HAWAII HEALTH SYSTEMS
CORPORATION
"Touching Lives Everyday"

January 11, 1999

CFO-99-003

The Honorable Benjamin J. Cayetano
Governor of Hawaii
Office of the Governor
State of Hawaii
Honolulu, Hawaii 96813

Dear Governor Cayetano:

We appreciate the opportunity to submit the annual report of the Hawaii Health Systems Corporation (HHSC) to the Legislature of the State of Hawaii. Thanks to the hard work of our employees, medical staff, advisors, Board of Directors, union partners, and many other stakeholders, coupled with support from our legislators, we have had many successes this past year, resulting in a FY '98 audited accrual loss of $17.7 million compared to audited losses of $46 million, $35 million, and $31 million for the previous three respective FYs of '97, '96, and '95. We are also making major headway reducing our outstanding accounts receivable to levels that approximate aggressive health care standards. In addition, HHSC has established a world class telemedicine system, including full motion video, throughout all of our facilities that allows us access to all other major facilities in Hawaii and also to other nations in the Pacific Rim, the U.S. Mainland, and beyond. These dramatic operational improvements and leveraging of technology have been accomplished through partnership in the State of Hawaii Telehealth Access Network (STAN). Thus, HHSC has actually enhanced services, through improved quality, access, cost, and customer focus on the care we provide to the communities we serve.

HHSC is a public hospital system and, as such, depends heavily on input and support from our local communities. Hundreds of community volunteers State-wide donate nearly 100,000 service hours to our facilities. Attached is a by-facility report that details the donations of time and money from our communities in support of our facilities. In accordance with H.R.S. Section 323F-22, we are pleased to enclose optional annual reports from all five of our Public Health Facility Management Advisory Committees (PHFMACs): East Hawaii, West Hawaii, Maui, Kauai, and Oahu. The continuing advise and support of the PHFMACs and our Physicians Advisory Group (PAG), which has also submitted an annual report, are tremendously important to the successful functioning of our system.

In addition to the significant operational improvements that HHSC has achieved in the fiscal year ending June 30, 1998, we also significantly improved financial management and accounting throughout the corporation. For the previous fiscal year ending June 30, 1997, the system received qualified audit opinions, with a significant number of material weaknesses being noted. The audit report enclosed, in accordance with H.R.S. Section 323F-22, for the fiscal year ending June 30, 1998, is an unqualified audit opinion (what can be referred to as a "clean audit"), with no material weaknesses being reported at the Corporate level or for any of our twelve individual facilities (with the exception of Year 2000 issues now noted on all governmental entity audits). The awarding of a corporate-wide audit contract to a single contractor has standardized the evaluation of our facilities and has resulted in a plainly stated report that clearly delineates the fiscal status of HHSC and its individual facilities.

Enclosed for your additional reference is An Introduction and Overview of the Hawaii Health Systems Corporation that discusses the accomplishments of the system over the past year and describes the challenges still facing us.

If you have any questions, please call me personally at 733-4151.

Most sincerely,

Tom Driskill

THOMAS M. DRISKILL, JR.
President and Chief Executive Officer
Hawaii Health Systems Corporation

Enclosures:
1. HHSC Facility Community Support
2. PHFMAC Reports for East Hawaii, West Hawaii, Maui, Kauai, and Oahu
3. PAG Report
4. Annual Audit Report: Financial Statements and Supplemental Information for the Year Ended June 30, 1998 and Independent Auditors' Reports
5. An Introduction and Overview of the Hawaii Health Systems Corporation

HHSC FACILITY COMMUNITY SUPPORT

Community support has played an integral role in enhancing the mission of the Hawaii Health Systems Corporation (HHSC); each community is diligently working together with HHSC to ensure the continuance of quality healthcare provided by its respective facility. Numerous community groups and individuals have generously contributed their time and expertise to serve the health needs of their respective communities. There are close to 1,000 active volunteers who contribute nearly 100,000 volunteer service hours each year for the combined facilities. Community improvement projects include:

EAST HAWAII REGION

- **Hilo Medical Center**
  - 200 active volunteers
    - Nearly 23, 400 volunteered service hours each year
    - HMC Auxiliary raises $25,000 annually
  - Hilo Medical Center Foundation
    - Raised, since inception, more than $69,000 via community contributions and grants

- **Hale Ho'ola Hamakua**
  - 23 active volunteers
    - Nearly 6,150 volunteered service hours each year

- **Kau Hospital**
  - 10 active volunteers
    - Nearly 1,050 volunteered service hours each year
  - Sun Deck Project
    - Donated materials and labor - $15,000 est. project cost

WEST HAWAII REGION

- **Kona Community Hospital**
  - 24 active volunteers
    - Nearly 3,550 volunteered service hours each year
  - Birthing Unit Renovation Project
    - Community donations – Over $200,000 raised
    - Kona Community Health Fair – Over $10,000 raised
  - Cable Television Service - $4,000 value donated by Sun Cable
  - Adopt-A-Room Renovation Project
    - Supplies and man-hours donated to repaint over 30 rooms

- **Kohala Hospital**
  - 45 active volunteers
    - Nearly 3,000 volunteered service hours each year
  - Employee Parking Lot Project
    - Free labor. donated equipment and material - $6,000
  - Emergency Room Renovation Project
    - $3,000 furnishing purchase by Kohala Advisory Committee
  - Sidewalk Stripping Project
    - Donated time and labor of Kohala Eagle Scouts - $500
  - Auxiliary Medical Equipment Purchases – over $7,500

KAUAI REGION

- **Kauai Veterans Memorial Hospital**
  - 21 active volunteers
    - Nearly 1,425 volunteered service hours each year
    - Auxiliary raised more than $123,800 in 1998
  - Auxiliary Gift Shop Project
    - Donated labor, equipment and material - $6,000
  - KVMH Foundation
    - Nine-member committee formed

- **Samuel Mahelona Memorial Medical Center**
  - 38 active vounteers
    - Nearly 11,700 volunteered service hours each year
    - Auxiliary raises more than $15,000 annually
    - $4,000 donates from AlohaCare
  - Pavilion Awning Project
    - Donated materials - $5,000 est. project cost
  - Long-Term Care Upgrading and Refurbishing
    - Donated materials - $9,.000 est. project cost (on-going)

MAUI REGION

- **Maui Memorial Medical Center**
  - 119 active volunteers
    - Nearly 18,000 volunteered service hours each year
    - Auxiliary raises more than $50,000 annually
  - MMMC Charitable Foundation
    - $1,500 donation for cancer treatment support
    - $500 donation from Patterson Maternal & Child Fund

- **Kula Hospital**
  - 48 active volunteers
    - Nearly 5,650 volunteered service hours each year

- **Lanai Community Hospital**
  - 20 active volunteers
    - Nearly 750 volunteered service hours each year

OAHU REGION

- **Leahi Hospital**
  - 346 active volunteers
    - Nearly 14,200 volunteered service hours each year

- **Maluhia**
  - 62 active volunteers
    - Nearly 10,900 volunteered service hours each year
    - Gift Shop raises more than $10,000 per year

Maui Region Public Health Facility Management Advisory Committee
Hawaii Health Systems Corporation
Annual Report to the Hawaii State Legislature
December, 1998

Thank you for the opportunity to provide this report. We have been extremely impressed with the new Chief Executive Officer of the Hawaii Health Systems Corporation (HHSC), Thomas Driskill, Jr. Mr. Driskill has been a savior to the Corporation and the Board of Directors.

