



*Hawaii Health Systems
Corporation*

*Consolidated Financial Statements for the
Years Ended June 30, 2006 and 2005,
Supplemental Information for the Year Ended
June 30, 2006, 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, 2006 and 2005 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 consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of HHSC's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the consolidated financial statements, 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, 2006 and 2005 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.

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, 2006 and 2005, 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 consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of HHSC's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, 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, 2006 and 2005 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, 2006, 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, 2006 and 2005 may be significantly different from those eventually included in the final settlement.

The management's discussion and analysis information on pages 4 through 14 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 34 and 35 is presented for the purpose of additional analysis and is not a required part of the basic financial statements. The supplemental combining and consolidating information on pages 36 through 38 is 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 is not a required part of the basic financial statements. This supplemental schedule and the supplemental combining and consolidating information 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 our report dated December 8, 2006 on our consideration of HHSC's internal control over financial reporting and our tests of its compliance and other matters. The purpose of that report is to describe the scope of our testing, and not to provide an opinion on the internal control over financial reporting or on compliance. 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

December 8, 2006

HAWAII HEALTH SYSTEMS CORPORATION

MANAGEMENT'S DISCUSSION AND ANALYSIS YEAR ENDED JUNE 30, 2006

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 Government 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 difference 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 statement of net assets, a statement of revenues, expenses, and changes in net assets, a statement of cash flows, and notes to financial statements.

FINANCIAL ANALYSIS

Consolidated Statements of Net Assets

Summarized financial information of HHSC's consolidated statements of net assets as of June 30, 2006 and 2005 is as follows:

| | 2006 | 2005 |
|--|----------------------|----------------------|
| ASSETS | | |
| Current assets | \$ 96,685,796 | \$ 83,779,878 |
| Capital assets—net | 221,454,648 | 195,793,055 |
| Other assets | <u>3,903,016</u> | <u>3,979,473</u> |
| Total assets | <u>\$322,043,460</u> | <u>\$283,552,406</u> |
| LIABILITIES | | |
| Current liabilities | \$ 74,815,892 | \$ 68,092,311 |
| Capital lease obligations—less current portion | 32,254,903 | 27,351,486 |
| Long-term debt—less current portion | 10,880,541 | 11,536,119 |
| Accrued vacation—less current portion | 26,552,028 | 24,479,604 |
| Due to the State of Hawaii | 34,122,507 | 34,122,507 |
| Other liabilities | <u>657,524</u> | <u>731,072</u> |
| Total liabilities | <u>179,283,395</u> | <u>166,313,099</u> |
| NET ASSETS | | |
| Invested in capital assets—net of related debt | 169,665,927 | 148,472,198 |
| Restricted | 493,445 | 1,302,537 |
| Unrestricted | <u>(27,399,307)</u> | <u>(32,535,428)</u> |
| Total net assets | <u>142,760,065</u> | <u>117,239,307</u> |
| Total liabilities and net assets | <u>\$322,043,460</u> | <u>\$283,552,406</u> |

At June 30, 2006, HHSC's capital assets, net of accumulated depreciation, comprised approximately 69% of its total assets. These assets consist mainly of land, hospital buildings, and equipment that are used in HHSC's operations. The increase of approximately \$25.7 million is due to property additions of \$44.7 million, offset by depreciation expense of \$18.5 million and retirements of \$0.6 million. The primary reason for the increase is due to the acquisition of medical equipment, information systems, and energy-saving equipment of \$13.3 million funded through HHSC's municipal leasing lines of credit and State-funded capital improvement projects of \$26.1 million. The State-funded capital improvement projects consisted primarily of construction costs for the \$38 million expansion of Maui Memorial Medical Center (MMMC) and for the construction of the Yukio Okutsu Veterans Care Home.

At June 30, 2005, HHSC's capital assets, net of accumulated depreciation, comprised approximately 69% of its total assets. These assets consist mainly of land, hospital buildings and equipment that are used in HHSC's operations. The increase of approximately \$6.5 million is due to property additions of \$24.0 million, offset by depreciation expense of \$16.9 million and retirements of \$0.6 million. The primary reason for the increase is

due to the acquisition of medical equipment, information systems, and energy-saving equipment of \$9.3 million funded through HHSC's municipal leasing lines of credit and State-funded capital improvement projects of \$10.1 million. The State-funded capital improvement projects consisted primarily of planning, design, and initial construction costs for the \$38 million expansion of MMMC.

A summary of HHSC's capital assets as of June 30, 2006 and 2005 is as follows:

| | 2006 | 2005 |
|--|-----------------------|-----------------------|
| Land and land improvements | \$ 5,180,572 | \$ 5,180,572 |
| Buildings and improvements | 221,899,300 | 216,954,326 |
| Equipment | 121,057,483 | 122,668,591 |
| Construction in progress | <u>63,085,041</u> | <u>30,385,291</u> |
| | 411,222,396 | 375,188,780 |
| Less accumulated depreciation and amortization | <u>(189,767,748)</u> | <u>(179,395,725)</u> |
| Capital assets—net | <u>\$ 221,454,648</u> | <u>\$ 195,793,055</u> |

At June 30, 2006, HHSC's current assets approximated 30% of total assets. Current assets increased \$12.9 million from the fiscal year 2005 balance due to an increase in cash and cash equivalents and an increase in patient accounts receivable. The increase in cash and cash equivalents of \$6.9 million is primarily due to the need to save sufficient funds to fund the July 20 payroll payment and an increase in the cash on deposit with the State of Hawaii of \$1.4 million (used to fund the July 5 payroll payment). The other reason for the increase in cash and cash equivalents is the increase in cash collections for fiscal year 2006 as compared to the prior year. HHSC collected \$351 million in fiscal year 2006 as compared to \$317 million in fiscal year 2005 due to \$12.7 million in extraordinary third-party payor settlements received as a result of the status of several HHSC facilities being designated as sole community hospitals, \$8.8 million in supplemental direct payments to hospitals from the State Department of Human Services (DHS), and HHSC's success in negotiating increases in reimbursement rates with third-party payors. Further, HHSC reduced its gross days in accounts receivable from 72.1 days at June 30, 2005 to 70.7 days at June 30, 2006. The reduction in gross days in accounts receivable was due to management's concerted effort to improve HHSC's revenue-cycle processes, focusing on regular monitoring of HHSC's revenue-cycle performance against industry key performance indicators, with corrective action being taken where necessary. The increase in patient accounts receivable of \$8.5 million is primarily due to the accrual of \$5.1 million in relief payments from DHS to mitigate the detrimental impact on reimbursements that Act 294 had on HHSC's long-term care facilities. This money was paid to HHSC in July 2006.

At June 30, 2005, HHSC's current assets approximated 30% of total assets. Current assets increased \$7.5 million from the fiscal year 2004 balance due to an increase in cash and cash equivalents and the establishment of estimated third-party payor settlement receivables. The increase in cash and cash equivalents of \$2.2 million is primarily due to the transfer of \$1.0 million from the State of Hawaii general fund to HHSC's cash accounts with the State Treasury to pay for the retroactive pay raises for United Public Workers (UPW) bargaining units 1 and 10. The other reason for the increase in cash and cash equivalents is the increase in cash collections for fiscal year 2005 as compared to the prior year. HHSC collected \$317 million in fiscal year 2005 as compared to \$291 million in fiscal year 2004 due to \$10.6 million in third-party payor settlements received as a result of the status of several HHSC facilities being designated either as critical access hospitals or sole community hospitals as well as HHSC's success in negotiating increases in reimbursement rates with third-party payors.

At June 30, 2006, HHSC's current liabilities approximated 42% of total liabilities. The primary reason for the increase from fiscal year 2005 is due to increases in accounts payable, accrued payroll, and estimated third-party payor settlements. Accounts payable at June 30, 2006 increased by \$2.9 million from June 30, 2005, primarily due to an increase of \$19.3 million in non-payroll expenses from fiscal year 2005 to fiscal year 2006. As a result, days in accounts payable increased from 35.6 days at June 30, 2005 to 38.8 days at June 30, 2006.

Accrued payroll at June 30, 2006 increased by \$1.7 million from June 30, 2005 as a result of a combination of collective bargaining pay raises and increases in full-time equivalents as a result of additional contracting personnel needed to comply with the requirements of the State Procurement Code and additional physician employees to ensure that sufficient medical coverage is available for patients needing care in HHSC's acute care facilities. The estimated third-party payor settlements increased from a receivable of \$4 million at June 30, 2005 to a payable of \$4.6 million at June 30, 2006. The increase is primarily due to open cost reports at the facilities and to the anticipated recoupment of Medicare coinsurance and deductibles by the Med-QUEST (QUEST) program.

