's required contribution to the ERS in fiscal year 2002. Accordingly, the $6,206,461 of prepaid pension costs at June 30, 2001 was charged to salaries and benefits expense during the year ended June 30, 2002. HHSC's contribution to the ERS for the year ended June 30, 2003 was $11,431,000, equal to the required contribution.

The ERS issues a publicly available financial report that includes financial statements and required supplementary information. That report may be obtained by writing to the Employees' Retirement System, 201 Merchant Street, Suite 1400, Honolulu, Hawaii 96813-2929 or by calling (808) 586-1660.

Post-Retirement Health Care and Life Insurance Benefits

In addition to providing pension benefits, the State of Hawaii Public Employees Health Fund provides certain health care (medical, prescription drug, vision, and dental) and life insurance benefits for retired employees. Contributions are based upon negotiated collective bargaining agreements and are limited by State statute to the actual cost of benefit coverage.

For employees first employed prior to June 30, 1996, HHSC pays for 100% of these benefits for employees who have at least 10 years of service. HHSC's share of the cost of these benefits is pro-rated for employees with less than 10 years of service.

For employees first employed after June 30, 1996, HHSC pays for 100% of these benefits for employees who have at least 25 years of service. HHSC's share of the cost of these benefits is pro-rated for employees with between 10 and 25 years of service.

HHSC also reimburses Medicare expenses of retirees and qualified spouses (through the State of Hawaii) who are at least 62 years of age and have at least 10 years of service.

HHSC's post-retirement benefits expense approximated $9,715,000 and $10,216,000 for the years ended June 30, 2003 and 2002, respectively.

Sick Leave

Accumulated sick leave as of June 30, 2003 and 2002 was approximately $39,107,000 and $36,244,000, respectively. For employees first employed on or before July 1, 2001, sick leave accumulates at the rate of 14 hours for each month of service, as defined, without limit. For employees first employed on or after July 2, 2001, sick leave accumulates at the rate of 10 hours for each month of service until the completion of ten years of work, and at the rate of 14 hours for each month of service thereafter. Sick pay can be taken only in the event of illness and is not convertible to pay upon termination of employment. Accordingly, no liability for sick pay is recorded in the accompanying consolidated financial statements.

10. COMMITMENTS AND CONTINGENCIES

Professional Liability

HHSC maintains professional and general liability insurance with a private insurance carrier with a $20 million limit per claim. HHSC's General Counsel advises that, in the unlikely event any judgments rendered against HHSC exceed HHSC's professional liability coverage, such amount would likely be paid from an appropriation from the State's general fund.

Workers' Compensation Liability

HHSC is self-insured for workers' compensation claims. HHSC pays a portion of wages for injured workers (as required by law), medical bills, judgments as stipulated by the State's Department of Labor, and other costs. HHSC's facilities also directly provide treatment for injured workers. The estimated liability is based on actuarial projections of costs using historical claims-paid data. Estimates are continually monitored and reviewed and, as settlements are made or estimates adjusted, differences are reflected in current operations. HHSC accrued a liability of $18,500,000 for unpaid claims as of June 30, 2003 and 2002.

Ceded Lands

The Office of Hawaiian Affairs (OHA) and the State of Hawaii are presently in litigation involving the State's alleged failure to properly account for and pay to OHA monies due to OHA under the provisions of the Hawaii State Constitution and Chapter 10 of the Hawaii Revised Statutes for use by the State of certain ceded lands. As of June 30, 2003, the outcome of the lawsuit had not been finalized.

At the present time, HHSC is not able to estimate the magnitude of a potential adverse ruling (or that portion of the exposure which may ultimately be allocated to claims relating to HHSC and certain of its facilities). HHSC does not believe that it will suffer any material adverse impact from an adverse ruling against the State because the claim is against the State and not HHSC. In addition, should any payments be required to be made to OHA, management believes that the Legislature would appropriate funds to cover any amounts allocated to HHSC.

Litigation

HHSC is a party to certain litigation arising in the normal course of business. In management's opinion, the outcome of such litigation will not have a material impact on HHSC's financial statements.