The Maui MAC has seen over-all system wide improvements in various areas of operations. The MAC is now a recognized body to the Board and able to provide input. The make up of the Board of Directors is now more equitable. The Physician's Advisory Group (PAG) was created and has provided positive networking between the medical staff and HHSC leadership. Currently, the PAG Board member is appointed by the Executive MAC, this should be re-visited, appointment should be made by the Physician's Advisory Group. The Corporation has done well making the system financially viable. Days in accounts receivable have improved considering the National average subsidy of 15% and HHSC receiving just 5% subsidy.

There will always be a need for legislative support especially for the long-term care facilities that cannot generate the income necessary to survive. We ask that you consider 10% State funding to ensure quality care and services. Act 262 mandates the provision of care to the community without any changes to current services making it impossible to function, and provide services, without legislative support.

I have attached a listing of the Capital Improvement Projects needed for the Maui Region for your consideration. Additionally, we are hopeful that funding will be provided for the pay raise that was granted prior to the formation of HHSC.

Respectfully Submitted:

Herbert Sakakihara
Maui Region MAC Chairman

East Hawaii PHFMAC
Hawaii Health Systems Corporation
December, 1998

Annual Report: To the Hawaii State Legislature:

Thank you for the opportunity to say a few words. This past year has continued to be a learning experience for the volunteer members of the MAC. We are not only learning what issues we should and should not be involved in, but we are learning about the process of change that occurs when a government run agency turns into a private run one.

We see some over-all, system wide improvements in many areas of operation. Accounts receivable time shortened, contractual matters handled more efficiently, huge savings in combined purchases and other such matters. At the same time, we see the difficulty of trying to accomplish this, while continuing to provide health services, particularly in the rural areas. It is quite a challenge you have laid before HHSC....that is to be more efficient, while at the same time, continuing to provide the services as before. Rural areas have become accustomed to having these services provided in a certain manner, and it will take much discussion and education on everyone's part to change the manner in which it is delivered.

The Legislature needs to understand that there will always be a need for some subsidy because of the facilities, particularly long term care, that cannot generate the income necessary to run them at a break even point.

We see the HHSC employees still in a period of transition. They are not fully private yet and still subject to the "old" State rules and while there is some betterment's under the new personnel rules it is understandable that the employees want the security provided by the State rules.

There are many local, issues that have come up and have been handled in ways, some of which was fine, and others, needed to be improved. We have chosen not to get into these in this report. We do feel that progress has been made, but there are many hurdles yet to cross and overcome.

Robert E. Cooper

Robert E. Cooper, Chair
East Hawaii MAC

WEST HAWAII PUBLIC HEALTH FACILITY MANAGEMENT ADVISORY COMMITTEE

REGIONAL INPUT FOR ANNUAL REPORT TO THE LEGISLATURE DECEMBER 1998

The West Hawaii Regional MAC is responsible for representing the community in an advisory capacity to the CEO of the Hawaii Health Systems Corporation (HHSC) which pertains to the health and safety of the residents and visitors who utilize the Kona Community Hospital and the Kohala Hospital. This includes the formulation of operational and CIP budgets, planning, construction, improvement, maintenance and operation of the public health facilities mentioned above.

We meet every month as a region and are utilizing the videoconference capabilities of the hospitals, which is working very well and eliminates hours traveling by car between Kohala and Kona for the meetings.

The chairs of the five regional MACs meet every month and appreciate the amendments made to ACT 262 last Legislative Session which included appointment of the Chair of the Executive MAC to the HHSC corporate board.

It should be noted that the West Hawaii Region is larger than the islands of Kauai, Oahu and Maui combined and this contributes to the "rural" atmosphere and isolation felt by the residents. However, their comfort zone is knowing that these two public health facilities are open and available to them.

It is our observation that the HHSC is working very hard to live within budget, but two factors require continued financial support from the legislature:

1) Aging facilities which must be upgraded and maintained;
2) Civil Service and union employees which involves workman compensation residuals, retirement benefits, negotiated pay raises and sick leave allowances.

Because the corporation has no control over these two factors it is our recommendation that keeping the state facilities open and available must be a top priority, provided that the corporation continues to exercise tight fiscal integrity.

We are also concerned about the impact of Y2K and how that will affect the ability of the hospitals to function if the federal, state, county and private computer systems are not ready for the year 2000.

We would like to request that the legislature look at the recent HMSA multi-million dollar rebate which was given back to employers but **not** to providers. Since HMSA is the major financial player for health reimbursement in the state, it would appear that if the rebate were given to providers, it could lower the cost of care to the public and also lower the financial support needed for the state hospitals. Are the HMSA premiums too high, or the reimbursement to providers too low? How does this affect health care?

The West Hawaii MAC has been involved with numerous activities, i.e., Kona Community Health Fair, sponsored by Kona Community Hospital and Hospital Auxiliary, which are helping the residents to become more aware that the state facilities need their support.

We do appreciate the support and compassion of the legislature for the continued operation of the state hospital facilities. We would be happy to provide more details or meet with you at your request.

Aloha a nui loa,

Virginia Isbell

Virginia Isbell
Chair, West Hawaii Regional MAC
P.O. Box 926 Kealakekua, Hi. 96750
Phone 323-2565 FAX 323-2920

evr

Public Health Facilities Management Advisory Committee Annual Report 1998

At the close of FY 97-98 HHSC is a much different organization than it was at its inception. A corporate identity and structure is evolving, that we in the PHFMAC Kaua`i Region believe will allow HHSC, to effectively manage the fifth largest hospital system in the nation. This system generates approximately 95% of its operating budget. It provides an acute care medical infrastructure for the residents and visitors of Kaua`i, Lanai, Maui and Hawai`i, encompassing 85% of the area of the state. PHFMAC Kaua`i sees the impact of HHSC facilities extending beyond medical services. Indeed the West Kauai Medical Center / KVMH and Samuel Mahelona Hospital are seen as essential and not optional parts of the infrastructure necessary for continued economic development in the communities of Kaua`i.

The PHFMAC Kaua`i is confident, in its judgment, that its facilities have undertaken and accomplished all the measures necessary to minimize the costs of providing service. Regionalization accomplished in FY 97-98, promises to further enhance savings, through staged consolidation of shared administrative functions. However, there are a number of labor and other issues, beyond HHSC control, that the legislature will need to resolve or ameliorate in this next session, in order for HHSC to move quickly on the road to self-sufficiency. Our communities are well aware of the fiscal constraints faced by the State of Hawaii. Its also clear that cost cutting and cost shifting alone will not make HHSC self sufficient. Revenue improvement is essential and quality of service cannot be compromised.

The 1998 legislative session should have made it clear that neighbor island citizens can be highly motivated and united when the issues, goals and actions needed are clear. Sensing a real threat to the continuation of services at KVMH and SMMH, community members created the Coalition to Preserve Rural Health Care, that grew to include communities state wide served by HHSC facilities. They were successful in maintaining legislative oversight of HHSC in the area of change of medical service and in securing support for needed HHSC funding. In addition, legislation was accomplished that allowed the addition of a PHFMAC member and PAC (Physicians Advisory Committee) member on the HHSC board. The ability to articulate community concerns and priorities and have physician input on clinical issues will allow HHSC to respond more quickly and effectively to the needs of the community and changing economics.