At June 30, 2005, HHSC's current liabilities approximated 41% of total liabilities. The primary reason for the decrease from fiscal year 2004 is due to a decrease in accounts payable. Due to the increased cash collections described above, HHSC was able to reduce its accounts payable balance significantly, from \$18.9 million at June 30, 2004 to \$12.3 million at June 30, 2005. Days in accounts payable also decreased significantly, from 62.2 days at June 30, 2004 to 35.6 days at June 30, 2005. The other significant reason for the decrease in current liabilities is a reclassification of the advance from the State of Hawaii of \$14 million from current liabilities to noncurrent liabilities. The reason for the reclassification is that HHSC does not have the ability to repay the advance, and HHSC management does not anticipate the State calling the loan within the next fiscal year. Discussions with the State of Hawaii to resolve this issue are ongoing.

At June 30, 2006 and 2005, HHSC's total capital lease obligation balance increased approximately \$5.3 million and \$1.3 million from fiscal years 2005 and 2004, 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 several municipal leasing companies, which allow HHSC to finance equipment purchases at interest rates below market rates.

At June 30, 2006, HHSC's long-term debt balances represented: 1) notes and term loans payable on the land, building, and medical equipment previously owned by Hilo Residency Training Program with a remaining balance of approximately \$10.2 million, 2) a mortgage note payable relating to the acquisition of nursing cottages on the MMC campus with a remaining balance of approximately \$1.2 million, and 3) notes payable to two individuals relating to the acquisition of clinic assets with a remaining balance of approximately \$0.2 million.

At June 30, 2006, the portion of HHSC's net assets that is reflected as its investment in capital assets, net of related debt, of approximately \$169.7 million, is larger than the total net assets of approximately \$142.8 million. This means that HHSC's net operations since inception have resulted in losses of over \$27.4 million.

Management believes that three factors impede the comparability of the fiscal year 2006 results with those of prior fiscal years: 1) property contributed by the State of Hawaii of \$26.1 million, which represents payments made by the State of Hawaii for HHSC's construction projects, 2) extraordinary third-party payor settlements for sole community hospital designation of HHSC's three acute care hospitals of \$9.2 million (see comment below), and 3) relief payments of \$8.2 million for fiscal years 2004 and 2005 to HHSC's facilities with long-term care beds for the negative impact of Act 294. Management believes that these factors are neither controllable nor recurring, and may not reflect HHSC's true operating performance. The following chart shows the impact of these three factors on HHSC's financial performance.

| | |
|--|------------------------|
| Increase in net assets for the year ended June 30, 2006 | <u>\$ 25,521,000</u> |
| Adjustments to exclude noncontrollable or nonrecurring items: | |
| Contributed capital assets and transfers | (26,116,000) |
| Extraordinary cost report settlements received | (9,166,000) |
| Act 294 relief payments | <u>(8,209,000)</u> |
| Total adjustments | <u>(43,491,000)</u> |
| Adjusted decrease in net assets for the year ended June 30, 2006 | <u>\$ (17,970,000)</u> |

Operating expenses in fiscal year 2006 were approximately 10.6% higher than fiscal year 2005. The increase was mainly in the category of salaries and benefits, supplies and drugs, professional fees, and purchased services expense. Salaries and benefits expense increased 7.2% from fiscal year 2005, due primarily to collective bargaining pay raises for HHSC's union employees and an increase in the fringe benefit rate assessed to HHSC by the State of Hawaii. During fiscal year 2006, HHSC's union employees in Hawaii Government Employees Association (HGEA) and UPW received pay raises from the unions' collective bargaining agreements with the State of Hawaii of varying percentages effective on various dates throughout the fiscal year. These pay raises represented an additional \$5.5 million in salaries expense over fiscal year 2005. Further, the fringe benefit rate assessed to HHSC by the State of Hawaii increased from 34.66% for fiscal year 2005 to 39.39% for fiscal year 2006. The primary reason for the increase is the increase in the required contribution to fund the State Employee Retirement System. The impact of the increase in fringe benefit rate on HHSC was approximately \$7.9 million for fiscal year 2006. The remaining increase is due to an increase in full-time equivalents as a result of additional contracting personnel needed to comply with the requirements of the State Procurement Code and additional physician employees to ensure that sufficient medical coverage is available for patients needing care in HHSC's acute care facilities. The increase in supplies and drugs expense was primarily due to a 7% increase in utilization of drugs sold to patients, as well as an increase in the use of chemotherapy drugs, which are much more expensive than other types of drugs. Chemotherapy procedures increased 41% from fiscal year 2005 to 2006. Professional fees and purchased services expenses increased \$8.7 million from fiscal year 2005 primarily due to an increase of \$4.8 million in registry nurse expense. The increase in registry nurse expense is primarily due to the need to maintain minimum nurse staffing ratios to keep up with patient volume. Increase is also due to the use of registry nurses to staff the emergency rooms that opened at Hale Ho'ola Hamakua, Kula Hospital, and Samuel Mahelona Memorial Hospital during fiscal year 2006. The remaining increase is primarily due to contracted payments to physicians to ensure the availability of specialty medical care and on-call coverage for neighbor island patients.

Operating expenses in fiscal 2005 were approximately 8% higher than fiscal 2004. The increase was mainly in the categories of salaries and benefits, supplies and drugs, professional fees and purchased services, and insurance expense. Salaries and benefits expense increased 7.7% from fiscal year 2004, due primarily to collective bargaining pay raises for HHSC's union employees and an increase in the fringe benefit rate assessed to HHSC by the State of Hawaii. HHSC's union employees in HGEA bargaining unit 9 (consisting

of registered nurses) and UPW bargaining units 1 and 10 (consisting of blue collar nonsupervisory employees and licensed practical nurses) received pay raises from the union's collective bargaining agreements with the State of Hawaii of 5% effective July 1, 2004. HHSC's employees in HGEA bargaining units 2, 3, 4, and 13 received step pay increases effective July 1, 2004, with a 5% pay increase effective January 1, 2005. These pay raises represented an additional \$7 million in salaries and benefits expense over fiscal year 2004. Further, the fringe benefit rate assessed to HHSC by the State of Hawaii increased from 32.2% for fiscal year 2004 to 34.7% for fiscal year 2005. The primary reason for the increase is the increase in the required contribution to fund the State Employee Retirement System. The impact of the increase in fringe benefit rate on HHSC was approximately \$3.6 million for fiscal year 2005. In fiscal year 2005, HHSC recorded an adjustment of \$3.7 million to increase its accrued workers' compensation liability based on an actuarial study. The reason for the increase was primarily due to rising medical costs for each workers' compensation claim and HHSC's inability to generate sufficient cash flow to settle its claims in an expedient manner. The increase in supplies and drugs expense was primarily due to a 6.3% increase in utilization of drugs sold to patients, as well as an increase in the use of chemotherapy drugs, which are much more expensive than other types of drugs. Chemotherapy procedures increased 37% from fiscal year 2004 to 2005. Professional fees and purchased services expenses increased by 4.9% primarily due to an increase in the amount of physician contracts entered into by HHSC due to the acquisition of a clinic by Kauai Veterans Memorial Hospital on December 31, 2004, as well as the need to ensure that certain specialty physician services are provided to Hawaii's rural communities, such as orthopedic and OB/GYN services. Insurance expenses increased due to the increase in malpractice insurance premiums. In fiscal year 2005, HHSC's malpractice insurance premium was \$4.3 million, as compared to \$1.475 million in fiscal year 2004. The reason for the increase is that the insurance carrier that provided coverage to HHSC in fiscal year 2004 decided to exit the Hawaii market and no longer provide such coverage.

Fiscal year 2006 operating revenues increased by approximately 9.9% over fiscal year 2005 as a result of extraordinary third-party payor settlements received for sole community hospital reimbursement (primarily at MMMC), payments received from the State Department of Human Services (DHS) for supplemental direct payments to hospitals, payments received from DHS for Act 294 relief provisions for fiscal years 2004 and 2005, and increases in negotiated reimbursement rates from private third-party payors. In fiscal year 2006, HHSC received \$9.2 million in third-party payor settlements from government-type payors relating to the sole community hospital reimbursement for MMMC, Hilo Medical Center (HMC), and Kona Community Hospital, with \$8.2 million of the total going to MMMC. The settlements covered the fiscal years 2002 through 2004. Sole community hospitals are hospitals that, because of factors such as isolated location, weather conditions, travel conditions, or absence of other hospitals, are the sole source of inpatient services reasonably available in a geographic area, or are located more than 35 road miles from another hospital. Sole community hospitals receive either hospital-specific prospective rates based on base year costs updated to the present or the federal PPS rate, whichever is higher. In fiscal year 2006, HHSC received \$8.8 million in supplemental direct payments to hospitals from DHS (see discussion on Medicaid reimbursement issues on page 12 for more information). In fiscal year 2006, HHSC also recorded \$8.2 million in relief payments from DHS for the detrimental reimbursement impact on HHSC's long-term care reimbursements as a result of Act 294 (see discussion on Medicaid reimbursement issues on page 11 for more information). The increase in negotiated reimbursement rates from private third-party payors primarily represented inflationary increases of varying percentages.