Asbestos Contamination

There is known asbestos contamination of the old hospital building located next to the Hilo Medical Center facility. Present estimates by management to demolish the building and remediate the asbestos contamination approach $2 million or more. During fiscal year 2003, the Legislature of the State appropriated $16 million (to be funded by State general obligation bonds) for the construction of a 200-bed State Veteran's Home on the site of the old hospital building. The remaining construction costs of the State Veteran's Home will be funded by the Department of Veterans Affairs State Home Construction Program. The total construction costs include the demolition of the old hospital building and remediation of the asbestos contamination. In July 2003, management performed a feasibility study and determined that a 95-bed facility with the capacity for expansion would better serve the State. Management is performing an engineering analysis to obtain a better estimate of the total construction costs of the Veteran's Home. As the amount of any asbestos remediation is still uncertain, a liability for the cost of the remediation has not been recorded in HHSC's financial statements.

11. CLINICAL LABORATORIES OF HAWAII JOINT VENTURE

On May 1, 2002, HHSC entered into a Partnership Agreement with Clinical Laboratories of Hawaii, Inc., St. Francis Healthcare Enterprises, Inc., and Kapiolani Service Corporation to form Clinical Laboratories of Hawaii, LLP ("Partnership"). The primary purpose of the Partnership is to provide clinical laboratory services within the State of Hawaii. On June 1, 2002, HHSC contributed the use of the laboratory space and related ancillary services in seven of its facilities (Hilo Medical Center, Kona Community Hospital, Maui Memorial Medical Center, Hale Ho'ola Hamakua, Ka'u Hospital, Kohala Hospital, and Kula Hospital) in exchange for a minority equity interest in the Partnership. Ordinary distributions from the Partnership are to be made at least annually from the Partnership's "Available Cash" (as defined in the Partnership Agreement). There were no partnership distributions made to HHSC during fiscal year 2003.

HHSC's investment in the Partnership and related contribution of laboratory space and ancillary services are being recorded over the life of the Partnership Agreement. The contributed space and services recognized in fiscal year 2003 amount to $709,000, and the investment balance as of June 30, 2003 was $768,000.

In addition, HHSC charges the Partnership for the use of clinical personnel employed in the facilities, and certain routine tests referred to a facility's laboratory by the Partnership. Amounts billed to the Partnership totaled $1,770,000 during fiscal year 2003. Amounts due from the Partnership for such charges aggregated $1,610,000 as of June 30, 2003.

HHSC contracts with the Partnership to provide clinical laboratory and pathology services at its facilities. Amounts charged by the Partnership aggregated approximately $11,414,000 during fiscal year 2003. Amounts due to the Partnership aggregated $7,244,000 as of June 30, 2003.

Kauai Veterans Memorial Hospital (KVMH) and Samuel Mahelona Memorial Hospital contract with the Partnership to provide various services, but did not contribute the use of laboratory space and ancillary services to the Partnership. Amounts charged by the Partnership were approximately $470,000 during fiscal year 2003. Amounts due to the Partnership for such charges were $10,000 as of June 30, 2003. In addition, the Partnership contracts with KVMH to perform certain routine tests referred to the KVMH laboratory by the Partnership. Amounts billed to the Partnership were $104,000 during fiscal year 2003. Amounts due from the Partnership for such charges were $30,000 as of June 30, 2003.

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HAWAI HEALTH SYSTEMS CORPORATION

SUPPLEMENTAL SCHEDULE OF RECONCILIATION OF CASH ON DEPOSIT WITH THE STATE OF HAWAII
JUNE 30, 2003

	Appropriation Symbol	
CASH ON DEPOSIT WITH THE STATE OF HAWAII:		
SPECIAL FUNDS:		
	S-92-312-H	$ 485
	S-93-312-H	544
	S-93-353-H	6,563
	S-93-359-H	5,681
	S-94-359-H	12,905
	S-94-359-M	33,400
	S-94-396-H	8,673
	S-95-396-H	19,636
	S-96-312-H	469
	S-96-359-H	23,019
	S-96-396-H	9,040
	S-97-359-H	5,877
	S-97-396-H	182
	S-98-396-H	1,687
	S-03-303-H	39,543
	S-03-312-H	362
	S-03-320-H	7,674,000
	S-03-350-H	2,686
	S-03-351-H	12,893
	S-03-352-H	16,315
	S-03-353-H	10,942
	S-03-354-H	58,430
	S-03-355-H	71,043
	S-03-358-H	11,304
	S-03-359-H	21,718
	S-03-365-H	4,489
	S-03-371-H	18,625
	S-03-373-H	283
TRUST FUNDS:		
	T-02-906-H	2,512
	T-03-909-H	36,206
	T-03-910-H	63,106
	T-03-914-H	13,678
	T-03-918-H	1,272
	T-03-921-H	6,679
TOTAL PER STATE		8,194,247

