HAWAII HEALTH SYSTEMS
C O R P O R A T I O N
"Touching Lives Everyday"

January 13, 2003

COO/CFO-02-019

The Honorable Linda Lingle
Governor of Hawaii
Executive Chambers
Hawaii State Capitol
Honolulu, Hawaii 96813

Dear Governor Lingle:

It is with sincere appreciation that we submit the annual report of the Hawaii Health Systems Corporation (HHSC) to you and the Legislature of the State of Hawaii. The continued dedication and hard work of our employees, medical staff, advisors, Board of Directors, union partners, and many other stakeholders, coupled with support from our legislators and the Administration, have resulted in many successes this past year.

We continue to improve our financial management and accounting systems throughout the Corporation. While the Corporation received a qualified audit with many material weaknesses in FY 97, we have now received our fifth consecutive "clean" unqualified audit with no material weaknesses for FY 02, FY 01, FY 00, FY 99 and FY 98. The FY 02 and FY 01 comparative audit report for the year ending June 30, 2002 is enclosed **(enclosure #1)** in accordance with H.R.S. Section 323F-22.

As a safety-net public hospital system, HHSC depends heavily on input and support from our local communities. Over this past year, hundreds of community volunteers statewide donated nearly 100,000 service hours to our facilities. The enclosed **(enclosure #2)** report 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 the optional comments as submitted by our five Management Advisory Committees (MACs): East Hawaii, West Hawaii, Maui, Kauai, and Oahu. Our Physicians Advisory Group (PAG) has also submitted comments. The continuing guidance and support of the MACs and PAG are tremendously important to the successful functioning of our system. Enclosed **(enclosure #3 and #4)** for your additional reference are a summary of specific accomplishments by HHSC over the past fiscal year and a general summary **(enclosure # 5)** of our accomplishments over the past five years.

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HILO • HONOKAA • KAU • KONA • KOHALA • WAIMEA • KAPAA • WAILUKU • KULA • LANAI • HONOLULU

We have continued to develop and improve our clinical and non-clinical quality programs continually putting into practice our mantra that "Quality is Priority One." The quality of our clinical operations was recognized by HMSA, as reflected on the enclosed **(enclosure # 6)** report, recently in $503,557.02 in checks to five HHSC facilities for our excellent results from participating in the HMSA Quality Service Recognition Program. HHSC's quality initiatives, which have provided the system with measurable solutions for improving quality of care, were accomplished through the dedicated efforts and cooperation of our staff, community physicians, and other healthcare professionals. Our four leading acute care facilities - Maui Memorial Medical Center, Hilo Medical Center, Kona Community Hospital, and Kauai Veterans Memorial Hospital, all received full three-year accreditation's from surveys conducted by the Joint Commission on the Accreditation of Healthcare Organizations (JCAHO). The high scores reflected on the enclosed **(enclosure # 7)** JCAHO survey summary indicate the high quality of the healthcare operations at these facilities. Depending upon the facility type, all HHSC facilities have either received JCAHO accreditation and/or passed their State licensure survey with full certification in all instances.

We have fully converted four HHSC facilities to Critical Access Hospital (CAH) status – Kauai Veterans Memorial Hospital, Lanai Community Hospital, Kohala Hospital, and Kau Hospital. The combined positive effect on enhanced reimbursements from the federal Medicare Rural Hospital Flexibility program and the parallel Medicaid program of the State of Hawaii authorized by Act 226 (July 2000) has been increased revenues and annual budget deficit reductions for these four facilities of approximately $2.2 Million, as reflected on the enclosed **(enclosure # 8)** summary of CAH program benefits for HHSC facilities. The CAH program has contributed significantly to the ability of these facilities to provide access to high quality healthcare services that others would not provide because of the population levels and economics of these rural communities.

HHSC management is continuing to work in concert with our Board of Directors, MACs, PAG and many other external constituencies to find creative and effective solutions to financial and operating issues in order to move toward greater financial self-sufficiency. We understand that the need is greater than ever to find new "out of the box" solutions to providing services to the communities that we serve while reducing the demands on the State to provide support. Until such time as the Legislature is willing to grant HHSC substantially more autonomy to implement the changes necessary to move to financial and operating self-sufficiency (such as moving away from operation under State Civil Service, State Collective Bargaining, restraints on managing our levels of service), HHSC must keep returning to the Legislature to request a minimal level of funding to support the mandated "safety net" services that we provide.

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If you have any questions, please call me personally at (808) 733-4151.

Mahalo Nui Loa,

Tom Driskill

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

Enclosures:

1. Annual Audit Report: Financial Statements and Supplemental Information for the Year Ended June 30, 2000 and 1999 and Independent Auditors' Reports
2. HHSC Volunteer Community Support
3. MAC Reports for East Hawaii, Maui, Kauai, and Oahu
4. PAG Report
5. Summary of Accomplishments
6. HMSA Quality Service Recognition Program Report
7. JCAHO Survey Results
8. Critical Access Hospitals Deficit Reductions

Hawaii Health Systems Corporation

Consolidated Financial Statements and Supplemental Information for the Year Ended June 30, 2002 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 year ended June 30, 2002 and the independent auditors' reports thereon.

SCOPE OF THE AUDIT

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

ORGANIZATION OF THE REPORT

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

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

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INDEPENDENT AUDITORS' REPORT

Board of Directors of Hawaii Health Systems Corporation:

We have audited the accompanying consolidated statement of net assets of Hawaii Health Systems Corporation (HHSC), a component unit of the State of Hawaii, as of June 30, 2002, and the related consolidated statements of revenues, expenses, and changes in net assets and of cash flows for the year 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 audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the 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.

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

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, 2002, 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 statement of net assets at June 30, 2002 may be significantly different from those eventually included in the final settlement.

As described in Note 2, HHSC has implemented a new financial reporting model, as required by the provisions of Governmental Accounting Standards Board (GASB) Statement No. 34, *Basic Financial Statements – and Management's Discussion and Analysis – for State and Local Governments*, as of June 30, 2002.

The management's discussion and analysis information on pages 4 through 9 is not a required part of the basic financial statements but is supplementary information required by the GASB. We have

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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 25 and 26 is presented for the purposes of additional analysis and is not a required part of the basic financial statements. The supplemental combining and consolidating schedules on pages 27 through 29 are presented for the purpose of additional analysis of the basic financial statements rather than to present the financial position and results of operations of individual facilities, and are not a required part of the basic financial statements. This supplemental information and the supplemental combining and consolidating schedules are the responsibility of HHSC's management. Such information has been subjected to the auditing procedures applied in our audit of the basic financial statements and, in our opinion, is fairly stated in all material respects when considered in relation to the basic financial statements taken as a whole.

In accordance with *Government Auditing Standards*, we have also issued a report dated November 1, 2002 on our consideration of HHSC's internal control over financial reporting and our tests of its compliance with certain provisions of laws, regulations, contracts and grants. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be read in conjunction with this report in considering the results of our audit.

Deloitte & Touche LLP

November 1, 2002

Overview of the Financial Statements

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

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

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

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

Financial Analysis

Consolidated Statements of Net Assets

Summarized financial information of HHSC's Consolidated Statements of Net Assets as of June 30, 2002 and 2001 is as follows:

ASSETS	2002	2001
Current assets	$ 67,312,163	$ 68,540,773
Capital assets - net	176,168,634	168,441,011
Other assets	921,797	1,497,744
Total assets	$244,402,594	$238,479,528
LIABILITIES		
Current liabilities	$ 68,915,916	$ 58,148,463
Accrued vacation - less current portion	18,285,526	17,510,560
Capital lease obligations - less current portion	17,049,951	9,316,639
Long-term debt - less current portion	11,423,465	12,018,679
Due to the State of Hawaii	20,122,507	20,122,507
Other liabilities	903,223	1,143,095
Total liabilities	136,700,588	118,259,943
NET ASSETS		
Invested in capital assets - net of related debt	140,464,914	144,104,900
Unrestricted	(33,244,379)	(24,832,755)
Restricted	481,471	947,440
Total net assets	107,702,006	120,219,585
Total liabilities and net assets	$244,402,594	$238,479,528

At June 30, 2002, HHSC's capital assets, net of accumulated depreciation, comprised approximately 72% 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 $7.7 million is due to capital asset additions of approximately $21.6 million, offset by depreciation expense of approximately $13.8 million. The primary reason for the increase is the acquisition of medical equipment (primarily the MRI, monitors, and imaging equipment for Maui Memorial Medical Center) and application systems (primarily the Lawson Human Resources application and Laser Arc data storage). The vast majority of these purchases were financed through HHSC's municipal leasing lines of credit (see further explanation below). A summary of HHSC's capital assets as of June 30, 2002 and 2001 is as follows:

	2002	2001
Land and land improvements	$ 4,809,354	$ 4,744,929
Buildings and improvements	193,742,748	192,495,936
Equipment	105,435,204	87,493,562
Construction in progress	14,986,281	13,798,590
	318,973,587	298,533,017
Less accumulated depreciation and amortization	(142,804,953)	(130,092,006)
Capital assets - net	$ 176,168,634	$ 168,441,011

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

At June 30, 2002, HHSC's current liabilities approximated 50% of total liabilities. The primary reason for the increase over fiscal year 2001 is a general delay in paying its creditors, caused by cash flow shortages, resulting in an increase of approximately $7.3 million in accounts payable and accrued expenses. The other reason for the increase is an increase in the current portion of capital lease obligations of approximately $3.8 million, due to the financing of the majority of HHSC's equipment purchases through its municipal leasing lines (see further explanation below).