Fiscal year 2005 operating revenues increased by approximately 11.3%, as a result of third-party payor settlements received for sole community hospital reimbursement (primarily at MMMC), increase in ER visits at HHSC's acute care hospitals, and increases in negotiated reimbursement rates from private third-party payors. In fiscal year 2005, HHSC received \$11.6 million in cost report settlements from Medicare and HMSA 65C+ relating to the sole community hospital reimbursement for MMMC, HMC, and Kona Community Hospital, with \$10.2 million of the total going to MMMC. The settlements covered the fiscal years 2002 through 2004. The sole community hospital status also resulted in an increase in Medicare and

HMSA 65C+ reimbursement rates during fiscal year 2005. The acute care reimbursement rates for MMMC, HMC, and Kona Community Hospital increased 27%, 11%, and 8%, respectively, in fiscal year 2005. Emergency Room visits for HHSC's three acute care hospitals increased 4.5% from fiscal year 2004 to fiscal year 2005. The largest increase occurred at MMMC, where Emergency Room visits increased 8.6% from fiscal year 2004 to fiscal year 2005. The increase in negotiated reimbursement rates from private third-party payors primarily represented inflationary increases of varying percentages.

For the year ended June 30, 2006, General Fund Appropriations from the State of Hawaii consisted of \$32.3 million approved for HHSC's operating purposes by the 2005 Legislature. For the year ended June 30, 2005, General Fund Appropriations from the State of Hawaii consisted of \$27.8 million approved for HHSC's operating purposes by the 2004 Legislature, reduced by approximately \$278,000 by the Governor for efficiency savings.

HHSC's management believes that the significant excess of operating expenses over operating revenues in both 2006 and 2005, 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 year 2006, 60% of HHSC's total gross revenues were from government-type payors (approximately 23% from Medicare and approximately 25% from Medicaid and QUEST). For fiscal year 2005, 61% of HHSC's total gross revenues were from government-type payors (approximately 23% from Medicare and approximately 27% from Medicaid and QUEST). In fact, government-type payors account for 89% of HHSC's long-term care revenues. 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.

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) would be positively impacted. Understanding the dramatic impact that implementation of Act 294 would have on HHSC, the Department of Human Services 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/revenue enhancements that can be reasonably explored will not be enough to absorb such costs. In September 2003, the Center for Medicare and Medicaid Services approved Hawaii's Medicaid State Plan Amendment to provide relief payments to those nursing facilities negatively impacted by Act 294. In fiscal year 2006, DHS paid \$3.1 million to HHSC in Act 294 relief payments for patient services rendered in fiscal year 2004. In July 2006, DHS paid \$5.1 million to HHSC in Act 294 relief payments for patient services rendered in fiscal year 2005 reflected in patient accounts receivable at June 30, 2006. While this will provide short-term relief for HHSC's facilities that are negatively impacted by Act 294, management is continuing to

work with the State Department of Human Services to explore long-term alternative reimbursement solutions that would ease the burden of Act 294 on HHSC's long-term care facilities.

When the State of Hawaii implemented the 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 Public Hospitals and Health Systems, 2004" states that "Medicaid DSH funding financed almost one-fifth of the unreimbursed care provided in 2004, while state and local subsidies financed 35 percent." In September 2005, the State Department of Human Services (DHS), in partnership with HHSC management, the Governor, the State of Hawaii Legislature, and the Healthcare Association of Hawaii (HAH), was able to use HHSC's fiscal years 2006 and 2007 projected losses from providing uncompensated care under the Medicaid fee-for-service program to draw down additional federal funding for all Hawaii hospitals. DHS has paid to HHSC \$8.8 million for fiscal year 2006, and management expects DHS to pay HHSC \$6.9 million in fiscal year 2007. Because of this innovative approach to drawing down additional federal funds, HHSC was able to reduce its request for State general fund appropriations by those amounts in fiscal years 2006 and 2007. Management will continue to work with DHS, the State of Hawaii Legislature, and HAH to explore long-term reimbursement enhancements that could reduce HHSC's reliance on general fund appropriations.

Second, HHSC's facilities on the neighbor islands suffer from an insufficient supply of long-term care beds. For fiscal year 2006, HHSC's long-term care occupancy percentage was 95.3%, and there are very few other freestanding long-term care facilities on the neighbor islands. As a result, HHSC's acute care facilities, especially HMC and MMMC, 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. Combined, HMC and MMMC have an average census of approximately 20-40 wait list patients per day. 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's salaries and benefits expenses represent approximately 60% of its total operating expenses, and management continues to face several challenging issues regarding management of personnel and personnel costs. HHSC is bound by the collective bargaining agreements negotiated by the State of Hawaii and the public employee unions (HGEA and UPW). 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.

Also, since the majority of HHSC's facilities are in rural locations, management faces many recruitment and retention issues of key clinical personnel. Areas of acute shortage include RNs and LPNs, anesthetists, imaging technicians, physicians, surgery technicians, pharmacists and pharmacy technicians, and health information management specialists. These shortage areas are caused by several factors: 1) a nation-wide shortage of health care workers, 2) the inability of local colleges and universities to provide sufficient classes and teachers that can educate students in these areas, and 3) competition for these same types of positions with private hospitals, which can pay significantly higher wage rates than HHSC. In particular, the shortage

of RNs and LPNs results in HHSC having to expend significant amounts for agency nurses, which are paid at significantly higher rates. Agency nurse expenses increased from \$5,909,792 for fiscal year 2005 to \$10,751,412 for fiscal year 2006. Another issue compounding HHSC's nursing situation is the fact that all of HHSC's nurses are full-time salaried employees, while the nurses at the other private hospitals are hourly employees. This allows the private hospitals to increase or decrease their nurse staffing based on census; by contrast, HHSC facilities cannot decrease their nurse staffing if census is lower than budgeted.

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 must be 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.

Fifth, in the 2004 State of Hawaii Legislative Session, the Legislature passed, and the Governor signed into law, HB 2136, which effectively removed exemptions from HRS 103(d) (the State procurement code) for many state agencies (including HHSC) effective January 1, 2005. The State procurement code required that for purchases greater than \$25,000, competitive sealed bids must be solicited, with the award of the contract made to the lowest responsive and responsible offeror. For purchases less than \$25,000, the State procurement code required that the State agency obtain no less than three price quotes, with the award of the contract made to the most advantageous quotation. Any exceptions to these regulations must be approved by the Chief Procurement Officer for that agency. Under Act 262, HHSC was granted the ability to develop its own internal policies and procedures for the procurement of goods and services, consistent with the goals of public accountability and public procurement practices, but not subject to HRS 103(d). In fact, prior to the formation of HHSC, the state hospitals under the Division of Community Hospitals were excluded from HRS 103(d) competitive procurement provisions, so that the hospitals could have the autonomy to procure goods and services in a setting where timeliness is crucial to the provision of quality health care to patients.

During the 2006 Legislative Session, the State of Hawaii Legislature passed S.B. 2898, S.D.2, H.D.2, C.D.1, designating the chief executive officer of HHSC as its chief procurement officer. This bill also amended HRS 103(d) by raising the small purchase threshold from \$25,000 to \$50,000. Even with the designation of chief procurement officer authority, HHSC has incurred significant costs in its attempt to comply with the provisions of HRS 103(d). The most troubling cost is in the area of delayed medical care due to the delay in obtaining needed medical equipment. This results in more pain for the patient and the likelihood of a detrimental outcome increases. Another cost is that the medical staffs at HHSC's hospitals are upset about the implementation of the code. These physicians are being forced to spend an inordinate amount of time justifying the purchase of a specific piece of essential medical equipment on a piece-by-piece basis, which is time that could better be spent providing care to their patients. Given the shortage of certain physician specialists on the neighbor islands, anything that would cause frustration to these physicians could result in a loss of certain specialty care in neighbor island communities should these physicians choose to leave. The medical staffs are also upset that preferences of a surgeon in using particular brands of medical equipment require extensive justification under HRS 103(d). Further, the State Procurement Office is having a difficult time providing answers to questions and training to HHSC personnel due to their limited staff and the difficulty in reconciling the provisions of HRS 323(f) (the statute that delineates the powers and governance of HHSC) and HRS 103(d). Finally, HHSC has incurred costs in increasing procurement/legal staff to handle the increased workload of complying with the requirements of HRS 103(d), as well as the cost of increased employee time to handle the increased paperwork and number of requests for proposal (RFPs) that are required under the code. Management estimates that HHSC will be required to perform 150 more RFPs/Invitation for Bid (IFBs) each year due to the requirements of HRS 103(d).