In 1996, it became clear to West Side communities that they would have to develop their own plan of action to turn things around for itself and its hospital. A plan gradually evolved, initiated by the Community Advisory Board of KVMH. The plan created a community based physicians group focused on the development and enhancement of primary care services in the community. Financing for the project was accomplished with a one-million dollar loan taken by the West Kaua`i Community Development, secured by its tangible assets and guarantees by HHSC and the USDA. The Ohana

Physicians Group was selected by the West Kaua`i CDC to provide physician services for the project. We expect full implementation in the next 12 months.

A needs assessment subsequently revealed that Kaua`i residents wanted more primary medical services available in their communities. Plans were implemented to develop a primary care clinic at SMMH, to take advantage of this opportunity. Other services and alliances with the Kaua`i Region include the St. Francis dialysis unit at the West Kaua`i Medical Center and projects with the Rehabilitation Hospital of the Pacific and Clinical Laboratories. The acquisition of full time radiology at KVMH has allowed imaging service development beyond routine plane film to CT scan, mammography and fluoroscopy. The radiology coverage now includes SMMH. The professional staff and community continue to seek opportunities to improve and expand services for the community. Having ones back against the wall is good for innovation.

The business community of West Kaua`i has become more proactive in its support of the West Kaua`i Medical Center/KVMH. Key businesses have chosen their employee health coverage provider based not only on the quality of benefits, but also because KVMH is the preferred provider. Businesses and the community understand that quality medical services impact economic development as well as health.

The Kaua`i Region of HHSC continues to make strides in the improvement of its fiscal position while improving the quality of the services it provides. The bottom line today is not where many would like it. However investment in the groundwork being laid will soon make that objective a reality. The PHFMAC Kaua`i supports the Kauai Regions innovative strategies that will make it an even more valued part of HHSC.

Hawaii Health Systems Corporation
Physician's Advisory Group
Annual Report to Hawaii State Legislature
1998 In Review

This past year, the elected Physician leaders of the HHSC Physician's Advisory Group contributed as a medical consultation body for a variety of medical related issues. These included:

1. Corporate Strategic Planning.
2. Standardization of inventory and pharmaceuticals for cost savings.
3. System-wide immunization requirements for health care workers.
4. System-wide sharing of emergency anti-HIV medication.
5. Centralized credentials verification.
6. Interhospital peer review (which especially benefits our more rural facilities).
7. Potential for participation in alternative health care modalities.
8. Redesign of emergency transport services.
9. Clinical applications of our telemedicine system.

1998 saw a major stride by HHSC in increasing the involvement of key stakeholders including physicians, union employees and the community. There has been an improved understanding by the legislature of what HHSC stands for and where it is going through strategic planning. For the first time, a practicing physician from our medical staff was appointed to the HHSC Board of Directors. As physicians, we hope that in 1999 the mission, vision and goals of HHSC will be shared not only by our physician leaders, but by all of our 360 plus medical staff membership.

We would like to thank CEO Tom Driskill, his Executive Management Team, the Regional CEOs and their administrative staffs, and the Regional Management Advisory Committees for their collaboration and support in 1998. We look forward to 1999.

Sincerely

T. Manoukian.

Anthony Manoukian, M.D.
HHSC Physician's Advisory Group

HAWAII HEALTH SYSTEMS CORPORATION

Financial Statements and Supplemental Information for the Year Ended June 30, 1998 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 financial statements of Hawaii Health Systems Corporation (HHSC) as of and for the year ended June 30, 1998 and the independent auditors' report thereon.

SCOPE OF THE AUDIT

The audit was required to be performed in accordance with generally accepted auditing standards and *Government Auditing Standards*. 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.

ORGANIZATION OF THE REPORT

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

- The first section presents this introduction.
- The second section presents the financial statements of HHSC as of and for the year ended June 30, 1998 and the independent auditors' report thereon. This section also presents supplemental financial information.
- The third section presents the independent auditors' report in accordance with *Government Auditing Standards* on HHSC's internal control structure and compliance with laws and regulations.

INDEPENDENT AUDITORS' REPORT

Board of Directors of Hawaii Health Systems Corporation:

We have audited the accompanying statement of financial position of Hawaii Health Systems Corporation (HHSC) as of June 30, 1998, and the related statements of operations - unrestricted funds, changes in fund balances, and cash flows - unrestricted funds for the year then ended. These financial statements are the responsibility of HHSC's management. Our responsibility is to express an opinion on these financial statements based on our audit.

Except as discussed in the following paragraph, we conducted our audit in accordance with generally accepted auditing standards and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

Governmental Accounting Standards Board Technical Bulletin 98-1, *Disclosures about Year 2000 Issues*, requires disclosure of certain matters regarding the year 2000 issue. HHSC has included such disclosures in Note 9. Because of the unprecedented nature of the year 2000 issue, its effects and the success of related remediation efforts will not be fully determinable until the year 2000 and thereafter. Accordingly, insufficient audit evidence exists to support HHSC's disclosures with respect to the year 2000 issue. Further, we do not provide assurance that HHSC is or will be year 2000 ready, that HHSC's year 2000 remediation efforts will be successful in whole or in part, or that parties with which HHSC does business will be year 2000 ready.

In our opinion, except for the effects of such adjustments, if any, as might have been determined to be necessary had we been able to examine evidence regarding year 2000 disclosures, such financial statements present fairly, in all material respects, the financial position of HHSC at June 30, 1998 and the results of its operations and the cash flows of its unrestricted funds for the year then ended in conformity with generally accepted accounting principles.

As discussed in Note 1, in fiscal 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, 1998, negotiations between the State and HHSC relating to the transfer of assets and liabilities (including amounts due to the State) were on-going. Accordingly, the assets, liabilities and fund balances reflected in the accompanying statement of financial position at June 30, 1998 may be significantly different from those eventually included in the final settlement.

Our audit was conducted for the purpose of forming an opinion on the basic financial statements taken as a whole. The supplemental information on pages 18 and 19 is presented for the purposes of additional analysis and is not a required part of the basic financial statements. The supplemental combining schedules on pages 20 through 22 are presented for the purpose of additional analysis of the basic financial statements rather than to present the financial position and results of operations of individual facilities, and are not a required part of the basic financial statements. This supplemental information is the responsibility of HHSC's management. Such information has been subjected to the auditing procedures applied in our audit of the basic financial statements and, in our opinion, is fairly stated in all material respects when considered in relation to the basic financial statements taken as a whole.

In accordance with *Government Auditing Standards*, we have also issued a report dated November 23, 1998 on our consideration of HHSC's internal control over financial reporting and our tests of its compliance with certain provisions of laws, regulations, contracts and grants.