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

At June 30, 2002, HHSC's long-term debt balances represented notes and term loans payable on land, building, and medical equipment previously owned by Hilo Residency Training Program of approximately $11.6 million and a term loan payable relating to the financing of the balance owing under HHSC's guarantee of an $800,000 loan made by a local bank to West Kauai Community Development Corporation of $375,000.

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

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

Summarized financial information of HHSC's Consolidated Statements of Revenues, Expenses, and Changes in Net Assets for the years ended June 30, 2002 and 2001 is as follows:

	2002	2001
Operating expenses:		
Salaries and benefits	$ 170,805,085	$ 142,269,185
Purchased services and professional fees	34,237,579	41,574,734
Supplies and drugs	42,657,736	35,981,166
Provision for doubtful accounts	12,265,438	14,002,665
Depreciation and amortization	13,835,128	11,457,171
Other	23,842,477	21,992,338
Total operating expenses	297,643,443	267,277,259
Operating revenues	267,296,489	241,237,548
Loss from operations	(30,346,954)	(26,039,711)
Nonoperating revenues:		
General appropriations from State of Hawaii	7,000,000	13,000,649
Collective bargaining pay raise appropriation from State of Hawaii	6,213,838	
Other nonoperating revenues - net	2,328,279	2,050,791
Nonoperating revenues - net	15,542,117	15,051,440
Loss before capital contributions	(14,804,837)	(10,988,271)
Capital assets contributed by State of Hawaii	2,287,258	
Decrease in net assets	$ (12,517,579)	$ (10,988,271)

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

Operating expenses in fiscal year 2002 were approximately 11.4% higher than fiscal year 2001. The increase was primarily in the categories of salaries and supplies and drugs. Salaries and benefits expense increased approximately 20% from fiscal year 2001, due primarily to an increase in full-time equivalent employees (FTEs). The increase in FTEs was primarily due to added personnel for imaging departments at Hilo Medical Center, Maui Memorial Medical Center, and Kona Community Hospital, accounting for approximately 47 FTEs, as well as the conversion of nurses that were previously on contract to full-time employees, accounting for approximately 78 FTEs. In addition, HHSC's union employees received pay raises ranging from 2% to 4% from the unions' collective bargaining agreements with the State of Hawaii. Further, HHSC amortized approximately $6.2

million in prepaid pension costs into salaries and benefits expense during fiscal year 2002, as the amount overpaid by HHSC in fiscal year 2000 was used for the fiscal year 2002 contribution to the ERS. Supplies and drugs expense increased approximately 19% from fiscal year 2001, primarily due to an increase in patient volume and an average 17% increase in the price of prescription drugs.

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

The significant excess of operating expenses over operating revenues in both fiscal years 2002 and 2001, 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 2002, 58% of HHSC's total gross revenues were from government-type payors (approximately 23% from Medicare and approximately 26% from Medicaid and Med-Quest). In fact, Medicare, Medicaid, and Med-Quest account for over 80% of HHSC's revenues for its long-term care facilities. Reimbursements from government-type payors has not kept up with the increasing costs of healthcare providers since the Balanced Budget Act of 1997 was passed, which dramatically reduced the level of reimbursements from government-type payors.

Second, HHSC's facilities on the neighbor islands suffer from an insufficient supply of long-term care beds. As noted above, HHSC's beds in its long-term care facilities are virtually fully occupied and there are very few other freestanding long-term care facilities on the neighbor islands. As a result, HHSC's acute care facilities, especially Hilo Medical Center and Maui Memorial Medical Center, have numerous patients initially admitted as acute patients, but who continue to occupy acute care beds while awaiting long-term care beds to become available. Such patients are called "wait-list" patients. HHSC receives little to no reimbursement from insurers for such patients, as insurers will not reimburse providers for patients whose required level of care does not coincide with the type of bed the patient is occupying. Hilo Medical Center and Maui Memorial Medical Center both have an average census of approximately 30-50 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 is bound by the collective bargaining agreements negotiated by the State of Hawaii and the public employee unions (Hawaii Government Employees Association and United Public Workers). The collective bargaining agreements not only bind HHSC to the negotiated pay raises, but also to the union work regulations and benefit packages. Management believes that such arrangements do not allow HHSC to manage its resources as effectively as other health-care systems.

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

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

HAWAII HEALTH SYSTEMS CORPORATION

CONSOLIDATED STATEMENT OF NET ASSETS
JUNE 30, 2002

ASSETS

CURRENT ASSETS:	
Cash and cash equivalents:	
On deposit with the State of Hawaii	$ 514,684
On deposit with banks and on hand	6,454,896
Patient accounts receivable - less allowances of $95,553,804 for contractual adjustments and doubtful accounts	52,914,430
Supplies and other current assets	7,428,153
Total current assets	67,312,163
CAPITAL ASSETS - Net (Notes 4, 5 and 6)	176,168,634
ASSETS LIMITED AS TO USE (Note 3)	862,830
OTHER ASSETS	58,967
TOTAL	$244,402,594

(Continued)

HAWAII HEALTH SYSTEMS CORPORATION

CONSOLIDATED STATEMENT OF NET ASSETS (Continued)
JUNE 30, 2002

LIABILITIES AND NET ASSETS

CURRENT LIABILITIES:	
Accounts payable and accrued expenses	$ 39,436,774
Accrued workers' compensation liability (Note 9)	18,500,000
Current portion of capital lease obligations (Note 5)	7,036,881
Estimated third-party payor settlements	1,978,549
Current portion of accrued vacation (Note 5)	719,154
Current portion of long-term debt (Note 6)	568,423
Other current liabilities	676,135
Total current liabilities	68,915,916
CAPITAL LEASE OBLIGATIONS - Less current portion (Note 5)	17,049,951
LONG-TERM DEBT - Less current portion (Note 6)	11,423,465
ACCRUED VACATION - Less current portion (Note 5)	18,285,526
DUE TO THE STATE OF HAWAII	20,122,507
PATIENTS' SAFEKEEPING DEPOSITS	381,359
OTHER LIABILITIES	521,864
Total liabilities	136,700,588
NET ASSETS:	
Invested in capital assets - net of related debt	140,464,914
Unrestricted (Note 3)	(33,244,379)
Restricted	481,471
Total net assets	107,702,006
TOTAL	$244,402,594

See notes to consolidated financial statements.

HAWAII HEALTH SYSTEMS CORPORATION

CONSOLIDATED STATEMENT OF REVENUES, EXPENSES, AND CHANGES IN NET ASSETS YEAR ENDED JUNE 30, 2002

OPERATING REVENUES:	
Net patient service revenues (Note 7)	$263,466,300
Other operating revenues (Note 7)	3,830,189
Total operating revenues	267,296,489
OPERATING EXPENSES:	
Salaries and benefits (Notes 7 and 8)	170,805,085
Medical supplies and drugs	31,628,897
Purchased services (Note 7)	17,324,902
Professional fees (Note 7)	16,912,677
Depreciation and amortization	13,835,128
Provision for doubtful accounts	12,265,438
Other supplies	11,028,839
Utilities	7,168,591
Repairs and maintenance	5,122,963
Rent and lease	2,874,317
Interest	1,910,873
Insurance	1,909,978
Other	4,855,755
Total operating expenses	297,643,443
LOSS FROM OPERATIONS	(30,346,954)
NONOPERATING REVENUES:	
General appropriations from State of Hawaii	7,000,000
Collective bargaining pay raise appropriation from State of Hawaii	6,213,838
Restricted contributions	947,032
Interest and dividend income	235,836
Other nonoperating revenues - net	1,145,411
Nonoperating revenues - net	15,542,117
LOSS BEFORE CAPITAL CONTRIBUTIONS	(14,804,837)
CAPITAL ASSETS CONTRIBUTED BY STATE OF HAWAII	2,287,258
DECREASE IN NET ASSETS	(12,517,579)
NET ASSETS, BEGINNING OF YEAR	120,219,585
NET ASSETS, END OF YEAR	$107,702,006

See notes to consolidated financial statements.