Management believes that exemption from HRS 103(d) is appropriate for HHSC in order for HHSC to provide timely medical services to the communities it serves in an efficient and effective manner. In the alternative, management believes that medical supplies, drugs, and medical purchased services should be exempt from the requirements of HRS 103(d) so that necessary medical services can be procured quickly to insure that patients are treated in a timely manner with equipment that is familiar to HHSC's medical staff.

Finally, HHSC is a significant provider of health care for the State of Hawaii. From fiscal year 2003 through fiscal year 2005, HHSC's facilities accounted for 19.19% of all acute care discharges in the State of Hawaii. HHSC's facilities discharged more acute care patients during that time period than most of the acute care hospitals on Oahu. Also, HHSC is the sole source of health care for several isolated neighbor island communities (e.g. Ka'u, Kohala, Lanai, etc.). Further, MMMC is the primary acute care facility on the island of Maui, and HMC and Kona Community Hospital are the only acute care facilities with more than 50 acute beds on the island of Hawaii. In large part because of HHSC's facilities in Maui, 89.5% of Maui County residents were discharged for acute care services from Maui hospitals instead of having to fly to Oahu to receive care. The same can be said for residents of East and West Hawaii: 84.6% of East Hawaii residents and 82.5% of West Hawaii residents were discharged for acute care services from hospitals on the island of Hawaii instead of having to fly to Oahu to receive care. 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.

HAWAII HEALTH SYSTEMS CORPORATION

CONSOLIDATED STATEMENTS OF NET ASSETS JUNE 30, 2006 AND 2005

| | 2006 | 2005 |
|---|-----------------------------|-----------------------|
| ASSETS | | |
| CURRENT ASSETS: | | |
| Cash and cash equivalents: | | |
| On deposit with the State of Hawaii | \$ 11,171,229 | \$ 9,805,315 |
| On deposit with banks and on hand (Note 3) | 16,317,741 | 10,748,445 |
| Patient accounts receivable, less allowances of \$75,777,177 and \$82,083,403 for contractual adjustments and doubtful accounts | 58,806,410 | 50,342,937 |
| Supplies and other current assets | 10,390,416 | 8,908,486 |
| Estimated third-party payor settlements | <u> </u> | <u>3,974,695</u> |
| Total current assets | 96,685,796 | 83,779,878 |
| CAPITAL ASSETS—Net (Notes 4, 6, 7, 12 and 14) | 221,454,648 | 195,793,055 |
| ASSETS LIMITED AS TO USE | 872,233 | 1,706,212 |
| OTHER ASSETS (Notes 11 and 13) | <u>3,030,783</u> | <u>2,273,261</u> |
| TOTAL | <u>\$ 322,043,460</u> | <u>\$ 283,552,406</u> |

(Continued)

HAWAII HEALTH SYSTEMS CORPORATION

CONSOLIDATED STATEMENTS OF NET ASSETS JUNE 30, 2006 AND 2005

| | 2006 | 2005 |
|---|-----------------------|-----------------------------|
| LIABILITIES AND NET ASSETS | | |
| CURRENT LIABILITIES: | | |
| Accounts payable and accrued expenses (Note 11) | \$ 39,871,147 | \$ 33,001,707 |
| Accrued workers' compensation liability (Note 10) | 19,274,950 | 25,282,963 |
| Current portion of capital lease obligations (Note 6) | 8,105,845 | 7,738,765 |
| Current portion of accrued vacation (Note 6) | 1,671,353 | 829,121 |
| Current portion of long-term debt (Note 7) | 699,070 | 694,487 |
| Other current liabilities | 605,314 | 545,268 |
| Estimated third-party payor settlements | <u>4,588,213</u> | <u> </u> |
| Total current liabilities | 74,815,892 | 68,092,311 |
| CAPITAL LEASE OBLIGATIONS—Less current portion (Note 6) | 32,254,903 | 27,351,486 |
| LONG-TERM DEBT—Less current portion (Note 7) | 10,880,541 | 11,536,119 |
| ACCRUED VACATION—Less current portion (Note 6) | 26,552,028 | 24,479,604 |
| DUE TO THE STATE OF HAWAII (Note 5) | 34,122,507 | 34,122,507 |
| PATIENTS' SAFEKEEPING DEPOSITS AND DEFERRED INCOME—Restricted contributions | 378,788 | 403,675 |
| OTHER LIABILITIES | <u>278,736</u> | <u>327,397</u> |
| Total liabilities | <u>179,283,395</u> | <u>166,313,099</u> |
| NET ASSETS: | | |
| Invested in capital assets—net of related debt | 169,665,927 | 148,472,198 |
| Restricted (Note 12) | 493,445 | 1,302,537 |
| Unrestricted (Note 3) | <u>(27,399,307)</u> | <u>(32,535,428)</u> |
| Total net assets | <u>142,760,065</u> | <u>117,239,307</u> |
| TOTAL | <u>\$ 322,043,460</u> | <u>\$ 283,552,406</u> |

See notes to consolidated financial statements.

(Concluded)

HAWAII HEALTH SYSTEMS CORPORATION

CONSOLIDATED STATEMENTS OF REVENUES, EXPENSES, AND CHANGES IN NET ASSETS YEARS ENDED JUNE 30, 2006 AND 2005

| | 2006 | 2005 |
|---|-----------------------------|-----------------------|
| OPERATING REVENUES: | | |
| Net patient service revenues (Note 8) | \$ 347,877,556 | \$ 315,092,101 |
| Other operating revenues (Note 8) | <u>4,894,582</u> | <u>5,829,071</u> |
| Total operating revenues | <u>352,772,138</u> | <u>320,921,172</u> |
| OPERATING EXPENSES: | | |
| Salaries and benefits (Notes 8 and 9) | 234,551,456 | 218,702,702 |
| Purchased services (Notes 8 and 11) | 43,926,743 | 34,765,839 |
| Medical supplies and drugs | 41,708,594 | 39,450,011 |
| Depreciation and amortization | 18,483,895 | 16,905,894 |
| Other supplies | 14,971,923 | 12,241,238 |
| Utilities | 8,733,781 | 7,556,158 |
| Repairs and maintenance | 7,085,095 | 6,426,572 |
| Insurance | 6,146,134 | 5,124,854 |
| Rent and lease | 4,520,138 | 3,915,669 |
| Professional fees | 4,159,362 | 4,586,912 |
| Other | <u>6,861,510</u> | <u>4,093,433</u> |
| Total operating expenses | <u>391,148,631</u> | <u>353,769,282</u> |
| LOSS FROM OPERATIONS | <u>(38,376,493)</u> | <u>(32,848,110)</u> |
| NONOPERATING REVENUES (EXPENSES): | | |
| General appropriations from State of Hawaii | 32,280,041 | 27,569,984 |
| Collective bargaining pay raise appropriation from State of Hawaii | 5,474,356 | 10,837,961 |
| Restricted contributions (Note 12) | 260,421 | 2,695,069 |
| Interest and dividend income | 539,539 | 241,709 |
| Interest expense (net of capitalized interest) (Notes 6 and 7) | (2,355,317) | (3,155,053) |
| Other nonoperating revenues—net (Note 8) | <u>1,582,367</u> | <u>1,916,400</u> |
| Total nonoperating revenues (expenses) | <u>37,781,407</u> | <u>40,106,070</u> |
| INCOME BEFORE CAPITAL CONTRIBUTIONS, TRANSFERS, AND SPECIAL ITEM | (595,086) | 7,257,960 |
| CONTRIBUTED CAPITAL ASSETS AND TRANSFERS (Notes 4 and 14) | 26,115,844 | 15,273,967 |
| SPECIAL ITEM—Demolition costs (Note 14) | <u> </u> | <u>(3,527,127)</u> |
| INCREASE IN NET ASSETS | 25,520,758 | 19,004,800 |
| NET ASSETS—Beginning of year | <u>117,239,307</u> | <u>98,234,507</u> |
| NET ASSETS—End of year | <u>\$ 142,760,065</u> | <u>\$ 117,239,307</u> |

See notes to consolidated financial statements.