November 23, 1998

HAWAII HEALTH SYSTEMS CORPORATION

STATEMENT OF FINANCIAL POSITION
JUNE 30, 1998

ASSETS

CURRENT ASSETS:	
Cash and cash equivalents	
On deposit with State of Hawaii	$ 3,948,952
On deposit with banks and on hand	14,824,070
Total cash and cash equivalents	18,773,022
Patient accounts receivable - less allowances of $68,574,063 for contractual adjustments and doubtful accounts	39,195,319
Supplies and other current assets	6,357,801
Total current assets	64,326,142
PROPERTY, PLANT AND EQUIPMENT - Net (Note 3)	144,071,470
ASSETS LIMITED AS TO USE (Notes 1 and 8)	4,792,454
TOTAL	$213,190,066

LIABILITIES AND FUND BALANCES

CURRENT LIABILITIES:	
Accounts payable and accrued expenses	$ 17,254,294
Accrued vacation	16,794,576
Accrued workers' compensation liability (Note 7)	20,000,000
Estimated third-party payor settlements	7,551,350
Patients' safekeeping deposits	421,917
Capital lease obligations - current portion (Note 4)	1,702,965
Other current liabilities	1,419,157
Total current liabilities	65,144,259
CAPITAL LEASE OBLIGATIONS - Less current portion (Note 4)	2,647,083
DUE TO STATE OF HAWAII	20,115,465
Total liabilities	87,906,807
FUND BALANCES:	
Unrestricted:	
Board-designated (Note 8)	3,000,000
Other	120,912,722
Total unrestricted	123,912,722
Restricted	1,370,537
Total fund balances	125,283,259
TOTAL	$213,190,066

See notes to financial statements.

HAWAII HEALTH SYSTEMS CORPORATION

STATEMENT OF OPERATIONS - UNRESTRICTED FUNDS
YEAR ENDED JUNE 30, 1998

OPERATING REVENUES:	
Net patient service revenues (Note 5)	$ 218,936,675
Other	2,817,224
Total operating revenues	221,753,899
OPERATING EXPENSES:	
Salaries and benefits	141,713,737
Medical supplies and drugs	20,395,242
Purchased services (Note 5)	16,925,228
Professional fees	15,369,996
Depreciation and amortization	9,760,293
Other supplies	9,306,298
Provision for doubtful accounts	8,324,675
Interest	506,602
Other	17,977,881
Total operating expenses	240,279,952
LOSS FROM OPERATIONS	(18,526,053)
NONOPERATING REVENUES (EXPENSES):	
Appropriations from the State of Hawaii	12,912,012
Write-off of investment in Hana Medical Center	(1,326,095)
Subsidy to Hana Medical Center	(923,988)
Other - net	2,115,963
Nonoperating revenues - net	12,777,892
EXCESS OF EXPENSES OVER REVENUES	$ (5,748,161)

See notes to financial statements.

HAWAII HEALTH SYSTEMS CORPORATION

STATEMENT OF CHANGES IN FUND BALANCES
YEAR ENDED JUNE 30, 1998

UNRESTRICTED FUNDS:	
Balance, beginning of year, as previously reported	$127,779,540
Prior-period adjustments, primarily workers' compensation liability (Note 10)	(8,896,926)
Balance at beginning of year, as restated	118,882,614
Excess of expenses over revenues	(5,748,161)
Property, plant and equipment contributed by State of Hawaii (Note 3)	10,778,269
Balance, end of year	$123,912,722
RESTRICTED FUNDS:	
Balance, beginning of year	$ 458,746
Restricted contributions	1,213,765
Transfers to unrestricted funds	(301,974)
Balance, end of year	$ 1,370,537

See notes to financial statements.

HAWAII HEALTH SYSTEMS CORPORATION

STATEMENT OF CASH FLOWS - UNRESTRICTED FUNDS
YEAR ENDED JUNE 30, 1998

OPERATING ACTIVITIES:	
Loss from operations	$(18,526,053)
Adjustments to reconcile loss from operations to net cash used in operating activities:	
Depreciation and amortization	9,760,293
Provision for doubtful accounts	8,324,675
Loss on sale of property	113,004
Change in operating assets and liabilities:	
Receivables	(2,084,296)
Supplies and other current assets	(1,709,544)
Assets limited as to use	(3,000,000)
Accounts payable, accrued expenses, and other liabilities	2,526,313
Accrued vacation	964,924
Accrued workers' compensation liability	2,891,165
Estimated third-party payor settlements	(6,905,299)
Other	(23,571)
Net cash used in operating activities	(7,668,389)
NONCAPITAL FINANCING ACTIVITIES:	
Appropriations from the State of Hawaii	12,912,012
Subsidy to Hana Medical Center	(923,988)
Other nonoperating revenues - net	1,223,781
Net cash provided by noncapital financing activities	13,211,805
CAPITAL AND RELATED FINANCING ACTIVITIES:	
Interest income	509,468
Capital expenditures	(4,611,504)
Repayments on capital lease obligations	(2,280,833)
Net cash used in capital and related financing activities	(6,382,869)
NET DECREASE IN CASH AND CASH EQUIVALENTS	(839,453)
CASH AND CASH EQUIVALENTS, BEGINNING OF YEAR	19,612,475
CASH AND CASH EQUIVALENTS, END OF YEAR	$ 18,773,022
SUPPLEMENTAL CASH FLOW INFORMATION:	
Interest paid, primarily on capital lease obligations	$ 506,602
Non-cash financing and investing activities:	
• Construction completed and in progress contributed by the State of Hawaii	10,778,269
• Interest capitalized on construction projects	382,714
• Equipment acquired under capital leases	449,244
• Write-off of investment in Hana Medical Center	1,326,095

See notes to financial statements.

HAWAII HEALTH SYSTEMS CORPORATION

NOTES TO FINANCIAL STATEMENTS
YEAR ENDED JUNE 30, 1998

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 an 11-member board of directors.

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

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

City and County of Honolulu:
- Leahi Hospital
- Maluhia

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

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

The Act became effective in fiscal 1997. 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 a component unit of the State of Hawaii. The accompanying financial statements relate only to HHSC and the facilities and are not intended to present the financial position of the Department of Health, the results of its operations, or the cash flows of its proprietary fund types in conformity with generally accepted accounting principles.

Negotiations between HHSC and the State relating to the transfer of assets and assumption of liabilities (including amounts due to the State) pursuant to Act 262 were continuing as of June 30, 1998. Accordingly, the assets, liabilities and fund balances of HHSC reflected in the accompanying statement of financial position may be significantly different from those eventually included in the final settlement.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Accounting - HHSC uses the proprietary fund method of accounting, which recognizes revenues and expenses on the accrual basis.

Financial Statement Presentation - The accompanying financial statements are presented in accordance with the pronouncements of the Government 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 financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from 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, 1998 is indicated in the accompanying statement of financial position as "Cash on deposit with 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 also has cash in financial institutions which is in excess of available depository insurance coverage.

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

Property, Plant and Equipment - Property, plant and equipment are recorded at cost or estimated fair market value at the date of donation. Donated buildings, equipment and land are considered additions to the permanent capital of HHSC and, therefore, are credited directly to the unrestricted fund balance. 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 property, plant and equipment are reflected in other nonoperating revenues. Normal repairs and maintenance expenses are charged to operations as incurred.

Depreciation and amortization is provided using the straight-line method over the estimated useful lives of the assets.

HHSC's capital improvement projects are managed by the State Department of Accounting and General Services. The related costs are transferred to HHSC's property, plant and equipment accounts as a contribution of capital as costs are incurred.