HAWAII HEALTH SYSTEMS CORPORATION

CONSOLIDATED STATEMENT OF CASH FLOWS
YEAR ENDED JUNE 30, 2002

OPERATING ACTIVITIES:	
Payments from government, insurance and patients	$ 240,123,598
Payments to employees	(163,340,414)
Payments to suppliers and others	(92,848,049)
Other receipts - net	3,453,886
Net cash used in operating activities	(12,610,979)
NONCAPITAL FINANCING ACTIVITIES:	
Appropriations from State of Hawaii	13,213,838
Other nonoperating revenues - net	757,421
Payments on long-term debt	(523,176)
Net cash provided by noncapital financing activities	13,448,083
CAPITAL AND RELATED FINANCING ACTIVITIES:	
Capital expenditures	(1,900,616)
Repayments on capital lease obligations	(3,879,484)
Proceeds from sale of capital assets	227
Net cash used in capital and related financing activities	(5,779,873)
NET DECREASE IN CASH AND CASH EQUIVALENTS	(4,942,769)
CASH AND CASH EQUIVALENTS, BEGINNING OF YEAR	11,912,349
CASH AND CASH EQUIVALENTS, END OF YEAR	$ 6,969,580

HAWAII HEALTH SYSTEMS CORPORATION

STATEMENT OF CASH FLOWS (Continued)
YEAR ENDED JUNE 30, 2002

RECONCILIATION OF LOSS FROM OPERATIONS TO NET CASH USED IN OPERATING ACTIVITIES:	
Loss from operations	$ (30,346,954)
Adjustments to reconcile loss from operations to net cash used in operating activities:	
Provision for doubtful accounts	12,265,438
Depreciation and amortization	13,835,128
Amortization of prepaid pension costs	6,206,461
Amounts released from restrictions	1,413,001
Change in operating assets and liabilities:	
Receivables	(21,276,875)
Supplies and other assets	(1,620,328)
Accounts payable, accrued expenses, and other liabilities	6,687,948
Accrued workers' compensation liability	1,516,063
Estimated third-party payor settlements	(2,065,827)
Accrued vacation	774,966
Net cash used in operating activities	$ (12,610,979)

SUPPLEMENTAL CASH FLOW INFORMATION:	
Interest paid, primarily on capital lease obligations, net of interest capitalized of $15,500	$ 2,312,522
Non-cash financing and investing activities:	
• Capital assets contributed by State of Hawaii	2,287,258
• Capital assets acquired under capital leases	15,445,269
• Capital asset purchases included in accounts payable	555,782
• Capital assets acquired through grants	585,084
• Contribution of capital assets	59,000
• Reclassification of deposits to capital assets	750,000

See notes to consolidated financial statements.

HAWAII HEALTH SYSTEMS CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
YEAR ENDED JUNE 30, 2002

1. ORGANIZATION

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

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

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

City and County of Honolulu:
- Leahi Hospital
- Maluhia

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

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

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

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

Negotiations between HHSC and the State relating to the transfer of assets and assumption of liabilities pursuant to Act 262 had not been finalized as of June 30, 2002. Accordingly, the assets, liabilities and net assets of HHSC reflected in the accompanying consolidated statement of net assets may be significantly different from those eventually included in the final settlement.

In fiscal year 2002, consolidated financial statements are being presented for HHSC, Hawaii Health Systems Foundation (HHSF), and Alii Community Care, Inc. (Alii). HHSF and Alii are non-profit organizations of which HHSC is the sole member. The purpose of HHSF is to raise funds and obtain gifts and grants on behalf of HHSC. The purpose of Alii is to own, manage, and operate assisted living and other health care facilities in the State of Hawaii. In fiscal year 2002, the operations of HHSF and Alii were not significant.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Financial Statement Presentation - In fiscal year 2002, HHSC adopted the provisions of the Governmental Accounting Standards Board (GASB) Statement No. 34, *Basic Financial Statements--and Management's Discussion and Analysis--for State and Local Governments* (GASB 34). GASB 34 establishes financial reporting standards for state and local governments. Among its requirements, GASB 34 requires governmental entities to report certain supplementary information, including management's discussion and analysis of the entity's financial performance. The adoption of GASB 34 did not have a significant impact on the consolidated financial statements.

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 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, 2002 is indicated in the accompanying consolidated statement of net assets as "Cash on deposit with the State of Hawaii." The Hawaii Revised Statutes authorize the Director of Finance to invest in obligations of, or guaranteed by, the U.S. Government, obligations of the State, federally-insured savings and checking accounts, time certificates of deposit, and repurchase agreements with federally-insured financial institutions. Cash and deposits with financial institutions are collateralized in accordance with State Statutes. All securities pledged as collateral are held either by the State Treasury or by the State's fiscal agents in the name of the State.

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

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

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

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

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

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

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

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

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

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

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

- ***Medicare*** - Inpatient acute services rendered to Medicare program beneficiaries are paid at prospectively determined rates per discharge. Effective August 1, 2000, certain inpatient services and all hospital outpatient services rendered to Medicare beneficiaries are paid at prospectively determined rates per discharge. These rates vary according to a patient classification system that is based on clinical, diagnostic and other factors. Inpatient non-acute services and defined capital and medical education costs related to Medicare beneficiaries were paid based upon a cost reimbursement methodology. HHSC was reimbursed at a tentative rate with final settlement determined after submission of annual cost reports and audits thereof by the Medicare fiscal intermediary. The appropriateness of admissions is subject to an independent review by peer review organizations under contract with HHSC. HHSC's Medicare cost reports have been audited by the Medicare fiscal intermediary through fiscal year 1999.

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

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

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

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

Bond Interest - HHSC reports as nonoperating expense the interest paid by the State for general obligation bonds whose proceeds were used for hospital construction. A corresponding contribution from the State is reported as nonoperating revenues. The bonds are obligations of the State, to be paid by the State's general fund, and are not reported as liabilities of HHSC. For the year ended June 30, 2002, the amount of bond interest allocated to HHSC was $2,381,176.

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 9.

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, 2002 was as follows:

Medicare	13%
Medicaid	24
HMSA	15
Other third-party payors	22
Patients and other	26
	100%

3. BOARD-DESIGNATED FUNDS

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

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

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

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

4. CAPITAL ASSETS

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

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

In 2002, the State Department of Accounting and General Services transferred capital assets, including construction in progress, aggregating $2,287,258 to HHSC.

5. LONG-TERM LIABILITIES

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

	Beginning of Year	Additions	Reductions	End of Year	Current Portion	Noncurrent Portion
Accrued vacation	$ 18,229,714	$ 1,494,120	$ (719,154)	$ 19,004,680	$ 719,154	$ 18,285,526
Capital lease obligations	12,521,047	15,445,269	(3,879,484)	24,086,832	7,036,881	17,049,951
Long-term liabilities	$ 30,750,761	$ 16,939,389	$(4,598,638)	$ 43,091,512	$ 7,756,035	$ 35,335,477

Future capital lease payments were as follows:

Year ended June 30:	
2003	$ 8,995,003
2004	8,248,610
2005	6,386,964
2006	3,305,411
2007	1,468,741
Thereafter	1,787,720
Total future minimum payments	30,192,449
Less amount representing interest	(6,105,617)
Total capital lease obligations	24,086,832
Current portion	(7,036,881)
Noncurrent portion	$ 17,049,951

HHSC has an arrangement with municipal 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 Corporate's financial statements. Upon completion, the asset is transferred to the facility's financial statements. Corporate makes the capital lease payments, while the facility records depreciation on the capital asset. The facilities reimburse Corporate through the due from affiliates account.

6. 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 loans and notes payable are collateralized by a security interest in the property, plant, and equipment acquired from HRTP, as well as any rights, interest, and other tangible assets relating to such property.

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

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

Loan payable to bank (HRTP); $9,500,000; interest at 8% until December 1, 2002, thereafter, interest at weekly average of 5-year U.S. Treasury Securities rate plus 250 basis points; monthly principal and interest payments of $71,000; due December 1, 2027	$ 9,243,754
Loan payable to bank (HRTP); $319,000; interest at 9% until June 8, 2004, thereafter, interest at weekly average of 3-year U.S. Treasury Securities rate plus 275 basis points; monthly principal and interest payments of $3,500; due June 8, 2007	256,859
Note payable to United States Department of Agriculture (USDA) (HRTP); $1,250,000; interest at 4.75%; monthly principal and interest payments of $6,188; due June 24, 2034	1,217,480
Note payable to USDA (HRTP); $1,000,000; interest at 4.75%; monthly principal and interest payments of $8,170; due August 13, 2014	898,795
Term loan agreement payable to bank (WKCDC); $700,000; interest at the bank's prime rate; interest payments monthly with additional payments of principal commencing on January 15, 2002 of $200,000, followed by equal quarterly payments of $125,000 commencing on April 15, 2002; due December 17, 2002	375,000
Total	11,991,888
Less current portion	(568,423)
Noncurrent portion	$11,423,465

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

	Beginning of Year	Additions	Reductions	End of Year
Long-term debt	$ 12,515,064	$ -	$ (523,176)	$ 11,991,888

Maturities of long-term debt are as follows:

Year ending June 30:	
2003	$ 568,423
2004	223,710
2005	281,867
2006	303,202
2007	326,241
Thereafter	10,288,445
Total	$11,991,888

7. FACILITY-BASED TECHNICAL SERVICE AGREEMENTS

HHSC has facility-based technical service agreements relating to certain ancillary services. These arrangements are generally related to administrative services, clinical personnel, space rental, and clinical services. Reimbursement arrangements vary by contractor and range from fixed amounts per month to 100% reimbursements of charges. Amounts charged by the contractors are included in operating expenses in purchased services and professional fees, and aggregated approximately $16.6 million during fiscal year 2002.