HAWAI HEALTH SYSTEMS CORPORATION

SUPPLEMENTAL SCHEDULE OF RECONCILIATION OF CASH ON DEPOSIT WITH THE STATE OF HAWAII (Continued)
JUNE 30, 2003

	Appropriation Symbol	
RECONCILING ITEMS:		
Outstanding checks		$ 469
Reconciling items		(1,277)
Other		(34,801)
		(35,609)
TOTAL PER HHSC		$ 8,158,638

ASSETS LIMITED AS TO USE:

	Appropriation Symbol	
PATIENT TRUST FUNDS:		
	T-02-926-H	$ 18
	T-03-911-H	22,912
	T-03-915-H	12,093
	T-03-919-H	1,044
	T-03-925-H	108,522
	T-03-926-H	12,473
TOTAL PER STATE		157,062
RECONCILING ITEMS:		
Patients' safekeeping deposits held by financial institutions		242,850
Restricted accounts receivable		100,000
Restricted net assets held by financial institutions		2,017,369
TOTAL PER HHSC		$ 2,517,281

HAWAII HEALTH SYSTEMS CORPORATION

SUPPLEMENTAL COMBINING AND CONSOLIDATING STATEMENT OF NET ASSETS INFORMATION
JUNE 30, 2003

	Facilities																			
ASSETS	**Hilo Medical Center**	**Kona Community Hospital**	**Maui Memorial Medical Center**	**Ka'u Hospital**	**Kula Hospital**	**Kauai Veterans Memorial Hospital**	**Samuel Mahelona Memorial Hospital**	**Hale Ho'ola Hamakua**	**Kohala Hospital**	**Leahi Hospital**	**Maluhia**	**Lanai Community Hospital**	**Total Facilities**	**Corporate**	**Reclassifi-cations and Elimi-nations**	**HHSC Combined**	**Hawaii Health Systems Founda-tion**	**Alii Com-munity Care**	**Reclassifi-cations and Elimi-nations**	**HHSC Consolidated**
CURRENT ASSETS:																				
Cash and cash equivalents:																				
On deposit with the State of Hawaii	$ 15,087	$ 58,430	$ 134,149	$ 22,994	$ 18,625	$ 34,399	$ 283	$ 16,677	$ 17,505	$ 71,935	$ 4,489	$ 11,304	$ 405,877	$ 7,752,761		$ 8,158,638				$ 8,158,638
On deposit with banks and on hand	30,080	23,734	87,000	6,848	1,575	(2,889)	50,104	500	91,561	469,237	37,781	9,772	805,303	6,019,254		6,824,557	$ 138,163	$ 149,544		7,112,264
Patient accounts receivable - less allowances for contractual adjustments and doubtful accounts	12,985,993	5,779,129	21,559,968	372,600	1,896,227	1,712,482	1,191,996	383,764	459,340	2,274,567	1,535,952	327,272	50,479,290			50,479,290				50,479,290
Supplies and other current assets	2,770,273	1,452,899	2,748,082	47,475	176,673	349,675	80,579	122,195	38,116	517,024	95,213	75,911	8,474,115	138,392		8,612,507	4,468	9,859		8,626,834
Total current assets	15,801,433	7,314,192	24,529,199	449,917	2,093,100	2,093,667	1,322,962	523,136	606,522	3,332,763	1,673,435	424,259	60,164,585	13,910,407		74,074,992	142,631	159,403		74,377,026
DUE FROM AFFILIATES - Net			5,506,925					355,872					5,862,797	118,367,748	$ (124,230,545)	-				-
CAPITAL ASSETS - Net	40,149,771	29,817,069	53,160,280	1,437,533	4,826,996	11,990,524	3,753,549	14,182,074	2,205,789	7,319,471	3,824,175	1,062,606	173,729,837	12,979,527		186,709,364	32,699	33,219		186,775,282
ASSETS LIMITED AS TO USE	47,830	55,392	200,000	5,276	53,290	31,002	27,901	17,876	14,881	151,839	99,699	2,121	707,107	20,495		727,602	1,789,679			2,517,281
OTHER ASSETS	397,851	139,269	202,024	6,807	5,675			8,136	7,810				767,572	97,822		865,394			$ (97,822)	767,572
TOTAL	$ 56,396,885	$ 37,325,922	$ 83,598,428	$ 1,899,533	$ 6,979,061	$ 14,115,193	$ 5,104,412	$ 15,087,094	$ 2,835,002	$ 10,804,073	$ 5,597,309	$ 1,488,986	$ 241,231,898	$ 145,375,999	$ (124,230,545)	$ 262,377,352	$ 1,965,009	$ 192,622	$ (97,822)	$ 264,437,161