Assets Limited as to Use - Assets limited as to use are restricted funds, board-designated funds, and patient trust funds. Patient trust funds represent funds received, or property belonging to the facilities' 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. In addition, such assets also include restricted contributions.

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 the rate of one and three quarters working days for each month of service. Vacation days may be accumulated to a maximum of 90 days.

Net Patient Service Revenues - Net patient service revenues are recorded on an accrual basis in the period in which the related services are provided at established rates, less contractual adjustments. HHSC, as a safety net provider, provides charity care to certain patients; the specific cost of such care is not determinable for the year ended June 30, 1998.

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

The estimated third-party payor settlement accrual of $7,551,350 as of June 30, 1998 is based on estimates, as complete information is not currently available to determine the final settlement amounts for certain cost report years. Management has used its best efforts, judgment, and certain methodologies to estimate the anticipated final outcome.

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

- ***Medicare*** - Inpatient acute services rendered to Medicare program beneficiaries are paid at prospectively determined rates per discharge. These rates vary according to a patient classification system that is based on clinical, diagnostic and other factors. Inpatient non-acute services, outpatient 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 are subject to an independent review by peer review organizations under contract with HHSC. HHSC's Medicare cost reports have been audited by the Medicare fiscal intermediary through fiscal 1996.

- ***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. HHSC's Medicaid cost reports have been audited by the Medicaid fiscal intermediary through fiscal 1996.

- ***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.

Donations - Restricted donations are recorded as additions to restricted funds. Resources restricted for specific operating purposes are transferred to the unrestricted fund and reflected as other operating revenues to the extent expended by the unrestricted fund during the year. Funds which are restricted for property expenditures are transferred from the restricted fund to the unrestricted fund to the extent expended within the year.

Unrestricted donations are recorded as nonoperating revenues.

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.

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 7.

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, 1998 was as follows:

Medicare	22%
Medicaid	21
HMSA	14
Other third-party payors	22
Patients and other	21
	100%

3. PROPERTY, PLANT AND EQUIPMENT

At June 30, 1998, property, plant and equipment consisted of the following:

Land and land improvements	$ 2,807,345
Buildings and improvements	169,014,172
Major moveable equipment	47,894,842
Fixed equipment	17,166,682
Construction in progress	14,192,444
	251,075,485
Less accumulated depreciation and amortization	(107,004,015)
Property, plant and equipment - net	$ 144,071,470

In 1998, the State Department of Accounting and General Services transferred property, plant and equipment, including construction in progress, aggregating $10,778,269 to HHSC as a contribution of capital.

4. CAPITAL LEASE OBLIGATIONS

The facilities lease equipment under capital leases which expire on various dates through fiscal 2004. Future lease payments as of June 30, 1998 were as follows:

Year ended June 30:	
1999	$ 1,994,771
2000	1,731,484
2001	675,414
2002	325,961
2003	162,607
Thereafter	8,392
Total future minimum payments	4,898,629
Less amount representing interest	(548,581)
Total capital lease obligations	4,350,048
Current portion	(1,702,965)
Noncurrent portion	$ 2,647,083

The cost of the leased equipment as of June 30, 1998 approximated $10,735,000, and the related accumulated depreciation was approximately $6,371,000.

5. FACILITY-BASED TECHNICAL SERVICE AGREEMENTS

HHSC has facility-based technical service agreements relating to certain ancillary services, such as pathology, laboratory, radiology, nuclear medicine, ultrasound, CT scan, anesthesiology, radiation therapy and oncology. 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 the charges. Amounts charged by the contractors are included in operating expenses in purchased services and aggregated approximately $16 million during fiscal 1998.

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

HHSC charges the contractors for use of the premises, supplies and laundry. These amounts are included in other operating revenues and aggregated approximately $1,530,000 during fiscal 1998.

6. EMPLOYEE BENEFITS

Defined Benefit Pension Plans

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

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

HHSC's contributions to the ERS for the years ended June 30, 1998, 1997 and 1996 approximated $14,552,000, $12,918,000, and $12,755,000, respectively, equal to the required contributions for each year.

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 Employee Retirement System, 201 Merchant Street, Suite 1400, Honolulu, Hawaii 96813-2929 or by calling (808) 586-1660.

Post-Retirement Health Care and Life Insurance Benefits

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

State statute to the actual cost of benefit coverage. HHSC pays for 100% of these benefits for employees who have at least 10 years of service. HHSC's share of the cost of these benefits is pro-rated for employees with less than 10 years of service. HHSC also reimburses Medicare expenses of retirees and qualified spouses (through the State of Hawaii) who are at least 62 years of age and have at least 10 years of service. HHSC's post-retirement benefits expense approximated $6,273,000 for the year ended June 30, 1998.

Sick Leave

Accumulated sick leave as of June 30, 1998 was approximately $26 million. 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 financial statements.

7. COMMITMENTS AND CONTINGENCIES

Professional Liability

HHSC maintains professional and general liability insurance with a private insurance carrier with a $40 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. HHSC has accrued a liability of $20 million for unpaid claims as of June 30, 1998.

Ceded Lands

The Attorney General of the State of Hawaii reported that an action was filed in 1994 by the Office of Hawaiian Affairs (OHA) against the State of Hawaii claiming the State's alleged failure to properly account 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. In May 1996, the Plaintiff filed certain motions for partial summary judgment as to the State's liability to pay OHA 20% of monies due from four specific sources, one of which included patient service receipts from three of HHSC's facilities. The State opposed Plaintiff's motions but on October 24, 1996, was denied dismissal by the First Circuit Court of Hawaii which granted OHA's motions for partial summary judgment.

The State filed an immediate appeal from the order denying its motion to dismiss to the Hawaii Supreme Court, and filed a second appeal from both orders after the Circuit Court granted the State permission to file an interlocutory appeal to the Hawaii Supreme Court. All other proceedings, including the trial previously scheduled to begin on November 18, 1996, were stayed pending the Hawaii Supreme Court's disposition of the two appeals. In April 1998, the Hawaii Supreme Court instructed the State and OHA to attempt to settle the dispute through negotiations. As of June 30, 1998, the State and OHA had agreed to enter into such negotiations.

The State is not able to estimate with reasonable certainty the magnitude of its potential loss, if any, nor its effect, if any, on HHSC. OHA's complaint and motions do not specify the State's alleged failures, nor do they state the dollar amount of the claims. OHA has not provided complete information for its claims for the period from 1981 through 1991, and has provided no information as to its claims for the period from 1991 to the present. The Circuit Court's October 24, 1996 order granting OHA's motions for partial summary judgment did not determine the amounts owing. The basis and methodology for calculating any such amount are disputed. The amount, if any, of the State's (or HHSC's) liability will not be determined until the Hawaii Supreme Court rules on the State's interlocutory appeal and, if the State is unsuccessful, after any subsequent trial and related appeals have been concluded.

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

Litigation

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

Asbestos Contamination

There is known asbestos contamination of the old hospital building located next to the Hilo Hospital facility. Present estimates by management to demolish the building and remediate the asbestos contamination approach $2 million or more. No decision has yet been made by HHSC on how to proceed on this issue.