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 $790,000 during fiscal year 2002. 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 $910,000 during fiscal year 2002.

8. EMPLOYEE BENEFITS

Defined Benefit Pension Plans

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

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

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

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

Post-Retirement Health Care and Life Insurance Benefits

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

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

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

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

HHSC's post-retirement benefits expense approximated $10,216,000 for the year ended June 30, 2002.

Sick Leave

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

9. COMMITMENTS AND CONTINGENCIES

Professional Liability

HHSC maintains professional and general liability insurance with a private insurance carrier with a $30 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 has accrued a liability of $18,500,000 for unpaid claims as of June 30, 2002.

Ceded Lands

The Office of Hawaiian Affairs (OHA) and the State of Hawaii are presently in litigation involving the State's alleged failure to properly account for and pay to OHA monies due to OHA under the provisions of the Hawaii State Constitution and Chapter 10 of the Hawaii Revised Statutes for use by the State of certain ceded lands. As of June 30, 2002, the outcome of the lawsuit had not been finalized.

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

Litigation

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

Asbestos Contamination

There is known asbestos contamination of the old hospital building located next to the Hilo Medical Center facility. Present estimates by management to demolish the building and remediate the asbestos contamination approach $2 million or more. 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. As such, a liability for the cost of the remediation has not been recorded in HHSC's financial statements.

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HAWAI HEALTH SYSTEMS CORPORATION

SUPPLEMENTAL SCHEDULE OF RECONCILIATION OF CASH ON DEPOSIT WITH THE STATE OF HAWAII
JUNE 30, 2002

	Appropriation Symbol	
CASH ON DEPOSIT WITH THE STATE OF HAWAII:		
SPECIAL FUNDS:		
	S-92-312-H	$ 484
	S-93-312-H	544
	S-93-359-H	5,681
	S-94-312-H	33,400
	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-97-359-H	5,878
	S-97-396-H	182
	S-98-396-H	1,687
	S-02-303-H	587
	S-02-312-H	32
	S-02-350-H	73,261
	S-02-351-H	11,418
	S-02-352-H	10,131
	S-02-353-H	16,845
	S-02-354-H	61,509
	S-02-355-H	73,193
	S-02-358-H	17,054
	S-02-359-H	38
	S-02-365-H	1
	S-02-371-H	29,737
	S-02-373-H	3,225
TRUST FUNDS:		
	T-02-906-H	2,512
	T-02-909-H	28,864
	T-02-910-H	63,106
	T-02-914-H	14,706
	T-02-918-H	1,272
	T-02-921-H	6,679
TOTAL PER STATE		535,768
RECONCILING ITEMS		(21,084)
TOTAL PER HHSC		$ 514,684

HAWAI HEALTH SYSTEMS CORPORATION

SUPPLEMENTAL SCHEDULE OF RECONCILIATION OF CASH ON DEPOSIT WITH THE STATE OF HAWAII (Continued)
JUNE 30, 2002

	Appropriation Symbol	
ASSETS LIMITED AS TO USE:		
PATIENT TRUST FUNDS:		
	T-02-911-H	$ 22,912
	T-02-915-H	12,823
	T-02-919-H	3,225
	T-02-921-H	6,679
	T-02-925-H	106,014
	T-02-926-H	13,308
TOTAL PER STATE		164,961
RECONCILING ITEMS:		
Patients' safekeeping deposits held by financial institutions		216,398
Restricted net assets held by financial institutions		481,471
TOTAL PER HHSC		$ 862,830

HAWAII HEALTH SYSTEMS CORPORATION

SUPPLEMENTAL COMBINING AND CONSOLIDATING STATEMENT OF NET ASSETS INFORMATION
JUNE 30, 2002

ASSETS	Facilities: Hilo Medical Center	Kona Community Hospital	Maui Memorial Medical Center	Ka'u Hospital	Kula Hospital	Kauai Veterans Memorial Hospital	Samuel Mahelona Memorial Hospital	Hale Ho'ola Hamakua	Kohala Hospital	Leahi Hospital	Maluhia	Lanai Community Hospital
CURRENT ASSETS:												
Cash and cash equivalents:												
On deposit with the State of Hawaii	$ 85,688	$ 61,509	$ 117,608	$ 16,717	$ 29,737	$ 47,521	$ 3,225	$ 11,815	$ 16,845	$ 63,793	$ 1	$ 17,054
On deposit with banks and on hand	138,380	173,111	5,052	9,663	3,086	8,257	12,561	500	11,935	286,095	95,231	18,833
Patient accounts receivable - less allowances for contractual adjustments and doubtful accounts	12,206,009	6,330,432	21,409,401	442,189	2,265,757	2,558,517	1,191,724	765,499	594,129	2,593,660	2,134,607	422,506
Supplies and other current assets	1,992,436	1,429,766	2,270,774	42,488	146,353	434,747	55,207	92,393	30,549	493,497	102,662	44,738
Total current assets	14,422,513	7,994,818	23,802,835	511,057	2,444,933	3,049,042	1,262,717	870,207	653,458	3,437,045	2,332,501	503,131
DUE FROM AFFILIATES - Net			9,724,336									
CAPITAL ASSETS - Net	35,922,030	28,168,878	49,489,076	903,838	5,124,257	9,354,336	3,969,972	14,677,262	763,610	7,460,293	4,222,285	567,648
ASSETS LIMITED AS TO USE	38,327	99,047		5,221	64,118	7,598	32,677	8,249	5,638	152,391	87,196	1,646
OTHER ASSETS	30,564	10,699	15,520	523	436			625	600			
TOTAL	$ 50,413,434	$ 36,273,442	$ 83,031,767	$ 1,420,639	$ 7,633,744	$ 12,410,976	$ 5,265,366	$ 15,556,343	$ 1,423,306	$ 11,049,729	$ 6,641,982	$ 1,072,425

ASSETS	Total Facilities	Corporate	Reclassifications and Eliminations	HHSC Combined	Hawaii Health Systems Foundation	Alii Community Care	Reclassifications and Eliminations	HHSC Consolidated
CURRENT ASSETS:								
Cash and cash equivalents:								
On deposit with the State of Hawaii	$ 471,513	$ 43,171		$ 514,684				$ 514,684
On deposit with banks and on hand	762,704	5,276,628		6,039,332	$ 270,863	$ 144,701		6,454,896
Patient accounts receivable - less allowances for contractual adjustments and doubtful accounts	52,914,430			52,914,430				52,914,430
Supplies and other current assets	7,135,610	292,291		7,427,901		252		7,428,153
Total current assets	61,284,257	5,612,090		66,896,347	270,863	144,953		67,312,163
DUE FROM AFFILIATES - Net	9,724,336	86,092,758	$ (95,817,094)	-				-
CAPITAL ASSETS - Net	160,623,485	15,537,423		176,160,908	3,339	4,387		176,168,634
ASSETS LIMITED AS TO USE	502,108	41,748		543,856	48,352	270,622		862,830
OTHER ASSETS	58,967	97,822		156,789			$ (97,822)	58,967
TOTAL	$ 232,193,153	$ 107,381,841	$ (95,817,094)	$ 243,757,900	$ 322,554	$ 419,962	$ (97,822)	$ 244,402,594