HAWAII HEALTH SYSTEMS CORPORATION

SUPPLEMENTAL COMBINING AND CONSOLIDATING STATEMENT OF NET ASSETS INFORMATION (Continued)
JUNE 30, 2003

LIABILITIES AND NET ASSETS	Facilities: Hilo Medical Center	Kona Community Hospital	Maui Memorial Medical Center	Ka'u Hospital	Kula Hospital	Kauai Veterans Memorial Hospital	Samuel Mahelona Memorial Hospital	Hale Ho'ola Hamakua	Kohala Hospital	Leahi Hospital	Maluhia	Lanai Community Hospital	Total Facilities	Corporate	Reclassifi-cations and Elimi-nations	HHSC Combined	Hawaii Health Systems Founda-tion	Alii Com-munity Care	Reclassifi-cations and Elimi-nations	HHSC Consolidated
CURRENT LIABILITIES:																				
Accounts payable and accrued expenses	$ 11,185,626	$ 5,910,959	$ 17,397,373	$ 314,127	$ 1,216,578	$ 2,106,793	$ 635,494	$ 382,458	$ 259,416	$ 1,085,866	$ 1,021,265	$ 289,196	$ 41,805,151	$ 2,296,785		$ 44,101,936	$ 58,645			$ 44,160,581
Accrued workers' compensation liability	5,491,474	2,051,024	4,032,298	147,490	1,947,407	790,785	455,572	494,175	227,388	1,456,373	924,220	138,450	18,156,656	343,344		18,500,000				18,500,000
Advance from the State of Hawaii														14,000,000		14,000,000				14,000,000
Current portion of capital lease obligations	368,055						21,327				5,185		394,567	7,538,635		7,933,202				7,933,202
Estimated third-party payor settlements	727,994	363,802	754,701	20,000	20,000	(721,357)	65,000	54,262	60,000	163,019	24,148	34,417	1,565,986			1,565,986				1,565,986
Current portion of accrued vacation	310,149	52,908	122,465	2,225	70,839	61,528	29,545	14,072	7,339	26,504	105,926	13,070	816,570	23,700		840,270				840,270
Current portion of long-term debt	246,577												246,577	130,756		377,333				377,333
Other current liabilities	95,682	4,083				138,780							238,545			238,545	103,496	$ 281,526		623,567
Total current liabilities	18,425,557	8,382,776	22,306,837	483,842	3,254,824	2,376,529	1,206,938	944,967	554,143	2,731,762	2,080,744	475,133	63,224,052	24,333,220		87,557,272	162,141	281,526		88,000,939
CAPITAL LEASE OBLIGATIONS - Less current portion	421,077												421,077	23,946,741		24,367,818				24,367,818
LONG-TERM DEBT - Less current portion	11,117,070												11,117,070	1,477,375		12,594,445				12,594,445
ACCRUED VACATION - Less current portion	4,651,966	2,737,033	5,246,733	188,197	1,099,025	1,068,596	997,620	495,910	308,364	1,799,800	1,363,002	234,312	20,190,558	694,310		20,884,868				20,884,868
DUE TO AFFILIATES - Net	20,700,092	14,166,643		6,131,908	7,088,600	31,284,816	9,718,512		5,542,518	6,396,998	14,419,213	7,023,713	122,473,013		$ (124,230,545)	(1,757,532)	537,355	1,220,177		-
DUE TO THE STATE OF HAWAII		7,605,205			1,114,264	1,043,345	2,417,150	506,153	528,149	6,416,791	491,450		20,122,507			20,122,507				20,122,507
PATIENTS' SAFEKEEPING DEPOSITS	47,830	5,411		5,276	53,290	7,764	24,857	8,595	4,628	151,839	75,164	2,121	386,775			386,775				386,775
OTHER LIABILITIES	1,320			10,932		45,400		29,841	13,542	45,005	13,296		159,336	217,380		376,716				376,716
Total liabilities	55,364,912	32,897,068	27,553,570	6,820,155	12,610,003	35,826,450	14,365,077	1,985,466	6,951,344	17,542,195	18,442,869	7,735,279	238,094,388	50,669,026	(124,230,545)	164,532,869	699,496	1,501,703		166,734,068
NET ASSETS:																				
Invested in capital assets - net of related debt	27,996,992	29,817,069	53,160,280	1,437,533	4,826,996	11,990,524	3,732,222	14,182,074	2,205,789	7,319,471	3,818,990	1,062,606	161,550,546	(20,113,980)		141,436,566	32,699	33,219		141,502,484
Unrestricted	(26,965,019)	(25,438,196)	2,684,578	(6,358,155)	(10,457,938)	(33,725,019)	(12,995,931)	(1,089,727)	(6,332,384)	(14,057,593)	(16,689,085)	(7,308,899)	(158,733,368)	114,800,458		(43,932,910)	(556,865)	(1,342,300)	$ (97,822)	(45,929,897)
Restricted		49,981	200,000			23,238	3,044	9,281	10,253		24,535		320,332	20,495		340,827	1,789,679			2,130,506
Total net assets	1,031,973	4,428,854	56,044,858	(4,920,622)	(5,630,942)	(21,711,257)	(9,260,665)	13,101,628	(4,116,342)	(6,738,122)	(12,845,560)	(6,246,293)	3,137,510	94,706,973		97,844,483	1,265,513	(1,309,081)	(97,822)	97,703,093
TOTAL	$ 56,396,885	$ 37,325,922	$ 83,598,428	$ 1,899,533	$ 6,979,061	$ 14,115,193	$ 5,104,412	$ 15,087,094	$ 2,835,002	$ 10,804,073	$ 5,597,309	$ 1,488,986	$ 241,231,898	$ 145,375,999	$ (124,230,545)	$ 262,377,352	$ 1,965,009	$ 192,622	$ (97,822)	$ 264,437,161