HAWAII HEALTH SYSTEMS CORPORATION

CONSOLIDATED STATEMENTS OF CASH FLOWS YEARS ENDED JUNE 30, 2006 AND 2005

| | 2006 | 2005 |
|---|-----------------------------|-----------------------------|
| OPERATING ACTIVITIES: | | |
| Receipts from government, insurance and patients | \$ 347,976,991 | \$ 308,918,775 |
| Payments to employees | (235,762,109) | (211,002,445) |
| Payments to suppliers and others | (133,378,977) | (128,403,163) |
| Other receipts—net | <u>4,894,582</u> | <u>5,849,484</u> |
| Net cash used in operating activities | <u>(16,269,513)</u> | <u>(24,637,349)</u> |
| NONCAPITAL FINANCING ACTIVITIES: | | |
| Appropriations from State of Hawaii | 37,754,397 | 38,407,945 |
| Other nonoperating revenues—net | <u>1,112,441</u> | <u>1,224,168</u> |
| Net cash provided by noncapital financing activities | <u>38,866,838</u> | <u>39,632,113</u> |
| CAPITAL AND RELATED FINANCING ACTIVITIES: | | |
| Repayments on capital lease obligations | (8,068,835) | (7,927,543) |
| Capital expenditures | (5,322,474) | (2,228,181) |
| Payments on long-term debt | (650,995) | (439,722) |
| Interest on capital lease obligations and long-term debt | (2,355,317) | (3,166,566) |
| Proceeds from sale of capital assets | 150 | 47,730 |
| Deposit on noncurrent asset | | (25,000) |
| Loss on disposal of capital assets—net | <u>551,756</u> | <u>565,459</u> |
| Net cash used in capital and related financing activities | <u>(15,845,715)</u> | <u>(13,173,823)</u> |
| INVESTING ACTIVITIES: | | |
| Distributions received from the Clinical Laboratories of Hawaii partnership | 183,600 | 212,160 |
| Purchase of clinic assets | | <u>(108,000)</u> |
| Net cash provided by investing activities | <u>183,600</u> | <u>104,160</u> |
| NET INCREASE IN CASH AND CASH EQUIVALENTS | 6,935,210 | 1,925,101 |
| CASH AND CASH EQUIVALENTS—Beginning of year | <u>20,553,760</u> | <u>18,628,659</u> |
| CASH AND CASH EQUIVALENTS—End of year | <u>\$ 27,488,970</u> | <u>\$ 20,553,760</u> |

(Continued)

HAWAII HEALTH SYSTEMS CORPORATION

CONSOLIDATED STATEMENTS OF CASH FLOWS YEARS ENDED JUNE 30, 2006 AND 2005

| | 2006 | 2005 |
|--|------------------------|------------------------|
| RECONCILIATION OF LOSS FROM OPERATIONS TO NET CASH USED IN OPERATING ACTIVITIES: | | |
| Loss from operations | \$ (38,376,493) | \$ (32,848,110) |
| Adjustments to reconcile loss from operations to net cash used in operating activities: | | |
| Provision for doubtful accounts | 21,173,044 | 16,057,850 |
| Depreciation and amortization | 18,483,895 | 16,905,894 |
| Amounts released from restrictions (Note 12) | 860,292 | 824,486 |
| Change in operating assets and liabilities: | | |
| Patient accounts receivable | (29,636,517) | (16,862,861) |
| Supplies and other assets | (1,481,657) | (812,430) |
| Accounts payable, accrued expenses, and other liabilities | 7,238,372 | (9,044,290) |
| Accrued workers' compensation liability | (6,008,013) | 3,428,963 |
| Estimated third-party payor settlements | 8,562,908 | (5,368,315) |
| Accrued vacation | <u>2,914,656</u> | <u>3,081,464</u> |
| Net cash used in operating activities | <u>\$ (16,269,513)</u> | <u>\$ (24,637,349)</u> |
| SUPPLEMENTAL CASH FLOW INFORMATION: | | |
| Interest paid, primarily on capital lease obligations | \$ 2,355,317 | \$ 3,166,566 |
| NONCASH FINANCING AND INVESTING ACTIVITIES: | | |
| • Capital assets acquired under capital leases | 13,339,332 | 9,271,683 |
| • Capital assets contributed by State of Hawaii | 26,115,844 | 11,746,840 |
| • Capital assets transferred from other noncurrent assets | 25,000 | |
| • Capital asset purchases included in accounts payable | 301,544 | 659,091 |
| • Contribution of capital assets | 24,736 | 212,848 |
| • Capital assets acquired with restricted assets (Note 12) | 209,221 | 1,517,641 |
| • Rental income contributed to and equity in earnings of the Clinical Laboratories of Hawaii partnership | 984,727 | 732,606 |
| • Demolition costs funded by transfers from the State of Hawaii | | 3,527,127 |
| • Acquisition of clinic assets: | | |
| Goodwill | | \$ 243,000 |
| Intangible asset | | 55,000 |
| Inventory | | 12,000 |
| Equipment | | 50,000 |
| Less cash paid | | <u>(108,000)</u> |
| Assets purchased through the issuance of long-term debt | | <u>\$ 252,000</u> |

See notes to consolidated financial statements.

(Concluded)

HAWAII HEALTH SYSTEMS CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS YEARS ENDED JUNE 30, 2006 AND 2005

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. HHSC currently operates the following facilities:

Hawaii County:

Hilo Medical Center
Hale Ho'ola Hamakua
Ka'u Hospital
Kohala Hospital
Kona Community Hospital
Yukio Okutsu Veterans Care Home

Maui County:

Maui Memorial Medical Center
Kula Hospital
Lanai Community Hospital

Kauai County:

Kauai Veterans Memorial Hospital
Samuel Mahelona Memorial Hospital

City and County of Honolulu:

Leahi Hospital
Maluhia

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, 2006. 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.

In fiscal year 2005, HHSC created a new division, the Yukio Okutsu Veterans Care Home (Veterans Home), to develop and operate a long-term care facility for veterans in Hilo, Hawaii (see Note 14).

The consolidated financial statements are being presented for HHSC, Hawaii Health Systems Foundation (HHSF), and Alii Community Care, Inc. (Alii). HHSF and Alii are nonprofit 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, 2006 and 2005 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. The amount of uninsured and uncollateralized deposits totaled approximately \$20,918,000 and \$9,510,000 at June 30, 2006 and 2005, respectively.

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, patients’ safekeeping deposits, and restricted deferred contributions. 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.

At June 30, 2006, the entire balance of assets limited as to use consisted of restricted cash. At June 30, 2005, assets limited as to use consisted of restricted cash of \$1,346,771 and a receivable from the Kona Hospital Foundation of \$359,441 (see Note 12).

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*. Vacation is earned at a rate of one and three-quarters working days 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 and provision for doubtful accounts. HHSC, as a safety net provider, provides charity care to certain patients; the specific cost of such care for the years ended June 30, 2006 and 2005 was \$2,575,220 and \$1,246,093, respectively.

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 adjustments to the final settlements did not have a significant impact on the fiscal year 2006 and 2005 financial statements.

The estimated third-party payor settlement payable of \$4,588,213 as of June 30, 2006 and the estimated third-party payor settlement receivable of \$3,974,695 as of June 30, 2005 are 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 effort, 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 are paid based upon 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 Medicare fiscal intermediary. The appropriateness of admissions is subject to an independent review by peer review organizations under contract with HHSC. Medicare cost reports for the various HHSC facilities have been audited by the Medicare fiscal intermediary through fiscal year 2004.

- **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.

Patient accounts receivable at June 30, 2006 and net patient service revenues for the year then ended include approximately \$5,100,000 of adjustments to Medicaid payments made by the State of Hawaii to mitigate the impact of Act 294 on HHSC's long-term care facilities.

- **Critical Access Hospitals**—HHSC has seven facilities (Hale Ho'ola Hamakua, Kauai Veterans Memorial Hospital, Ka'u Hospital, Kohala Hospital, Kula Hospital, Lanai Community Hospital, and Samuel Mahelona Memorial Hospital) that are designated as critical access hospitals (CAH) by the Center for Medicare and Medicaid Services. CAHs are limited-service hospitals located in rural areas that receive cost-based reimbursement. To be designated a CAH, a facility must, among other requirements: 1) be located in a county or equivalent unit of a local government in a rural area, 2) be located more than a 35-mile drive from a hospital or another health care facility, or 3) be certified by the State as being a necessary provider of health care services to residents in the area. These facilities are paid an interim reimbursement rate throughout the year based on each facility's expected costs per inpatient day or the allowable outpatient cost-to-charge. After the close of each fiscal year, the facility would receive retrospective settlements for the difference between interim payments received and the total allowable cost as documented in the Medicare cost reports.
- **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, 2006 and 2005, the amount of bond interest allocated to HHSC was approximately \$4,414,000 and \$2,665,000, 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, 2006 and 2005 was as follows:

| | 2006 | 2005 |
|--------------------------|-------------|-------------|
| Medicare | 15% | 13% |
| Medicaid | 20 | 16 |
| HMSA | 14 | 11 |
| Other third-party payors | 25 | 28 |
| Patients and other | <u>26</u> | <u>32</u> |
| | <u>100%</u> | <u>100%</u> |

Reclassifications—Certain amounts in the 2005 financial statements have been reclassified to conform to the 2006 presentation.