The ultimate ownership of the old building is still in negotiation between the State of Hawaii and HHSC, since Act 262 did not specify which assets and liabilities would transfer to HHSC. In addition, no decision has been made to demolish the building. As such, a liability for the cost of the remediation has not been recorded in HHSC's financial statements.

8. BOARD-DESIGNATED FUNDS

As of June 30, 1998, HHSC's Board of Directors had designated cash reserves as follows:

For capital equipment acquisitions and/or equity investments for growth initiatives	$2,500,000
For settlement and extinguishment of residual workers' compensation claims	500,000
Total	$3,000,000

The designated funds are included in assets limited as to use and in the board-designated fund balance.

9. YEAR 2000 ISSUES (UNAUDITED)

The approach of the year 2000 presents significant issues for HHSC's financial, information, and operational systems and for equipment with imbedded microchips. These systems may not be able to appropriately interpret dates after December 31, 1999, because certain systems allow only two digits to indicate the year in a date. As a result, such systems are unable to distinguish January 1, 2000 from January 1, 1900, which could have adverse consequences on HHSC's operations and on the integrity of information processing, causing safety, operational, and financial issues. In addition, equipment with imbedded chips could malfunction at the turn of the century.

The following are the key components of HHSC's plan to address the year 2000 issues:

a) ***Written and Approved Plan*** - A plan has been developed that outlines HHSC's procedures for resolving the year 2000 issues. Such plan has been reviewed with senior management and the Board of Directors.

b) ***Personnel and Resources*** - A project team has been established with a Project Manager and seven supervisors for each of the project areas: Hardware, Applications, Desktop, Networks, External Interfaces, Biomedical Devices, and Facilities. In addition, external consultants have been engaged to support the project team.

c) ***Monitoring Progress*** - A process has been established for monitoring progress against the plan. A software program has been developed which includes expected completion dates for various phases of the projects.

d) ***Comprehensive Inventory*** - The plan includes a process for preparing a comprehensive inventory of financial, informational, operational systems, and equipment and services that are reliant on computer technology. The plan includes procedures to identify those mission critical systems that may be negatively impacted by year 2000 system deficiencies.

   As of the date of this report, the inventory was still in the process of being completed. The expected completion date is December 1998.

e) ***Strategy to Fix Critical Systems*** - HHSC's plan for fixing critical systems and equipment is either to upgrade or replace as considered necessary. A detailed schedule for problem resolution or system replacement is being developed for every critical system or item of equipment with year 2000 issues.

f) ***Timing of Compliance*** - HHSC expects all financial systems to be year 2000 compliant by June 1999, and all other systems, including biomedical devices and facilities, by September 1999. HHSC is uncertain as to the percentage of critical systems that are currently year 2000 compliant.

g) ***Testing*** - HHSC has not yet estimated the processing resources required for renovation and testing.

h) ***External Business Relationships*** - HHSC has not yet established procedures to determine that the systems of key vendors, service providers, and customers are year 2000 compliant. HHSC anticipates working on this area in January 1999.

i) ***Litigation/Regulations*** - HHSC is currently establishing procedures to mitigate its risk of litigation and noncompliance with government regulations as a result of year 2000 operating problems or product/service failures. HHSC's General Counsel is reviewing such procedures.

j) ***Contingency Plans*** - HHSC is developing contingency plans in the event that systems or equipment fail to function appropriately at the turn of the century.

k) *Oversight Responsibility* - A chain of command has been established for the year 2000 project. The reporting responsibility in ascending order is as follows: (1) Year 2000 Project Manager, (2) HHSC Vice President and Chief Information Officer, (3) Regional Chief Executive Officers' Information Systems Steering Committee, (4) HHSC Chief Executive Officer, and (5) HHSC Board of Directors.

l) *Cost* - The estimated cost of the year 2000 project has been included in HHSC's fiscal 1999 operating budget. Such cost is estimated to approximate $5,300,000.

10. PRIOR-PERIOD ADJUSTMENTS

In 1998, management determined that certain facts had been misinterpreted as of June 30, 1997 and, accordingly, recorded the following adjustments at July 1, 1997 to correct the errors:

Beginning fund balance, as previously reported	$ 127,779,540
Adjustments:	
Underaccrual of accrued workers' compensation	(8,784,161)
Other - net	(112,765)
Net decrease in unrestricted fund balance at July 1, 1997	(8,896,926)
Beginning fund balance, as restated	$ 118,882,614

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HAWAI HEALTH SYSTEMS CORPORATION

SCHEDULE 1 - SUPPLEMENTAL SCHEDULE OF RECONCILIATION OF CASH ON DEPOSIT WITH THE STATE OF HAWAII
JUNE 30, 1998

	Appropriation Symbol	
REPORTED AS CASH ON DEPOSIT WITH STATE OF HAWAII		
SPECIAL FUNDS:		
	S-92-312-H	$ 485
	S-92-354-H	16,195
	S-93-312-H	544
	S-93-350-H	28,334
	S-93-353-H	6,563
	S-93-359-H	14,134
	S-94-354-H	838
	S-94-355-H	2,023
	S-94-359-H	12,905
	S-94-396-H	8,673
	S-95-396-H	19,636
	S-96-312-H	469
	S-96-359-H	23,019
	S-96-396-H	9,040
	S-97-312-H	96,723
	S-97-350-H	3,918
	S-97-351-H	39
	S-97-352-H	17
	S-97-353-H	1,108
	S-97-354-H	33,284
	S-97-358-H	124
	S-97-359-H	5,877
	S-97-365-H	21,899
	S-97-371-H	52,082
	S-97-373-H	4,635
	S-98-303-H	783
	S-98-312-H	523,955
	S-98-350-H	4,754
	S-98-351-H	112,705
	S-98-352-H	623,366
	S-98-353-H	102,454
	S-98-354-H	285,235
	S-98-355-H	57,218
	S-98-358-H	275,611
	S-98-359-H	866,650
	S-98-365-H	123,300
	S-98-373-H	352,678
	S-98-396-H	1,371
TRUST FUNDS:		
	T-98-909-H	(273)
	T-98-909-H	6,275
	T-98-909-H	3,531
	T-98-914-H	28,757

HAWAI HEALTH SYSTEMS CORPORATION

SCHEDULE 1 - SUPPLEMENTAL SCHEDULE OF RECONCILIATION OF CASH ON DEPOSIT WITH THE STATE OF HAWAII (Continued)
JUNE 30, 1998

	Appropriation Symbol	
RECONCILING ITEMS:		
Disbursements recorded by State in June 1998; recorded by HHSC in July 1998		$ 165,436
Held in State Treasury for Hospital improvements		55,447
Other		(2,865)
TOTAL		$3,948,952

INCLUDED IN ASSETS LIMITED AS TO USE

	Appropriation Symbol	
GIFT FUNDS:		
	T-97-915-H	$ 21,597
	T-98-910-H	69,928
	T-98-911-H	22,040
	T-98-995-H	2,197
PATIENT TRUST FUNDS:		
	T-97-990-H	19,275
	T-98-920-H	4,292
	T-98-921-H	6,679
	T-98-925-H	97,471
	T-98-926-H	11,700
	T-98-983-H	5,980
	T-98-988-H	12,004
	T-98-989-H	10,122
	T-98-991-H	2,449
	T-98-992-H	68,984
	T-98-996-H	28,254
	T-98-997-H	73,113
PLANT IMPROVEMENT FUNDS:		
	S-87-361-M	13,375
	S-94-361-M	25,677
SPECIFIC-PURPOSE FUNDS	T-97-919-H	1,044
RECONCILING ITEMS:		
Cash held by financial institutions		56,255
Other		36,596
TOTAL		$ 589,032