HAWAII HEALTH SYSTEMS CORPORATION

SUPPLEMENTAL COMBINING AND CONSOLIDATING STATEMENT OF REVENUES, EXPENSES, AND CHANGES IN NET ASSETS INFORMATION
YEAR ENDED JUNE 30, 2003

	Facilities																			
	Hilo Medical Center	Kona Community Hospital	Maui Memorial Medical Center	Ka'u Hospital	Kula Hospital	Kauai Veterans Memorial Hospital	Samuel Mahelona Memorial Hospital	Hale Ho'ola Hamakua	Kohala Hospital	Leahi Hospital	Maluhia	Lanai Community Hospital	Total Facilities	Corporate	Reclassifi-cations and Elimi-nations	HHSC Combined	Hawaii Health Systems Founda-tion	Alii Com-munity Care	Reclassifi-cations and Elimi-nations	HHSC Consolidated
OPERATING REVENUES:																				
Net patient service revenues	$ 75,384,433	$35,790,740	$103,383,933	$2,299,614	$10,682,512	$11,006,037	$ 7,058,671	$5,221,620	$ 2,447,838	$16,474,934	$12,444,395	$ 1,705,936	$283,900,663			$283,900,663				$283,900,663
Other operating revenues	1,284,095	320,808	783,088	16,519	123,405	532,984	74,640	24,363	28,378	468,360	41,761	10,751	3,709,152		$ (95,750)	3,613,402		$ 896,374		4,509,776
Total operating revenues	76,668,528	36,111,548	104,167,021	2,316,133	10,805,917	11,539,021	7,133,311	5,245,983	2,476,216	16,943,294	12,486,156	1,716,687	287,609,815		(95,750)	287,514,065		896,374		288,410,439
OPERATING EXPENSES:																				
Salaries and benefits	48,872,050	23,201,815	51,534,678	1,890,852	10,004,829	9,409,315	6,307,395	4,148,255	2,506,454	13,694,878	11,259,312	1,670,018	184,499,851	$ 5,008,689		189,508,540	$ 66,596	854,612		190,429,748
Medical supplies and drugs	9,899,262	4,814,875	14,122,141	83,081	821,674	1,048,000	298,277	132,567	81,869	514,429	568,456	141,241	32,525,872			32,525,872				32,525,872
Professional fees	3,926,445	2,476,338	9,473,804	613,421	304,515	2,232,304	129,782	75,381	458,830	71,088	27,971	116,053	19,905,932	339,919		20,245,851	37,977	175,385		20,459,213
Purchased services	3,997,766	1,994,926	8,777,336	117,310	484,185	259,485	379,175	185,544	81,611	584,418	1,122,398	324,772	18,308,926	474,501	(95,750)	18,687,677		6,892		18,694,569
Provision for doubtful accounts	4,196,553	2,419,998	9,174,444	157,501	(73,657)	186,422	126,064	(46,650)	(76,371)	293,372	21,828	357,375	16,736,879			16,736,879				16,736,879
Depreciation and amortization	3,070,347	2,330,189	3,989,832	89,433	358,069	614,346	354,817	544,683	104,009	943,836	362,569	85,361	12,847,491	2,644,298		15,491,789	1,344			15,493,133
Other supplies	2,475,019	781,488	5,653,052	68,517	642,760	268,814	286,010	257,350	136,052	1,083,195	652,496	83,368	12,388,121	35,893		12,424,014	18,026	142,836		12,584,876
Utilities	1,823,928	757,956	1,895,775	96,101	176,291	640,105	296,385	303,975	77,426	554,941	364,249	96,016	7,083,148	123,659		7,206,807		95,888		7,302,695
Repairs and maintenance	1,724,581	952,031	1,618,856	11,192	57,652	228,855	142,940	96,598	27,778	197,386	138,038	26,908	5,222,815	224,373		5,447,188	393	6,319		5,453,900