3. BOARD-DESIGNATED FUNDS

As of June 30, 2006 and 2005, 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 | <u>500</u> |
| Total | <u>\$ 5,500</u> |

During the years ended June 30, 2006 and 2005, 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, 2006 and 2005 were as follows:

| | Beginning of Year | Additions | Retirements | Transfers | End of Year |
|--|-----------------------|----------------------|---------------------|------------------|-----------------------|
| 2006 | | | | | |
| Assets Not Subject to Depreciation: | | | | | |
| Land and land improvements | \$ 5,180,572 | \$ - | \$ - | \$ - | \$ 5,180,572 |
| Construction in progress | 30,385,291 | 37,868,620 | | (5,168,870) | 63,085,041 |
| Assets Subject to Depreciation: | | | | | |
| Buildings and improvements | 216,954,326 | 838,620 | (383,809) | 4,490,163 | 221,899,300 |
| Major moveable equipment | 79,429,038 | 5,755,287 | (2,152,755) | 1,223,907 | 84,255,477 |
| Fixed equipment | <u>43,239,553</u> | <u>216,533</u> | <u>(6,108,880)</u> | <u>(545,200)</u> | <u>36,802,006</u> |
| | 375,188,780 | 44,679,060 | (8,645,444) | - | 411,222,396 |
| Less accumulated depreciation and amortization | <u>(179,395,725)</u> | <u>(18,465,561)</u> | <u>8,093,538</u> | | <u>(189,767,748)</u> |
| Capital assets—net | <u>\$ 195,793,055</u> | <u>\$ 26,213,499</u> | <u>\$ (551,906)</u> | <u>\$ -</u> | <u>\$ 221,454,648</u> |
| 2005 | | | | | |
| Assets Not Subject to Depreciation: | | | | | |
| Land and land improvements | \$ 5,083,354 | \$ 16,875 | \$ (22,006) | \$ 102,349 | \$ 5,180,572 |
| Construction in progress | 22,810,939 | 16,680,644 | (209,894) | (8,896,398) | 30,385,291 |
| Assets Subject to Depreciation: | | | | | |
| Buildings and improvements | 214,386,005 | 914,657 | (4,430,315) | 6,083,979 | 216,954,326 |
| Major moveable equipment | 74,983,042 | 6,277,197 | (1,841,417) | 10,216 | 79,429,038 |
| Fixed equipment | <u>41,447,428</u> | <u>134,280</u> | <u>(1,042,009)</u> | <u>2,699,854</u> | <u>43,239,553</u> |
| | 358,710,768 | 24,023,653 | (7,545,641) | - | 375,188,780 |
| Less accumulated depreciation and amortization | <u>(169,422,283)</u> | <u>(16,905,894)</u> | <u>6,932,452</u> | | <u>(179,395,725)</u> |
| Capital assets—net | <u>\$ 189,288,485</u> | <u>\$ 7,117,759</u> | <u>\$ (613,189)</u> | <u>\$ -</u> | <u>\$ 195,793,055</u> |

In 2006 and 2005, the State Department of Accounting and General Services transferred capital assets, including construction in progress, aggregating \$26,115,844 and \$11,746,840, respectively, to HHSC as a contribution of capital.

During fiscal years 2006 and 2005, \$209,221 and \$1,517,641, respectively, of capital assets were purchased with funds contributed by outside organizations.

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. At June 30, 2006, HHSC did not have the ability, and thus does not intend to repay the advance. Furthermore, management does not expect the State of Hawaii to demand payment of the

advance in fiscal year 2007. Accordingly, the advance is classified as a noncurrent liability at June 30, 2006.

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, 2006 and 2005 were as follows:

| | Beginning of Year | Additions | Reductions | End of Year | Current Portion | Noncurrent Portion |
|---------------------------|----------------------|--------------|---------------|----------------|--------------------|-----------------------|
| 2006 | | | | | | |
| Accrued vacation | \$ 25,308,725 | \$ 4,586,009 | \$(1,671,353) | \$ 28,223,381 | \$ 1,671,353 | \$ 26,552,028 |
| Capital lease obligations | 35,090,251 | 13,339,332 | (8,068,835) | 40,360,748 | 8,105,845 | 32,254,903 |
| 2005 | | | | | | |
| Accrued vacation | \$ 22,227,261 | \$ 6,024,307 | \$(2,942,843) | \$ 25,308,725 | \$ 829,121 | \$ 24,479,604 |
| Capital lease obligations | 33,746,111 | 9,271,683 | (7,927,543) | 35,090,251 | 7,738,765 | 27,351,486 |

Future capital lease payments were as follows:

| Years Ended June 30 | |
|-----------------------------------|----------------------|
| 2007 | \$ 10,576,881 |
| 2008 | 8,139,759 |
| 2009 | 7,224,777 |
| 2010 | 6,153,438 |
| 2011 | 5,445,898 |
| 2012-2016 | 13,626,767 |
| 2017-2019 | <u>1,755,888</u> |
| Total future minimum payments | 52,923,408 |
| Less amount representing interest | <u>(12,562,660)</u> |
| Total capital lease obligations | 40,360,748 |
| Current portion | <u>(8,105,845)</u> |
| Noncurrent portion | <u>\$ 32,254,903</u> |

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 years ended June 30, 2006 and 2005, interest capitalized for Corporate and all facilities was approximately \$1,279,000 and \$685,000, respectively.

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.

Maui Memorial Medical Center Nurses' Cottages—During fiscal year 2003, HHSC acquired buildings for \$1,690,900 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 loan payable is collateralized by a security interest in the capital assets acquired.

Long-term debt as of June 30, 2006 and 2005 consisted of the following:

| | 2006 | 2005 |
|---|---------------------|---------------------|
| Loan payable to Central Pacific Bank; \$9,500,000; interest at 5.75% at June 30, 2006 (interest at weekly average of 5-year U.S. Treasury Securities rate plus 250 basis points); monthly principal and interest payments of \$57,015; due December 1, 2027 | \$ 8,423,972 | \$ 8,598,940 |
| Loan payable to Central Pacific Bank; \$319,000; interest at 5.875% at June 30, 2006 (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 | 161,951 | 189,544 |
| Loan payable to Academic Capital; \$1,690,900; interest at 6.3%; monthly principal and interest payments of \$19,028; due November 4, 2012 | 1,189,928 | 1,338,193 |
| 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 | 1,003,357 | 1,153,106 |
| Note payable to USDA; \$1,000,000; interest at 4.75%; monthly principal and interest payments of \$8,170; due August 13, 2014 | 648,765 | 718,370 |
| Notes payable to two individuals; \$252,000; interest at 5% at June 30, 2006; monthly principal and interest payments of \$22,745; due January 1, 2008 (see Note 13) | <u>151,638</u> | <u>232,453</u> |
| Total | 11,579,611 | 12,230,606 |
| Less current portion | <u>(699,070)</u> | <u>(694,487)</u> |
| Noncurrent portion | <u>\$10,880,541</u> | <u>\$11,536,119</u> |

Transactions in long-term debt during the years ended June 30, 2006 and 2005 were as follows:

| | Beginning of Year | Additions | Reductions | End of Year |
|----------------|----------------------|------------|--------------|----------------|
| 2006 | | | | |
| Long-term debt | \$ 12,230,606 | \$ - | \$ (650,995) | \$ 11,579,611 |
| 2005 | | | | |
| Long-term debt | \$ 12,418,328 | \$ 252,000 | \$ (439,722) | \$ 12,230,606 |

Maturities of long-term debt are as follows:

| Years Ending June 30 | Principal | Interest | Total |
|-------------------------|---------------------|--------------------|---------------------|
| 2007 | \$ 699,070 | \$ 633,001 | \$ 1,332,071 |
| 2008 | 541,147 | 601,130 | 1,142,277 |
| 2009 | 502,510 | 571,400 | 1,073,910 |
| 2010 | 532,229 | 541,680 | 1,073,909 |
| 2011 | 563,723 | 510,186 | 1,073,909 |
| 2012-2016 | 2,217,926 | 2,119,560 | 4,337,486 |
| 2017-2021 | 2,196,505 | 1,544,276 | 3,740,781 |
| 2022-2026 | 2,916,072 | 824,708 | 3,740,780 |
| 2027-2031 | 1,229,563 | 119,485 | 1,349,048 |
| 2032-2034 | 180,866 | 13,548 | 194,414 |
| Total | <u>\$11,579,611</u> | <u>\$7,478,974</u> | <u>\$19,058,585</u> |

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 aggregated approximately \$13,114,000 and \$9,616,000 (excluding Clinical Laboratories of Hawaii partnership fees of approximately \$12,724,000 and \$11,211,000 as disclosed in Note 11) during fiscal years 2006 and 2005, 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 nonoperating revenues and aggregated approximately \$1,070,000 and \$1,008,000 during fiscal years 2006 and 2005, 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 approximately \$848,000 and \$751,000 during fiscal years 2006 and 2005, 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. These 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.