HAWAII HEALTH SYSTEMS CORPORATION

SUPPLEMENTAL COMBINING STATEMENT OF FINANCIAL POSITION INFORMATION
JUNE 30, 1998

ASSETS	Facilities: Hilo Medical Center	Hale Ho'ola Hamakua	Ka'u Hospital	Kohala Hospital	Kona Community Hospital	Maui Memorial Medical Center	Kula Hospital	Lanai Community Hospital	Kauai Veterans Memorial Hospital	Samuel Mahelona Memorial Hospital	Leahi Hospital	Maluhia	Total Facilities	Corporate	Reclassifications and Eliminations	Total HHSC
CURRENT ASSETS:																
Cash and cash equivalents:																
On deposit with State of Hawaii	$ 65,763	$ 119,019	$ 626,369	$ 110,125	$ 335,552	$ 59,241	$ 151,205	$ 275,735	$ 916,461	$ 423,626	$ 681,154	$ 145,199	$ 3,909,449	$ 39,503		$ 3,948,952
On deposit with banks and on hand	480,483	27,226	(736)	42,128	852,596	814,303	37,988	22,000	21,560	20,550	452,710	329,120	3,099,928	11,724,142		14,824,070
Total cash and cash equivalents	546,246	146,245	625,633	152,253	1,188,148	873,544	189,193	297,735	938,021	444,176	1,133,864	474,319	7,009,377	11,763,645		18,773,022
Patient accounts receivable - less allowances for contractual adjustments and doubtful accounts	11,326,411	517,270	327,421	812,543	6,070,682	9,923,234	1,419,654	348,837	2,209,241	1,301,637	3,251,944	1,686,445	39,195,319			39,195,319
Due from affiliates - net	8,768,282	535,785			806,090	5,014,169					241,264		15,365,590	7,765,733	$ (23,131,323)	-
Supplies and other current assets	1,479,442	97,495	45,820	31,226	1,731,154	1,954,234	100,137	53,029	325,714	59,768	286,320	132,759	6,297,098	60,703		6,357,801
Total current assets	22,120,381	1,296,795	998,874	996,022	9,796,074	17,765,181	1,708,984	699,601	3,472,976	1,805,581	4,913,392	2,293,523	67,867,384	19,590,081	(23,131,323)	64,326,142
PROPERTY, PLANT AND EQUIPMENT - Net	25,116,043	16,604,548	1,107,523	881,891	20,329,418	41,759,403	5,873,089	630,601	10,683,044	4,793,326	9,956,729	4,552,143	142,287,758	1,783,712		144,071,470
ASSETS LIMITED AS TO USE	28,254	12,004	8,876	5,980	28,133	85,103	69,215	2,449	29,069	20,319	165,426	134,205	589,033	4,203,421		4,792,454
TOTAL	$ 47,264,678	$ 17,913,347	$ 2,115,273	$ 1,883,893	$ 30,153,625	$ 59,609,687	$ 7,651,288	$ 1,332,651	$ 14,185,089	$ 6,619,226	$ 15,035,547	$ 6,979,871	$ 210,744,175	$ 25,577,214	$ (23,131,323)	$ 213,190,066

HAWAII HEALTH SYSTEMS CORPORATION

SUPPLEMENTAL COMBINING STATEMENT OF FINANCIAL POSITION INFORMATION (Continued)
JUNE 30, 1998

	Facilities															
LIABIITIES AND FUND BALANCES	Hilo Medical Center	Hale Ho'ola Hamakua	Ka'u Hospital	Kohala Hospital	Kona Community Hospital	Maui Memorial Medical Center	Kula Hospital	Lanai Community Hospital	Kauai Veterans Memorial Hospital	Samuel Mahelona Memorial Hospital	Leahi Hospital	Maluhia	Total Facilities	Corporate	Reclassifi-cations and Elimi-nations	Total HHSC
CURRENT LIABILITIES:																
Accounts payable and accrued expenses	$ 4,390,606	$ 339,538	$ 228,381	$ 560,406	$ 1,981,979	$ 4,021,750	$ 602,178	$ 138,608	$ 950,019	$ 444,446	$ 1,287,608	$ 1,159,941	$ 16,105,460	$ 1,148,834		$ 17,254,294
Accrued vacation	3,496,751	422,764	183,492	283,666	1,762,460	4,142,210	1,172,231	238,613	1,019,909	1,065,605	1,299,387	1,464,176	16,551,264	243,312		16,794,576
Accrued workers' compensation liability	5,320,000	480,000	220,000	280,000	2,280,000	4,940,000	1,100,000	200,000	980,000	840,000	1,800,000	1,360,000	19,800,000	200,000		20,000,000
Due to affiliates			2,026,120	907,915			2,686,371	1,852,278	8,272,654	2,742,922		4,643,063	23,131,323		$ (23,131,323)	-
Estimated third-party payor settlements	816,193	206,282	8,021	304,484	567,709	2,440,271	107,974	230,099	553,001	550,915	1,608,785	157,616	7,551,350			7,551,350
Patients' safekeeping deposits	28,254	12,004	8,876	5,980	8,255		69,215	2,449	29,070	19,275	165,426	73,113	421,917			421,917
Capital lease obligations - current portion	712,952		13,976		148,994	681,375	4,143		96,986	7,790		23,467	1,689,683	13,282		1,702,965
Other current liabilities	1,171,124				52,634				171,817				1,395,575			1,395,575
Total current liabilities	15,935,880	1,460,588	2,688,866	2,342,451	6,802,031	16,225,606	5,742,112	2,662,047	12,073,456	5,670,953	6,161,206	8,881,376	86,646,572	1,605,428	(23,131,323)	65,120,677
CAPITAL LEASE OBLIGATIONS - Less current portion	1,212,568				313,820	782,011	23,582		283,291	7,047		27,370	2,649,689	20,976		2,670,665
DUE TO STATE OF HAWAII		506,153		528,149	7,605,205		1,114,264		1,036,303	2,417,150	6,416,791	491,450	20,115,465			20,115,465
Total liabilities	17,148,448	1,966,741	2,688,866	2,870,600	14,721,056	17,007,617	6,879,958	2,662,047	13,393,050	8,095,150	12,577,997	9,400,196	109,411,726	1,626,404	(23,131,323)	87,906,807
FUND BALANCES:																
Unrestricted:																
Board-designated														3,000,000		3,000,000
Other	30,116,230	15,946,606	(573,593)	(986,707)	15,412,693	42,516,967	771,330	(1,329,396)	792,039	(1,476,968)	2,457,550	(2,481,417)	101,165,334	19,747,388		120,912,722
Total unrestricted	30,116,230	15,946,606	(573,593)	(986,707)	15,412,693	42,516,967	771,330	(1,329,396)	792,039	(1,476,968)	2,457,550	(2,481,417)	101,165,334	22,747,388		123,912,722
Restricted					19,876	85,103				1,044		61,092	167,115	1,203,422		1,370,537
Total fund balances	30,116,230	15,946,606	(573,593)	(986,707)	15,432,569	42,602,070	771,330	(1,329,396)	792,039	(1,475,924)	2,457,550	(2,420,325)	101,332,449	23,950,810		125,283,259
TOTAL	$ 47,264,678	$ 17,913,347	$ 2,115,273	$ 1,883,893	$ 30,153,625	$ 59,609,687	$ 7,651,288	$ 1,332,651	$ 14,185,089	$ 6,619,226	$ 15,035,547	$ 6,979,871	$ 210,744,175	$ 25,577,214	$ (23,131,323)	$ 213,190,066