HAWAII HEALTH SYSTEMS CORPORATION

SUPPLEMENTAL COMBINING AND CONSOLIDATING STATEMENT OF NET ASSETS INFORMATION (Continued)
JUNE 30, 2002

	Facilities									
LIABILITIES AND NET ASSETS	Hilo Medical Center	Kona Community Hospital	Maui Memorial Medical Center	Ka'u Hospital	Kula Hospital	Kauai Veterans Memorial Hospital	Samuel Mahelona Memorial Hospital	Hale Ho'ola Hamakua	Kohala Hospital	Leahi Hospital
CURRENT LIABILITIES:										
Accounts payable and accrued expenses	$ 11,499,715	$ 4,122,294	$ 14,818,920	$ 181,642	$ 946,160	$ 1,668,708	$ 496,680	$ 352,599	$ 184,638	$ 1,140,219
Accrued workers' compensation liability	5,491,474	2,051,024	4,032,298	147,490	1,947,407	790,785	455,572	494,175	227,388	1,456,373
Current portion of capital lease obligations	413,094	24,028	-		4,235	2,466	22,060			
Estimated third-party payor settlements	1,212,577	218,288	360,083	41,482	59,653	(355,109)	3,998	36,690	219,647	55,000
Current portion of accrued vacation	125,546	47,288	139,249		97,370	20,875	17,432	51,233	8,336	81,777
Current portion of long-term debt	193,423					375,000				
Other current liabilities	218,940	4,033				143,204				
Total current liabilities	19,154,769	6,466,955	19,350,550	370,614	3,054,825	2,645,929	995,742	934,697	640,009	2,733,369
CAPITAL LEASE OBLIGATIONS - Less current portion	808,739						19,479			
LONG-TERM DEBT - Less current portion	11,423,465									
ACCRUED VACATION - Less current portion	4,378,489	2,247,769	4,348,545	165,758	931,609	1,015,478	958,851	348,688	274,117	1,530,985
DUE TO AFFILIATES - Net	7,547,166	11,106,824		5,480,069	6,008,883	26,085,765	9,085,562	309,742	4,534,967	6,047,921
DUE TO THE STATE OF HAWAII		7,605,205			1,114,264	1,043,345	2,417,150	506,153	528,149	6,416,791
PATIENTS' SAFEKEEPING DEPOSITS	38,327	5,877		5,221	64,118	7,598	29,633	8,249	5,638	152,391
OTHER LIABILITIES	2,348	23,113	42,299	10,932		45,400	2,430	19,841		45,005
Total liabilities	43,353,303	27,455,743	23,741,394	6,032,594	11,173,699	30,843,515	13,508,847	2,127,370	5,982,880	16,926,462
NET ASSETS:										
Invested in capital assets - net of related debt	23,083,309	28,144,850	49,489,076	903,838	5,120,022	9,351,870	3,928,433	14,677,262	763,610	7,460,293
Unrestricted	(16,023,178)	(19,420,321)	9,801,297	(5,515,793)	(8,659,977)	(27,784,409)	(12,174,958)	(1,248,289)	(5,323,184)	(13,337,026)
Restricted		93,170					3,044			
Total net assets	7,060,131	8,817,699	59,290,373	(4,611,955)	(3,539,955)	(18,432,539)	(8,243,481)	13,428,973	(4,559,574)	(5,876,733)
TOTAL	$ 50,413,434	$ 36,273,442	$ 83,031,767	$ 1,420,639	$ 7,633,744	$ 12,410,976	$ 5,265,366	$ 15,556,343	$ 1,423,306	$ 11,049,729

	Facilities									
LIABILITIES AND NET ASSETS	Maluhia	Lanai Community Hospital	Total Facilities	Corporate	Reclassifi-cations and Elimi-nations	HHSC Combined	Hawaii Health Systems Founda-tion	Alii Com-munity Care	Reclassifi-cations and Elimi-nations	HHSC Consolidated
CURRENT LIABILITIES:										
Accounts payable and accrued expenses	$ 1,185,626	$ 139,091	$ 36,736,292	$ 2,700,482		$ 39,436,774				$ 39,436,774
Accrued workers' compensation liability	924,220	138,450	18,156,656	343,344		18,500,000				18,500,000
Current portion of capital lease obligations	6,055		471,938	6,564,943		7,036,881				7,036,881
Estimated third-party payor settlements	70,000	56,240	1,978,549			1,978,549				1,978,549
Current portion of accrued vacation	104,748	5,309	699,163	19,991		719,154				719,154
Current portion of long-term debt			568,423			568,423				568,423
Other current liabilities			366,177			366,177	$ 260,657	$ 49,301		676,135
Total current liabilities	2,290,649	339,090	58,977,198	9,628,760		68,605,958	260,657	49,301		68,915,916
CAPITAL LEASE OBLIGATIONS - Less current portion	6,069		834,287	16,215,664		17,049,951				17,049,951
LONG-TERM DEBT - Less current portion			11,423,465			11,423,465				11,423,465
ACCRUED VACATION - Less current portion	1,294,446	205,151	17,699,886	585,640		18,285,526				18,285,526
DUE TO AFFILIATES - Net	13,337,853	6,096,469	95,641,221		$ (95,817,094)	(175,873)	175,873			-
DUE TO THE STATE OF HAWAII	491,450		20,122,507			20,122,507				20,122,507
PATIENTS' SAFEKEEPING DEPOSITS	62,661	1,646	381,359			381,359				381,359
OTHER LIABILITIES	14,902	13,900	220,170	301,694		521,864				521,864
Total liabilities	17,498,030	6,656,256	205,300,093	26,731,758	(95,817,094)	136,214,757	436,530	49,301		136,700,588
NET ASSETS:										
Invested in capital assets - net of related debt	4,210,161	567,648	147,700,372	(7,243,184)		140,457,188	3,339	4,387		140,464,914
Unrestricted	(15,090,744)	(6,151,479)	(120,928,061)	87,851,519		(33,076,542)	(165,667)	95,652	(97,822)	(33,244,379)
Restricted	24,535		120,749	41,748		162,497	48,352	270,622		481,471
Total net assets	(10,856,048)	(5,583,831)	26,893,060	80,650,083		107,543,143	(113,976)	370,661	(97,822)	107,702,006
TOTAL	$ 6,641,982	$ 1,072,425	$ 232,193,153	$ 107,381,841	$ (95,817,094)	$ 243,757,900	$ 322,554	$ 419,962	$ (97,822)	$ 244,402,594

HAWAII HEALTH SYSTEMS CORPORATION

SUPPLEMENTAL COMBINING AND CONSOLIDATING STATEMENT OF REVENUES, EXPENSES, AND CHANGES IN NET ASSETS INFORMATION
YEAR ENDED JUNE 30, 2002

	Facilities																			
	Hilo Medical Center	Kona Community Hospital	Maui Memorial Medical Center	Ka'u Hospital	Kula Hospital	Kauai Veterans Memorial Hospital	Samuel Mahelona Memorial Hospital	Hale Ho'ola Hamakua	Kohala Hospital	Leahi Hospital	Maluhia	Lanai Community Hospital	Total Facilities	Corporate	Reclassifi-cations and Elimi-nations	HHSC Combined	Hawaii Health Systems Founda-tion	Alii Com-munity Care	Reclassifi-cations and Elimi-nations	HHSC Consolidated
OPERATING REVENUES:																				
Net patient service revenues	$ 70,176,019	$ 32,943,241	$ 94,047,861	$ 2,041,751	$ 10,729,572	$ 10,022,749	$ 6,843,206	$ 4,735,715	$ 2,275,746	$ 15,784,930	$ 12,550,118	$ 1,315,392	$ 263,466,300			$ 263,466,300				$ 263,466,300
Other operating revenues	1,217,641	307,137	1,157,486	22,818	105,064	527,039	112,854	23,931	31,079	287,385	37,043	712	3,830,189			3,830,189				3,830,189
Total operating revenues	71,393,660	33,250,378	95,205,347	2,064,569	10,834,636	10,549,788	6,956,060	4,759,646	2,306,825	16,072,315	12,587,161	1,316,104	267,296,489			267,296,489				267,296,489
OPERATING EXPENSES:																				
Salaries and benefits	46,261,830	21,094,904	43,188,652	1,666,504	8,272,272	8,651,613	5,758,329	3,465,677	2,426,490	13,050,029	10,368,587	1,461,567	165,666,454	$ 5,061,093		170,727,547		$ 77,538		170,805,085
Medical supplies and drugs	9,980,727	4,211,068	13,529,642	57,888	747,873	1,100,170	278,916	183,311	90,983	669,234	680,271	98,814	31,628,897			31,628,897				31,628,897
Purchased services	4,152,763	1,961,799	6,725,568	106,320	286,365	223,364	310,197	207,546	72,901	676,523	1,517,319	265,345	16,506,010	814,760		17,320,770	$ 4,132			17,324,902
Professional fees	4,665,865	1,452,910	5,991,841	608,166	217,670	1,976,130	248,913	155,825	416,561	119,309	63,107	51,804	15,968,101	868,559		16,836,660	7,452	68,565		16,912,677
Depreciation and amortization	3,099,584	1,937,045	2,877,917	84,809	392,275	697,547	396,448	548,393	94,304	941,449	342,062	45,066	11,456,899	2,376,851		13,833,750	1,378			13,835,128
Provision for doubtful accounts	3,655,491	2,532,944	3,737,299	247,859	375,138	500,359	324,957	(87,355)	75,856	122,019	564,434	216,437	12,265,438			12,265,438				12,265,438
Other supplies	2,325,967	682,703	4,849,836	69,750	599,645	302,372	263,409	241,303	83,929	868,550	562,140	74,651	10,924,255	74,065		10,998,320	104	30,415		11,028,839
Utilities	1,793,212	806,810	1,727,676	119,970	201,508	646,769	282,065	344,841	94,191	533,892	359,935	121,081	7,031,950	131,780		7,163,730		4,861		7,168,591
Repairs and maintenance	1,419,259	1,074,276	1,389,094	10,951	70,841	258,625	140,722	63,509	10,849	160,513	147,089	36,782	4,782,510	340,453		5,122,963				5,122,963
Rent and lease	733,563	278,927	1,442,660	4,310	12,446	251,762	20,466	23,578	19,514	26,310	7,665	3,084	2,824,285	47,920		2,872,205		2,112		2,874,317
Interest	963,686	26,024	25,077		5,835	31,507	5,398	902	337	7,351	5,159		1,071,276	839,597		1,910,873	11,468		$ (11,468)	1,910,873
Insurance	680,887	247,113	633,747	12,513	34,706	105,185	19,637	35,765	22,998	56,649	28,913	9,703	1,887,816	22,162		1,909,978				1,909,978
Other	1,214,201	654,490	1,368,674	46,341	97,021	393,551	92,430	42,033	86,416	94,361	76,638	40,770	4,206,926	381,754		4,588,680	21,188	245,887		4,855,755
Total operating expenses	80,947,035	36,961,013	87,487,683	3,035,381	11,313,595	15,138,954	8,141,887	5,225,328	3,495,329	17,326,189	14,723,319	2,425,104	286,220,817	10,958,994		297,179,811	45,722	429,378	(11,468)	297,643,443
INCOME (LOSS) FROM OPERATIONS	(9,553,375)	(3,710,635)	7,717,664	(970,812)	(478,959)	(4,589,166)	(1,185,827)	(465,682)	(1,188,504)	(1,253,874)	(2,136,158)	(1,109,000)	(18,924,328)	(10,958,994)		(29,883,322)	(45,722)	(429,378)	11,468	(30,346,954)
NONOPERATING REVENUES AND EXPENSES:																				
General appropriations from State of Hawaii														7,000,000		7,000,000				7,000,000
Collective bargaining pay raise appropriation from State of Hawaii	1,807,709	782,185	1,557,670	56,385	241,645	297,931	209,853	128,415	77,541	485,518	343,213	63,944	6,052,009	161,829		6,213,838				6,213,838
Restricted contributions		35,820									1,100		36,920	85,718		122,638	124,394	700,000		947,032
Corporate allocation expense	(2,663,237)	(1,177,713)	(3,011,887)	(95,343)	(396,343)	(495,986)	(269,325)	(180,834)	(116,879)	(599,847)	(510,586)	(82,489)	(9,600,469)	9,600,469		-				-
Interest and dividend income	10,172	7,044	24,086	854		3,529	109	129	1,295	969	1,750		49,937	194,838		244,775	312	2,217	(11,468)	235,836
Other nonoperating revenues (expenses) - net	17,231	258,356	87,094	19,730	10,990	1,817	65,278	125,986	2,989	564,671	13,773	14,777	1,182,692	52,062		1,234,754	(89,343)	97,822	(97,822)	1,145,411
Nonoperating revenues (expenses) - net	(828,125)	(94,308)	(1,343,037)	(18,374)	(143,708)	(192,709)	5,915	73,696	(35,054)	451,311	(150,750)	(3,768)	(2,278,911)	17,094,916		14,816,005	35,363	800,039	(109,290)	15,542,117
INCOME (LOSS) BEFORE CAPITAL CONTRIBUTIONS	(10,381,500)	(3,804,943)	6,374,627	(989,186)	(622,667)	(4,781,875)	(1,179,912)	(391,986)	(1,223,558)	(802,563)	(2,286,908)	(1,112,768)	(21,203,239)	6,135,922		(15,067,317)	(10,359)	370,661	(97,822)	(14,804,837)
CAPITAL ASSETS CONTRIBUTED BY STATE OF HAWAII	270,256		651,324	77,000	22,000	484,117	194,131	12,000	134,851	50,001	307,126	84,452	2,287,258			2,287,258				2,287,258
INCREASE (DECREASE) IN NET ASSETS	$ (10,111,244)	$ (3,804,943)	$ 7,025,951	$ (912,186)	$ (600,667)	$ (4,297,758)	$ (985,781)	$ (379,986)	$ (1,088,707)	$ (752,562)	$ (1,979,782)	$ (1,028,316)	$ (18,915,981)	$ 6,135,922	$ -	$ (12,780,059)	$ (10,359)	$ 370,661	$ (97,822)	$ (12,517,579)