Rent and lease	663,513	317,200	1,057,840	11,228	10,927	209,216	7,865	18,642	21,484	23,097	6,406	1,705	2,349,123	47,971		2,397,094	5,392	1,102,632		3,505,118
Insurance	1,149,348	422,596	1,124,041	19,723	57,891	172,598	37,807	66,013	42,010	100,598	49,232	17,306	3,259,163	10,724		3,269,887		58,393		3,328,280
Interest (net of capitalized interest)	892,117	19,301	24,532		7,346	5,653	2,113	371	220	2,770	1,296		955,719	1,418,242		2,373,961	11,482		$ (11,482)	2,373,961
Other	1,109,483	581,208	1,136,263	59,649	118,278	453,244	70,565	39,761	117,068	81,659	106,824	32,175	3,906,177	424,135		4,330,312	85,863	138,284		4,554,459
Total operating expenses	83,800,412	41,069,921	109,582,594	3,218,008	12,970,760	15,728,357	8,439,195	5,822,490	3,578,440	18,145,667	14,681,075	2,952,298	319,989,217	10,752,404	(95,750)	330,645,871	227,073	2,581,241	(11,482)	333,442,703
INCOME (LOSS) FROM OPERATIONS	(7,131,884)	(4,958,373)	(5,415,573)	(901,875)	(2,164,843)	(4,189,336)	(1,305,884)	(576,507)	(1,102,224)	(1,202,373)	(2,194,919)	(1,235,611)	(32,379,402)	(10,752,404)	-	(43,131,806)	(227,073)	(1,684,867)	11,482	(45,032,264)
NONOPERATING REVENUES AND EXPENSES:																				
General appropriations from State of Hawaii														13,300,000		13,300,000				13,300,000
Collective bargaining pay raise appropriation from State of Hawaii	3,419,783	1,588,489	3,442,301	98,370	556,116	571,658	397,606	258,738	152,887	863,290	707,006	92,716	12,148,960	245,508		12,394,468				12,394,468
Restricted contributions		165,395	250,000			23,238		9,281	10,253				458,167	350,000		808,167	1,989,357		(350,000)	2,447,524
Interest and dividend income	20,311	6,820	82,611	660		3,808	589	825	1,092	6,817	2,415		125,948	99,127		225,075	2,574	5,125	(11,482)	221,292
Corporate allocation expense	(2,872,968)	(1,334,192)	(3,594,027)	(106,242)	(483,119)	(549,668)	(291,369)	(195,329)	(127,093)	(630,654)	(523,057)	(92,749)	(10,800,467)	10,800,467		-				-
Other nonoperating revenues (expenses) - net	17,554	43,016	114,876	17,420	(122)	78,336	110,451	127,900	14,650	(23,928)	(61,957)	24,646	462,842	14,192		477,034	(385,369)		350,000	441,665
Nonoperating revenues (expenses) - net	584,680	469,528	295,761	10,208	72,875	127,372	217,277	201,415	51,789	215,525	124,407	24,613	2,395,450	24,809,294		27,204,744	1,606,562	5,125	(11,482)	28,804,949
INCOME (LOSS) BEFORE CAPITAL CONTRIBUTIONS	(6,547,204)	(4,488,845)	(5,119,812)	(891,667)	(2,091,968)	(4,061,964)	(1,088,607)	(375,092)	(1,050,435)	(986,848)	(2,070,512)	(1,210,998)	(29,983,952)	14,056,890	-	(15,927,062)	1,379,489	(1,679,742)	-	(16,227,315)
CAPITAL ASSETS CONTRIBUTED BY STATE OF HAWAII	519,046	100,000	1,874,297	583,000	981	783,246	71,423	47,747	1,493,667	125,459	81,000	548,536	6,228,402			6,228,402				6,228,402
INCREASE (DECREASE) IN NET ASSETS	$ (6,028,158)	$ (4,388,845)	$ (3,245,515)	$ (308,667)	$ (2,090,987)	$ (3,278,718)	$ (1,017,184)	$ (327,345)	$ 443,232	$ (861,389)	$ (1,989,512)	$ (662,462)	$ (23,755,550)	$ 14,056,890	$ -	$ (9,698,660)	$ 1,379,489	$ (1,679,742)	$ -	$ (9,998,913)