HHSC's contribution to the ERS for the years ended June 30, 2006 and 2005 was approximately \$22,973,000 and \$14,126,000, respectively, 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 provides certain health care (medical, prescription drug, vision, and dental) and life insurance benefits for retired employees.

For employees hired before July 1, 1996, the State pays the entire monthly health care premium for employees retiring with 10 or more years of credited service, and 50% of the monthly premium for employees retiring with fewer than 10 years of credited service.

For employees hired after June 30, 1996, and who retire with fewer than 10 years of service, the State makes no contributions. For those retiring with at least 10 years but fewer than 15 years of services, the State pays 50% of the retired employees' monthly Medicare or non-Medicare premium. For employees hired after June 30, 1996, and who retire with at least 15 years but fewer than 25 years of service, the State pays 75% of the retired employees' monthly Medicare or non-Medicare premium; for those retiring with over 25 years of service, the State pays the entire health care premium.

Free life insurance coverage for retirees and free dental coverage for dependents under age 19 are also available. Retirees covered by the medical portion of Medicare are eligible to receive reimbursement of the basic medical coverage premium.

Contributions are financed on a pay-as-you-go basis, and are limited by State statute to the actual cost of benefit coverage. HHSC's post-retirement benefits expense approximated \$11,179,000 and \$10,835,000 for the years ended June 30, 2006 and 2005, respectively.

Sick Leave

Accumulated sick leave as of June 30, 2006 and 2005 was approximately \$50,105,000 and \$46,105,000, respectively. Sick leave accumulates at the rate of 14 hours for each month of service, as defined, without limit. 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 \$19,274,950 and \$25,282,963 for unpaid claims as of June 30, 2006 and 2005, respectively.

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.

During the 2006 Legislative Session, the State of Hawaii Legislature enacted Act 178, which provided interim measures to ensure that a certain amount of proceeds were made available to OHA from the pro rata portion of the public land trust, for the betterment of the conditions of native Hawaiians. The Act provided that the State agencies that collect receipts from the use of lands within the public land trust transfer a total of \$3,775,000 to OHA within 30 days of the close of each fiscal quarter (or \$15,100,000 per fiscal year), beginning with the 2006 fiscal year. In addition, the Act appropriated \$17,500,000 out of the State's general revenues to pay OHA for underpayments of the State's use of lands in the public land trust for the period from July 1, 2001 to June 30, 2005.

On September 20, 2006, the Governor of the State of Hawaii issued Executive Order No. 06-06, which established procedures for the State agencies to follow in order to carry out the requirements of Act 178. Each State agency that collects receipts from the use of ceded or public land trust land is to determine OHA's share of such receipts by calculating the ceded/non-ceded fraction of the parcel that generated the receipt, multiplying the receipt by the ceded/non-ceded fraction, and multiplying that result by 20%. The resulting amounts are to be deposited into a trust holding account established for such purpose, and within 10 days of the close of each fiscal quarter, the amounts are to be transferred to OHA. Within a specified period after the close of each quarter, the Director of Finance is to reconcile the actual amounts transferred to OHA with the required amount of \$3,775,000, and adjust each specific agency's payments accordingly.

For the quarter ended September 30, 2006, HHSC's share of public land trust payments to OHA approximated \$57,000.

Litigation

HHSC is a party to various 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. In fiscal year 2003, the State appropriated funds for the construction of the Veterans Home on the site of the old hospital building (see Note 1). Funding for the construction will also come from the Department of Veterans Affairs State Home Construction Program. The total construction costs to be funded will include the demolition of the old hospital building and remediation of the asbestos contamination (see Note 14).

Construction Commitment

In fiscal year 2002, the State Legislature approved the issuance of \$38 million of State of Hawaii general obligation bonds, the proceeds of which are to be used for the renovation and expansion of the MMMC campus. The Facility began construction in fiscal year 2005 and expects to complete the project in fiscal year 2007.

11. CLINICAL LABORATORIES OF HAWAII PARTNERSHIP

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, MMMC, Hale Ho'ola Hamakua, Ka'u Hospital, Kohala Hospital, and Kula Hospital) in exchange for a less than controlling 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). In fiscal years 2006 and 2005, HHSC received partnership distributions of \$183,600 and \$212,160, respectively.

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 2006 and 2005 amounted to \$984,727 and \$732,606, respectively, and the investment balance as of June 30, 2006 and 2005 was \$2,760,283 and \$1,959,156, respectively. The

contributed space and services are included in other nonoperating revenues in the consolidated statements of revenues, expenses and changes in net assets, and the investment balance is included in other assets in the consolidated statements of net assets.

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 approximately \$1,706,000 and \$1,522,000 during fiscal years 2006 and 2005, respectively. Amounts due from the Partnership for such charges aggregated approximately \$522,000 and \$605,000 as of June 30, 2006 and 2005, respectively.

HHSC contracts with the Partnership to provide clinical laboratory and pathology services at its facilities. Amounts charged by the Partnership aggregated approximately \$12,724,000 and \$11,211,000 during fiscal years 2006 and 2005, respectively. Amounts due to the Partnership aggregated approximately \$3,388,000 and \$1,314,000 as of June 30, 2006 and 2005, respectively.

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 \$93,000 and \$81,000 during fiscal years 2006 and 2005, respectively. 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 approximately \$79,000 and \$102,000 during fiscal years 2006 and 2005, respectively. There were no amounts due from or due to the Partnership as of June 30, 2006 and 2005.

12. TEMPORARILY RESTRICTED NET ASSETS

Changes in temporarily restricted net assets for the years ended June 30, 2006 and 2005 were as follows:

| | 2006 | 2005 |
|--------------------------------------|-------------------|---------------------|
| Balance, beginning of year | \$1,302,537 | \$ 949,595 |
| Restricted contributions received | 260,421 | 2,695,069 |
| Expenditures for restricted purposes | (860,292) | (824,486) |
| Capital assets purchased | <u>(209,221)</u> | <u>(1,517,641)</u> |
| Balance, end of year | <u>\$ 493,445</u> | <u>\$ 1,302,537</u> |

In fiscal year 2005, HHSC received a pledge from an affiliated foundation of \$1,818,840 to build a new radiation therapy unit at Kona Community Hospital.

13. PURCHASE OF CLINIC ASSETS

In December 2004, the Facility purchased certain assets of a clinic operated by certain physicians for \$360,000. The assets purchased included office equipment, supplies, a trademark/service mark, and non-compete agreements for two physicians. No existing liabilities of the clinic were assumed. Since the purchase price exceeded the estimated fair value of the purchased assets, goodwill of \$243,000 was recorded. The non-compete agreements were valued at \$55,000 and are being amortized over the three-year period of the agreements.

In connection with the purchase, the Facility paid cash of \$108,000 and signed two promissory notes to the former clinic owners totaling \$252,000. The cash was advanced from HHSC. The promissory notes require monthly payments of \$22,745 through January 2008, including interest at 5%. At June 30, 2006 and 2005, the balance of the long-term debt totaled \$151,638 and \$232,453, respectively.

14. VETERANS HOME

In fiscal years 2006 and 2005, HHSC received \$3,392,928 and \$5,169,021, respectively, from the State of Hawaii for construction of the new veterans' long-term care facility. Of this amount, \$5,034,822 was expended for planning, design, and construction costs, and is included in construction in progress in the consolidated statements of net assets. The remaining \$3,527,127 was expended to demolish an old, existing building on the campus site, and is included as a special item in the consolidated statements of revenues, expenses, and changes in net assets, due to the infrequent nature of such expenditures by HHSC.