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

Board of Directors of Hawaii Health Systems Corporation:

We have audited the consolidated financial statements of Hawaii Health Systems Corporation (HHSC) as of and for the year ended June 30, 2002, and have issued our report thereon dated November 1, 2002. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

Compliance

As part of obtaining reasonable assurance about whether HHSC's consolidated financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grants, noncompliance with which could have a direct and material effect on the determination of consolidated financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit and accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance that are required to be reported under *Government Auditing Standards*.

Internal Control over Financial Reporting

In planning and performing our audit, we considered HHSC's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the consolidated financial statements and not to provide assurance on the internal control over financial reporting. However, we noted 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 operation of the internal control over financial reporting that, in our judgment, could adversely affect HHSC's ability to record, process, summarize and report financial data consistent with the assertions of management in the consolidated financial statements. The reportable conditions are described in a separate letter to management of HHSC dated November 1, 2002 and are summarized as follows:

- Reconciliations of the capital lease obligation and capital assets accounts are not performed on a timely basis.
- Inadequate segregation of duties over the payables cycle.

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

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

Deloitte & Touche LLP

November 1, 2002

FISCAL YEAR 2002
HAWAII HEALTH SYSTEMS CORPORATION (HHSC)
VOLUNTEER COMMUNITY SUPPORT

Community support has played an integral role in enhancing the mission of the Hawaii Health Systems Corporation (HHSC) over the past year. Each community has diligently worked 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 assist in serving 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**
  - 95 active volunteers
    - Nearly 21,100 volunteered service hours each year
  - Auxiliary raises between $15,000-$30,000 annually
    - Commission from Baby Photos - $3,500
    - Palm Tree Gift Shop & Auxiliary Workshop - $25,000
    - Commission from Pay Telephones - $400
    - Grants ten (10) $500 nursing scholarship annually to nursing students at both UHH and HCC - $10,000
  - Hilo Medical Center Foundation
    - Since inception, raised more than $219,400 via community contributions and grants. Raised over $119,290 this fiscal year
- **Hale Ho'ola Hamakua**
  - 25 active volunteers
    - Nearly 6,270 volunteered service hours each year

- Annual cable television service provided by the Kamehameha Cable Vision ($385)

- The Kohala Hospital Charitable Foundation was established

- Capital improvement funds totaled $1.4 million:

    - Facility reroofing
    - Electrical system upgrade

KAUAI REGION

- **Kauai Veterans Memorial Hospital**

- 20 active volunteers

    - Nearly 1800 volunteered service hours each year

    - Auxiliary raised more than $15,000
        $10,000 in the Gift Shop
        $ 3,000 in commission sales (vending machines)
        $ 3,000 Gross profit from the Annual Christmas Craft Fair

    - $64 donated to Auxiliary from massage clinic held

    - $500 donation from Women's Health and Patricia Beck

    - $1,000 Nursing Scholarship distributed by Auxiliary to two students seeking a Nursing Degree ($500 each). ($250 from Virginia Beck – Women's Health Program, $750 Auxiliary)

    - $450 in personal donations

    - Auxiliary purchases included ($8,948):
        - Registration fees for Educational Training for staff (off-site)
            - Registered Nurses in the various acute departments for continued education certification
        - Office supplies and equipment
            - Filing supplies for the LTC Unit
        - Computer equipment for the Respiratory Therapy Department
        - Various furniture
            - Storage Cabinet for the LTC Unit
            - Refrigerator (replacement) for the LTC Unit
            - Six (6) Colored TV's for the LTC Unit

- Awareness pamphlets
- Sponsored in-house education & training & materials (printed) for CPR and other classes
- Recognition Awards Program (gift certificate awards, balloons, leis)
- Doctor's Day Festivities (donation of $100 towards gifts)
- Catered Events in community

- **Samuel Mahelona Memorial Medical Center**

  - 58 active volunteers

    - Nearly 7,500 volunteered service hours each year
    - Auxiliary raised more than $5,800 (Thrift Shop)
    - $5,000 donated from Hawaii Hotel Industry Association
    - $337 raised from Rummage Sale
    - $711 raised from the Country Store
    - $300 raised from Tee & Polo shirt sales
    - $400 donated from the Kauai Orchid Society
    - $750 donated from the Kapaa Rotary Club
    - $50 donated from the Kapaa Hongwanji Women Association.
    - $50 donated from the Kapaa Meisho Fujinkai
    - $460 in personal donations
    - Auxiliary purchases included:
      - Aquarium Supplies & Repairs
      - Furniture for Wards
      - Three Floating Lounges for Residents
      - New Years Party for Residents
      - Petting Zoo expenses
      - Two air conditioners
      - Office Supplies
      - Computer Supplies
      - Christmas for Residents; gifts & party
      - Kapaa High School Student Health Field Scholarships & Award Luncheon.
      - Resident Council expenses

- Auxiliary has raised more than $1950, in addition to providing two (2) $250 scholarships

- **Ka'u Hospital**
  - 3 active volunteers
    - Nearly 1620 volunteered service hours each year
  - Hospital Auxiliary provided two (2) $250.00 scholarships and raised over $500.00 (jointly with HMC and HHH Auxiliaries in the operation of a food booth at an event in Hilo)

WEST HAWAII REGION

- **Kona Community Hospital**
  - 61 active volunteers
    - Nearly 7,570 volunteered service hours each year
  - Auxiliary has donated $600 to both Kalani Ola and Long-Term Care for patient use
  - Auxiliary has donated eight nursing scholarships totaling $11,250
  - Auxiliary has donated support for patient Lifeline emergency response system - $1,100
  - Auxiliary has donated $300 for Hospital Week activities
  - Auxiliary donated baby caps for the newborns
  - Auxiliary White Elephant Sale proceeds totaled nearly $2,455.000
  - Auxiliary produces and coordinates Vital Signs, hospital's monthly newsletter

- **Kohala Hospital**
  - 21 active volunteers
    - Nearly 1,700 volunteered service hours each year
  - Annual Hospital Auxiliary Spaghetti Fundraiser Dinner raised $4,000.