HAWAII HEALTH SYSTEMS CORPORATION

SUPPLEMENTAL COMBINING STATEMENT OF OPERATIONS - UNRESTRICTED FUNDS INFORMATION
YEAR ENDED JUNE 30, 1998

	Facilities															
	Hilo Medical Center	Hale Ho'ola Hamakua	Ka'u Hospital	Kohala Hospital	Kona Community Hospital	Maui Memorial Medical Center	Kula Hospital	Lanai Community Hospital	Kauai Veterans Memorial Hospital	Samuel Mahelona Memorial Hospital	Leahi Hospital	Maluhia	Total Facilities	Corporate	Reclassifi-cations and Elimi-nations	Total HHSC
OPERATING REVENUES:																
Net patient service revenues	$62,998,936	$5,323,457	$1,773,842	$2,401,499	$26,327,360	$74,049,497	$ 8,623,241	$ 947,037	$ 7,087,689	$ 5,684,996	$13,664,179	$10,054,942	$218,936,675			$218,936,675
Other	2,054,202	17,025	9,388	1,876	111,743	251,085	38,424		49,552	23,851	227,452	32,626	2,817,224			2,817,224
Total operating revenues	65,053,138	5,340,482	1,783,230	2,403,375	26,439,103	74,300,582	8,661,665	947,037	7,137,241	5,708,847	13,891,631	10,087,568	221,753,899			221,753,899
OPERATING EXPENSES:																
Salaries and benefits	36,324,460	3,385,178	1,542,640	2,021,671	15,930,347	35,826,867	7,760,477	1,407,326	6,875,057	5,885,175	12,542,646	9,597,695	139,099,539	$ 2,614,198		141,713,737
Medical supplies and drugs	6,337,036	317,242	76,359	90,761	4,355,790	6,385,523	414,894		659,611	236,146	1,051,762	470,118	20,395,242			20,395,242
Purchased services	9,255,923	518,107	47,872	263,742	389,703	3,934,186	233,448	147,451	228,576	71,249	1,176,163	642,781	16,909,201	16,027		16,925,228
Professional fees	535,845		369,752	86,664	967,713	7,619,121	187,296		1,037,587	251,647	261,714	110,199	11,427,538	3,942,458		15,369,996
Depreciation and amortization	2,235,115	567,769	87,711	115,299	1,120,644	2,481,776	400,524	81,999	540,390	460,566	943,926	421,292	9,457,011	303,282		9,760,293
Other supplies	2,165,092	63,196	58,524	92,971	491,362	4,479,895	544,927		203,283	357,259	317,863	461,040	9,235,412	70,886		9,306,298
Provision for doubtful accounts	1,883,325	(42,145)	858	148,219	1,943,008	2,778,288	161,326	30,000	483,943	257,853	110,000	420,000	8,174,675	150,000		8,324,675
Interest	185,369	90	1,640		25,074	248,692			23,052	1,548	11,243	6,211	502,919	3,683		506,602
Insurance and other	4,574,788	372,685	197,976	255,828	2,377,214	5,563,094	508,925	419,133	1,298,109	455,527	484,173	750,264	17,257,716	720,165		17,977,881
Total operating expenses	63,496,953	5,182,122	2,383,332	3,075,155	27,600,855	69,317,442	10,211,817	2,085,909	11,349,608	7,976,970	16,899,490	12,879,600	232,459,253	7,820,699		240,279,952
INCOME (LOSS) FROM OPERATIONS	1,556,185	158,360	(600,102)	(671,780)	(1,161,752)	4,983,140	(1,550,152)	(1,138,872)	(4,212,367)	(2,268,123)	(3,007,859)	(2,792,032)	(10,705,354)	(7,820,699)		(18,526,053)
NONOPERATING REVENUES (EXPENSES):																
Appropriations from the State of Hawaii														12,912,012		12,912,012
Write-off of investment in Hana Medical Center														(1,326,095)		(1,326,095)
Subsidy to Hana Medical Center														(923,988)		(923,988)
Other - net	(1,355,856)	(90,217)	(37,317)	(169,742)	(430,799)	(1,640,533)	(251,030)	(55,573)	(195,518)	(213,749)	(542,978)	(368,064)	(5,351,376)	7,467,339		2,115,963
Nonoperating revenues - net	(1,355,856)	(90,217)	(37,317)	(169,742)	(430,799)	(1,640,533)	(251,030)	(55,573)	(195,518)	(213,749)	(542,978)	(368,064)	(5,351,376)	18,129,268		12,777,892
EXCESS OF REVENUES OVER EXPENSES (EXPENSES OVER REVENUES)	$ 200,329	$ 68,143	$ (637,419)	$ (841,522)	$(1,592,551)	$ 3,342,607	$ (1,801,182)	$(1,194,445)	$(4,407,885)	$(2,481,872)	$(3,550,837)	$(3,160,096)	$ (16,056,730)	$10,308,569	$	$ (5,748,161)

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

Board of Directors of Hawaii Health Systems Corporation:

We have audited the financial statements of Hawaii Health Systems Corporation (HHSC) as of and for the year ended June 30, 1998, and have issued our report thereon dated November 23, 1998. We conducted our audit in accordance with generally accepted auditing standards and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

Compliance

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

Internal Control over Financial Reporting

In planning and performing our audit, we considered HHSC's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide assurance on the internal control over financial reporting. However, we noted certain matters involving the internal control over financial reporting and its operation that we consider to be reportable conditions. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operations of the internal control over financial reporting that, in our judgment, could adversely affect HHSC's ability to record, process, summarize and report financial data consistent with the assertions of management in the financial statements. Reportable conditions are described in a separate letter to management of HHSC dated November 23, 1998 and are summarized as follows:

- Reconciliations of certain accounts, including cash, accounts receivable, and property, are not performed on a timely basis.

- Due to limited personnel resources, there is a lack of segregation of cash-related duties, as the same individuals have the ability to handle, record and reconcile cash.

- Procurement policies and procedures are not consistently followed. Such policies include:
  - Goods and services
    » $4,000 - $24,999 - A minimum of two quotes, either written or oral, should be obtained.
    » $25,000 - $99,999 - At least two written quotes must be obtained.
  - Construction
    » $10,000 - $49,999 - At least two oral bids should be obtained.
    » $50,000 - $200,000 - At least two written quotes should be obtained.
- Due to limited information systems and resources, budgetary monitoring is inadequate.

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 financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses. However, we believe none of the reportable conditions described above is a material weakness.

This report is intended for the information of the Board of Directors and management of Hawaii Health Systems Corporation. However, this report is a matter of public record and its distribution is not limited.

November 23, 1998