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INDEPENDENT AUDITORS' REPORT ON COMPLIANCE AND ON INTERNAL CONTROL OVER FINANCIAL REPORTING BASED UPON THE AUDIT PERFORMED IN ACCORDANCE WITH *GOVERNMENT AUDITING STANDARDS*

Board of Directors of Hawaii Health Systems Corporation:

We have audited the consolidated financial statements of Hawaii Health Systems Corporation (HHSC) as of and for the years ended June 30, 2003 and 2002, and have issued our report thereon dated November 14, 2003. 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.

Compliance

As part of obtaining reasonable assurance about whether HHSC's consolidated financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grants, 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 that are required to be reported under *Government Auditing Standards*.

Internal Control over Financial Reporting

In planning and performing our audit, we considered HHSC's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the consolidated financial statements and not to provide assurance on the internal control over financial reporting. However, we noted a matter involving the internal control over financial reporting and its operation that we consider to be a reportable condition. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control over financial reporting that, in our judgment, could adversely affect HHSC's ability to record, process, summarize and report financial data consistent with the assertions of management in the consolidated financial statements. The reportable condition is described in a separate letter to management of HHSC dated November 14, 2003 and is summarized as follows:

- Billing of accounts receivable was not performed on a timely basis.

A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements in amounts that would be material in relation to the consolidated financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses. However, we do not believe the reportable conditions described above are material weaknesses.

This report is intended solely for the information and use of the Board of Directors and management of Hawaii Health Systems Corporation and is not intended to be and should not be used by anyone other than these specified parties.

Deloitte & Touche LLP

November 14, 2003