- Farm Fair Booth expenses

MAUI REGION

- **Maui Memorial Medical Center**
  - 60 active volunteers
    - Nearly 16,200 volunteered service hours each year
    - Auxiliary donated a nearly $96,050.00 in equipment and scholarships
    - Auxiliary donated $50,000 for dialysis equipment
  - MMMC Charitable Foundation
    - Donated $43,000 for a Sentinel Node Probe
    - Raised $200,000 for the Angiography Suite
    - Received a gift of property valued at $174,000
    - Donated $45,000 for cancer patient and continuing medical education programs.
- **Kula Hospital**
  - 56 active volunteers
    - Nearly 6,850 volunteered service hours each year
    - Auxiliary purchases totaled more than $26.500
      - Lateral transfer device
      - Lightweight wheelchairs
      - Touch lamps
      - Large-print book club membership
      - IV arm and hand kit
      - Trauma manikin
      - Straight top over bed table with locking casters
      - Electronic labeling system
      - Bedside cabinets with hutches
      - Suction unit with charger
      - Resident name and number signs
      - Blanket warmer
      - Portable air compressors
      - Defibrillation adapters

- Two-way radios
- Audio pillows
- Television and VCR
- Book shelf
- Blood flow doppler
- Lap trays

- **Lanai Community Hospital**
  - 54 active volunteers
    - Nearly 1,715 volunteered service hours each year
    - $500 student scholarship from the Auxiliary

OAHU REGION

- **Leahi Hospital**
  - 146 active volunteers
    - Nearly 14,680 volunteered service hours each year
    - Thrift Shop raised a net of more than $15,000
    - In kind donations totaled $2,033
    - Monetary donations totaled $765
- **Maluhia**
  - 75active volunteers
    - Nearly 14,800 volunteered service hours each year
    - Gift Shop raises more than $18,000 per year
    - Monetary donations totaled $5,500
    - Auxiliary covered the costs of the following items: new tables and chairs for the Lanai; new equipment for Dietary; new supplies for Recreational Department; microwave ovens for nursing stations; and renovation efforts for lobby and office space
    - Equipment donated:

- Computer with Japanese language games for resident usage
- Puzzles, games, and activity equipment
- Artwork for resident rooms and facility hallways
- Wheel chairs
- Computers for resident internet access

Attachment 3

Hilo Medical Center
We Care for Our Community

East Hawaii Region Management Advisory Report
HHSC Annual Report
December 2002

The East Hawaii Region had a very busy and exciting fiscal year. Despite facing a difficult payer mix for declining reimbursements, all three facilities in the region, Hilo Medical Center, Hale Ho'ola Hamakua and Ka'u Hospital, continued to progress with projects that enhance not only healthcare in the community, but a healthy community.

Ka'u Hospital made a reality, the dream of a rural health clinic to expand primary care in one of the most rural and the largest (in terms of acreage) district community on the Big Island of Hawai'i. The hospital successfully hired three physicians to provide primary care and to cover emergency care for the community, thereby tripling coverage that was previously there. The development of the rural health clinic will also provide healthcare in a cost-effective way to ensure its perpetuity.

Hale Ho'ola Hamakua continues to operate at almost full capacity, highlighting the pressing need for additional beds in this coastal community. The infrastructure for the additional beds is already in place, as the facility was actually built and for planned future expansion. The *future* is here, and a request for capital improvement funds (CIP) to complete the much needed expansion of Hale Ho'ola is planned for the upcoming fiscal year. One of Hale Ho'ola's proud achievements was to see the partnership with the University of Hawaii at Hilo for a branch campus in the old Honokaa Hospital come to fruition. Classes have already begun, to assist community members with educational opportunities without the long commute.

Hilo Medical Center spent much of the year securing federal funds for a VA State Home on the hospital campus. With the VA Home Division committing 65% of the construction funds, Hilo Medical Center's Foundation will work towards securing the remaining 35% in CIP funding and through community support. Through the support of the Honorable Senator Daniel K. Inouye, this project will provide a much needed service in a community that is at over 95% capacity in long-term care beds.

The East Hawaii Region continues to manage in a challenging environment with approximately 75% of patients with Medicare/Medicaid/Quest coverage. With the assistance of the corporate staff and the support of the Board, the Region facilities continue to build and grow services for its communities, balancing fiscal and fiduciary responsibilities.

Respectfully Submitted,

Jerry Broughton
Hawaii Region Management Advisory Committee Chairperson

West Kauai Medical Center/KVMH
Mahelona Medical Center/SMMH
P.O. Box 337
Waimea, HI 96796
Phone (808) 338-9431 Fax (808) 338-9420

...Hospitals of the Hawaii Health Systems Corporation

December 31, 2002

Kauai Region Public Health Facilities Management Advisory Committee Annual Report 2002 (CY January 1, 2002 to December 31, 2002)

Hauoli Makahiki Hou!
Aloha, and thank you for the opportunity to share, with you, the events and activities that took place in the Kauai Region, for the year 2002. The Kauai Region Senior Management Team has been working diligently to continually lead the various hospital departments in providing quality healthcare for our Island community.

The accomplishments for the Calendar Year 2002 are as follows:

- Kauai Region Hospitals maintained their State Licensures and Medicare/Medicaid certifications.
- KVMH received a score of 98 for the Joint Commission on Accreditation of Hospital Organizations (JCAHO) Critical Access Hospital (CAH) Accreditation Program with NO Type I citations. We have also received deemed status for State Licensure.
- The Kauai Region continued implementing initiatives necessary to improve its cash collections. The region began the year with A/R days of 99 at KVMH and 78 days at SMMH. While staffing shortages hampered the region from reaping the gains of its efforts in FY02, the results of these initiatives have been dramatically realized in FY03. As of October 31, 2002, KVMH and SMMH's A/R days dropped to 67 from 99 days and from 83 to 61 days respectively.
- The Obstetrics Wing Renovation Project at the Kauai Veterans Memorial Hospital began (June 2002) with targeted completion date of January 2003.
- The Fire Alarm and Fire Sprinkler projects have been completed a KVMH in all areas accept the Obstetrics Wing (scheduled for completion in 2003). The Nurse Call System at KVMH is scheduled to begin in 2003.
- The Fire Alarm System at SMMH is complete and in operation. Both the Fire Sprinkler, and Nurse Call System upgrade projects will begin at SMMH in 2003.
- Labor costs have continued to be reduced at both hospitals. Regionalization has been the key for Kauai as it has made it possible for us to improve our services and

has contributed to a considerable reduction in managerial and staff positions through attrition, thus reducing our salary budget.

- All financial benefits seen for KVMH have been related to the Critical Access Hospital (CAH) Program.
- SMMH celebrated its 85th Anniversary in August 2002.
- Warren Brown, MD – Internist, Pediatrician joined the West Kauai Clinics in September 2002. With his arrival, we entered into a partnership with Kalaheo Clinic, Inc., to expand our outreach into new communities.
- Finalized behavioral health contract with the Hawaii State Hospital for SMMH. A contract is currently in effect to house and care for "forensic" psychiatric patients.
- SMMH saw an increased use in their Psychiatric Unit. Comparison of the period of July through November 2001 and July through November 2002 showed a 62% increase in revenue.
- SMMH increased its LTC bed count from 66 to 70 beds, which decreased its Acute bed count from 6 to 2 beds.
- KVMH enhanced its ultrasound services to 24 hours a day, 7 days a week, decreasing the need to transfer patients to other facilities. Also, new ultrasound equipment (scheduled to be installed in January 2003) will enable us to do cardiac ultrasound procedures, which will also enable us to service our community better.

Future Goals and Challenges:

1. Develop a Comprehensive Geriatric Center of Excellence on the Samuel Mahelona Memorial Hospital Campus.
2. Markedly increase Market Share.
3. Develop a seamless Healthcare Delivery System with other providers.

The Kauai Region has continued to move forward in great strides. Its Regional Senior Management Team has been working together, sharing ideas to keep the Region moving forward. It is here today through the leadership and guidance of Ms. Orianna Skomoroch, Regional CEO and her Senior Team.

I would like to sincerely thank the Board of Directors of the Hawaii Health Systems Corporation and Mr. Thomas Driskill, Jr. the President and CEO, HHSC for their continued support of the Kauai Region.

Respectfully submitted,

M. Jean Odo

M. Jean Odo
Kauai Region MAC Chair

Maui Region Public Health Facility Management Advisory Committee
Hawaii Health Systems Corporation
Annual Report to the Hawaii State Legislature
December, 2002

Thank you for the opportunity to provide this report. On behalf of the Maui Region Public Health Facility Management Advisory Committee, I would like to report that John Schaumburg, the new, permanent Regional Chief Executive Officer for Maui Memorial Medical Center (MMMC)/the Region, is doing an excellent job. A permanent Chief Medical Officer has also been hired.