15. SUBSEQUENT EVENT

On October 15, 2006, an earthquake with a magnitude of 6.7 occurred approximately 10 miles north-northwest of Kailua-Kona on the island of Hawaii. The earthquake and its subsequent aftershocks caused significant damage to the structure and fixtures at Kona Community Hospital, Hale Ho'ola Hamakua, and Kohala Hospital, forcing the temporary evacuation of some patients to other nearby facilities or hospitals. As of the date of this report, management cannot reasonably estimate the amount or the extent of the damage caused by the earthquake. Management expects that the majority of the costs of repairing the hospitals' facilities will be paid from a combination of proceeds from the State of Hawaii's property insurance policy and disaster relief assistance from the Federal Emergency Management Agency.

* * * * *

HAWAI HEALTH SYSTEMS CORPORATION

SUPPLEMENTAL SCHEDULE OF RECONCILIATION OF CASH ON DEPOSIT WITH THE STATE OF HAWAII JUNE 30, 2006

| | Appropriation Symbol | |
|--|-------------------------|---------------------|
| CASH ON DEPOSIT WITH THE STATE OF HAWAII: | | |
| SPECIAL FUNDS: | | |
| | S-93-359-H | \$ 2,818 |
| | S-94-396-H | 8,673 |
| | S-95-396-H | 19,636 |
| | S-96-359-H | 2,007 |
| | S-96-396-H | 9,039 |
| | S-97-359-H | 3,556 |
| | S-97-396-H | 182 |
| | S-98-396-H | 1,687 |
| | S-04-353-H | 168,185 |
| | S-04-358-H | 88,449 |
| | S-05-345-H | 1,556,866 |
| | S-05-350-H | 2,769,139 |
| | S-05-355-H | 62 |
| | S-06-303-H | 267,914 |
| | S-06-320-H | 16,126 |
| | S-06-351-H | 251,323 |
| | S-06-352-H | 185,243 |
| | S-06-355-H | 3,117,891 |
| | S-06-359-H | 549,593 |
| | S-06-365-H | 627,979 |
| | S-06-371-H | 534,573 |
| | S-06-373-H | 1,074,562 |
| | | |
| TRUST FUNDS: | | |
| | T-04-918-H | 1,272 |
| | T-04-921-H | 6,678 |
| | T-04-923-H | 4,129 |
| | T-05-906-H | 50 |
| | T-06-907-H | 183 |
| | T-06-915-H | 1,640 |
| | | |
| TOTAL PER STATE | | 11,269,455 |
| RECONCILING ITEMS | | <u>(98,226)</u> |
| TOTAL PER HHSC | | <u>\$11,171,229</u> |

(Continued)

HAWAI HEALTH SYSTEMS CORPORATION

SUPPLEMENTAL SCHEDULE OF RECONCILIATION OF CASH ON DEPOSIT WITH THE STATE OF HAWAII JUNE 30, 2006

| | Appropriation Symbol | |
|---|---------------------------------|-------------------|
| ASSETS LIMITED AS TO USE: | | |
| PATIENT TRUST FUNDS: | | |
| | T-04-911-H | \$ 22,912 |
| | T-04-919-H | 1,044 |
| | T-06-915-H | 12,763 |
| | T-06-925-H | 109,269 |
| | T-06-926-H | <u>9,396</u> |
| TOTAL PER STATE | | 155,384 |
| RECONCILING ITEMS: | | |
| Patients' safekeeping deposits held by financial institutions | | 224,673 |
| Restricted net assets held by financial institutions | | 430,602 |
| Other | | <u>61,574</u> |
| TOTAL PER HHSC | | <u>\$ 872,233</u> |

(Concluded)

HAWAII HEALTH SYSTEMS CORPORATION

SUPPLEMENTAL COMBINING AND CONSOLIDATING STATEMENT OF NET ASSETS INFORMATION
 JUNE 30, 2006

| ASSETS | Facilities | | | | | | | | | | | | | Corporate | Reclassifications and Eliminations | HHSC Combined | Hawaii Health Systems Foundation | Aili Community Care | Reclassifications and Eliminations | HHSC Consolidated | | |
|---|---------------------|-------------------------|------------------------------|---------------|---------------|----------------------------------|-----------------------------------|---------------------|-----------------|----------------|--------------|--------------------------|---------------------------------|----------------|------------------------------------|------------------|----------------------------------|---------------------|------------------------------------|-------------------|------------------|--|
| | 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 | Yukio Okutsu Veterans Care Home | | | | | | | | Total Facilities | |
| CURRENT ASSETS | | | | | | | | | | | | | | | | | | | | | | |
| Cash and cash equivalents: | | | | | | | | | | | | | | | | | | | | | | |
| On deposit with the State of Hawaii | \$ 2,769,139 | \$ 1,556,866 | \$ 3,117,953 | \$ 191,921 | \$ 524,573 | \$ 536,638 | \$ 314,221 | \$ 252,645 | \$ 168,185 | \$ 707,932 | \$ 627,979 | \$ 88,449 | \$ - | \$ 10,866,501 | \$ 304,728 | \$ - | \$ 11,171,229 | \$ - | \$ - | \$ - | \$ 11,171,229 | |
| On deposit with banks and on hand | 131,545 | 160,258 | 148,470 | 48,950 | 37,793 | 351,368 | 40,922 | 10,482 | 44,399 | 355,175 | 216,674 | 28,835 | - | 1,574,871 | 13,931,290 | - | 15,506,161 | 686,667 | 124,913 | - | 16,317,741 | |
| Patient accounts receivable - less allowances for contractual adjustments and doubtful accounts | 11,081,612 | 8,383,190 | 23,351,298 | 566,686 | 3,080,162 | 3,474,985 | 2,181,655 | 1,125,832 | 477,392 | 2,860,050 | 1,941,502 | 282,046 | - | 58,806,410 | - | - | 58,806,410 | - | - | - | 58,806,410 | |
| Supplies and other current assets | 2,068,647 | 2,153,820 | 3,483,650 | 67,392 | 240,881 | 735,553 | 112,131 | 100,053 | 32,526 | 789,801 | 481,144 | 83,724 | - | 10,349,322 | 32,070 | - | 10,381,392 | - | 9,024 | - | 10,390,416 | |
| Total current assets | 16,050,943 | 12,254,134 | 30,101,371 | 874,949 | 3,893,409 | 5,098,544 | 2,648,929 | 1,489,012 | 722,502 | 4,712,958 | 3,267,299 | 483,054 | - | 81,597,104 | 14,268,088 | - | 95,865,192 | 686,667 | 133,937 | - | 96,685,796 | |
| DUE FROM AFFILIATES - Net | | | 7,350,645 | | | | | | | | | | | 7,350,645 | 222,403,935 | (220,499,447) | 9,255,133 | | | (9,255,133) | - | |
| CAPITAL ASSETS - Net | 38,541,115 | 28,819,224 | 87,061,065 | 1,174,536 | 4,379,046 | 14,806,216 | 5,043,263 | 13,025,643 | 1,976,527 | 5,408,313 | 4,410,108 | 876,449 | 5,062,484 | 210,583,989 | 10,580,703 | - | 221,164,692 | | 289,956 | | 221,454,648 | |
| ASSETS LIMITED AS TO USE: | 39,609 | 30,152 | 194,654 | 14,251 | 63,814 | 42,543 | 64,260 | 14,473 | 20,760 | 136,924 | 72,903 | 453 | - | 694,136 | - | - | 694,136 | 178,097 | - | - | 872,233 | |
| OTHER ASSETS | 1,430,732 | 500,831 | 726,507 | 24,459 | 20,410 | 270,500 | - | 29,257 | 28,687 | - | - | - | - | 3,030,783 | 97,822 | - | 3,128,605 | - | - | (97,822) | 3,030,783 | |
| TOTAL | \$ 56,061,799 | \$ 41,604,341 | \$ 125,434,242 | \$ 2,088,195 | \$ 8,356,679 | \$ 20,217,803 | \$ 7,756,452 | \$ 14,558,385 | \$ 2,747,816 | \$ 10,258,195 | \$ 7,750,310 | \$ 1,359,956 | \$ 5,062,484 | \$ 203,256,657 | \$ 247,350,548 | \$ (220,499,447) | \$ 330,107,758 | \$ 864,764 | \$ 423,893 | \$ (9,352,955) | \$ 322,043,460 | |

(Continued)

INDEPENDENT AUDITORS' REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING AND COMPLIANCE AND OTHER MATTERS 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, 2006 and 2005, and have issued our report thereon dated December 8, 2006. 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.

Internal Control over Financial Reporting

In planning and performing our audits, 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. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control over financial reporting that might be material weaknesses. 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. We noted no matters involving the internal control over financial reporting and its operation that we consider to be material weaknesses.

Compliance and Other Matters

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.

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

Deloitte & Touche LLP

December 8, 2006