I would like to thank you for the much needed $38 Million GO bond issue appropriated. This project will ensure improvement of patient care areas critical to the Medical Center's growth and quality patient care to meet the needs of Maui County.

I would like to ask for your continued support of our safety net hospital system. Healthcare reimbursements are down and operations going forward look gloomy. Maui Memorial along with other facilities within our system are faced with a growing waitlist for long term care placement. MMMC waitlist cost from lost income for 2002 is approximately $15,000,000 . For the Maui Region, the losses from Medicare, Medicaid, and Quest reimbursements approximated $12,700,000 and bad debt expense and charity care approximated $4,471,000. As part of the Maui Region, Lanai Community Hospital and Kula Hospital faced net losses of ($1,028,000) and ($601,000), respectively, for fiscal year 2002."

The entire Hawaii Healthcare Systems Corporation (HHSC) suffered an approximate $12,500,000 loss this year alone. Despite the tremendous obstacles Tom Driskill, HHSC President and CEO faced this year, he and his team were still able to provide the health safety net for the entire state of Hawaii. I ask that you please continue to support HHSC. Thank you for your commitment to healthcare in Hawaii.

Respectfully submitted,

Herbert Sakakihara
Maui Region Management
Advisory Committee Chairman

Oahu Region

2002 ANNUAL SUMMARY

ACCOMPLISHMENTS

- Leahi Hospital lease agreement with the University of Hawaii was completed. We are presently working on an agreeable methodology for utility cost allocation to UH.

- Regionalization has moved forward with:

  1. Regional Director of Nursing becoming more involved with Maluhia's nursing operations.

  2. The DON position at Maluhia was eliminated and the Nursing Supervisor was promoted to the Assistant DON position.

  3. The Maluhia Medical Records director has assumed the additional responsibilities of the Leahi Hospital medical records department and is working on streamlining and standardizing functions in medical records departments of both facilities.

  4. HR functions were regionalized in January 2002.

  5. Overtime was reduced by $223K for Leahi Hospital.

- Both facilities maintained hospital licensure through the DOH Office of Health Care Assurance.

- Voluntary employee exercise program after work hours instituted. Employees report better weight, blood pressure and pulse rate as well as feeling healthier.

- Medical staff voted to revise their Bylaws to an open medical staff structure.

- Disaster Committee restructured to involve various hospital sections participating in monthly meetings and is involved with the Healthcare Association of Hawaii Disaster Committee.

- Human Resources

  1. Employee of the Quarter program instituted and has increased staff morale and recognition.

  2. Pre-employment drug testing commenced April 2002.

3. Lawson HR system fully operational January 2002.

4. Performance Evaluation System now consistent with HHSC. PAS were completed on a timely basis by managers and supervisors.

5. Workers compensation cost reduced from:

   Leahi Hospital – $236K FY 01; $57K FY02
   Maluhia – $231K FY01; $0 FY02

6. Workers compensation cases reduced from:

   Leahi Hospital – 34 FY01; 25 FY02
   Maluhia – 6 FY01; 1 FY02

Fiscal Services

- Cash collections exceeded HHSC targets by 9 percent

  FY02 actual collections were $15M, target was $13M

- Accounts payables reduced to $110K from $500K for Leahi Hospital

- Budget for FY03 – Section heads were involved in developing and monitoring their own budgets

Nursing Services

- As part of the Nursing regionalization, Leahi has two nurse supervisors providing after hours coverage.

- Compensatory time off has been lowered from $96K to $85K.

- Various cost reductions initiatives have been instituted which include reducing the nursing hours per patient day from 4.5 hours to 3.8 hours at Leahi Hospital. Light duty staff have been returned to duty.

- Nursing overtime has decreased from $537K in 1999 to $290K in FY02.

- Majority of RNs have completed a nursing assessment training class.

<u>CHALLENGES</u>

- There is a need for funds to maintain the facility infrastructure of the hospitals, which includes repair/replacing roofs on the Sinclair Building.

- Need for funds to move to a steam generator system and phase out the costly boiler system to be cost effective.

- Little progress has been made toward the critical need for increase the electrical power needs for Leahi Hospital. The Load Shedding Study has been completed; however, the power need study remains incomplete by the engineering consulting firm.

- Managerial skills for department heads continues to need improvement. Various inservice training which includes drug education, workplace violence, budget management have been initiated.

- Reduce PACE losses to a manageable level.

We thank the Oahu Region Public Health Facilities Management Advisory Committee for their continued guidance and support.

WEST HAWAII MANAGEMENT ADVISORY COMMITTEE
OF THE HAWAII HEALTH SYSTEMS CORPORATIONS

ANNUAL REPORT FOR 2002

The year 2002 has been a challenging, but fruitful, 12 months for the Hawaii Health Systems Corporation's West Hawaii Region and its West Hawaii Management Advisory Committee (WHMAC). As for the composition of this latter team, upon completion of her WHMAC term this year Laura Power was succeeded by Keli'i Sine, R.N., Ph.D. The WHMAC much appreciates the interest and active service which both have demonstrated during their WHMAC membership.

The West Hawaii Region's challenges have been largely economic in nature, and reflect national and State trends of rapid advances in costs of health care without comparable increases in revenue, and wide negative balances between patient expenses and patient/insurance payments. In addition, by providing the required and much-needed healthcare "safety net" for rural communities, this Region cares for and treats a large population of uninsured or underinsured people without recompense; and is faced with spiraling employee compensation/benefits for which it has no voice in negotiating.

In spite of the challenges, during the year a competent team of physicians, employees, and administrators at HHSC's two facilities in West Hawaii made significant improvements in the quality and quantity of healthcare services being provided residents and visitors of that area, with the advice/support of the WHMAC.

At Kohala Hospital (KH) this included virtual completion of replacing the roof and providing electrical/mechanical upgrade, adjusting to its new status as a Critical Access Hospital, and establishing its own active Kohala Hospital Foundation.

In the meantime Kona Community Hospital (KCH) initiated a Board-certified Internal Medicine and Board-certified General Surgeon Hospitalist program, completed painting of the hospital's exterior, collected $5 million more than in the prior year, opened a $4.2 million Imaging Center and a 2100 square-foot Outpatient Services Building for chemotherapy, began generating its own electricity and providing co-generation heat, initiated Digital EchoCardiogram capability, and gained full three-year Accreditation in its JCAHO Survey.

In 2002 both facilities greatly strengthened partnerships with local communities and other healthcare facilities. This involved implementing services heretofore unavailable in their areas, as illustrated by obtaining mobile lithotripter equipment (for use by both public and private hospitals on the Big Island) as the State's first non-invasive kidney stone service outside of Honolulu, staging a public Golf Classic which raised $125K toward a Radiation Therapy Unit, and receiving an additional $550,000 in contributions from community organizations and individuals for specific projects and for the Kona Hospital Foundation. Both facilities gained greatly increased positive media exposure, and KCH was named West Hawaii's Large Employer of the Year by the Kona-Kohala Chamber of Commerce.

As noteworthy and important as are the above improvements, there are more challenges ahead. Many of these matters require prompt attention by the Legislature and/or other decision-making level, in the interest of delivery of effective quality health care to residents and guests of this State at reasonable costs. In the judgement of the WHMAC, those issues include the following:

1. Grant sufficient autonomy to HHSC and its facilities as to permit streamlined recruiting/placement of staff and HHSC negotiation of their salaries/benefits, with higher regard for the interests of the community and its tax-paying citizens.

2. Assure an equal level of care/treatment service for people throughout the State, regardless of whether they reside in an urban area (such as Honolulu) or in rural neighbor island regions.

3. Arrange for a greater portion of actual costs of treatment/care to be reimbursed by the patients and/or their insurance companies.

4. Provide more adequate, hospitable, high quality healthcare facilities for the aged.

5. Consider further partnering with other governmental agencies and the private sector to provide greater quality and efficiency in easily-accessible care/treatment at a minimal expense. Consider joint private-government operation of some facilities.

6. Consider introducing health wellness programs in the hospitals to provide a service to the public, while acquainting the community with the facilities when they are well, and increasing revenue through utilizing facilities during "down-times".

Many Mahalos for your kind attention, continued support, and your consideration of these challenges, attainments and suggestions.

WEST HAWAII MANAGEMENT ADVISORY COMMITTEE

Donna Brown, Secretary — Ken Clewett, Chair
Robyn Cook, M.D., Vice-Chair — Louise Hector, R.N.
Frank Jung, J.D. — Reggie Morimoto
Roy Nagle, M.D. — Frank Sayre, D.D.S.
Keli'i Sine, R.N., Ph.D.

PHYSICIANS ADVISORY GROUP
HAWAII HEALTH SYSTEMS CORPORATION
ANNUAL REPORT TO HAWAII STATE LEGISLATURE
2002

It is a pleasure to write this annual report on behalf of the Physicians Advisory Group of the Hawaii Health Systems Corporation.

The HHSC Physicians Advisory Group consists of appointed and elected physician leaders, including the Chiefs of Staff, and represents a Medical Staff which now numbers over 800 strong.

We urge you to consider healthcare to be a top priority for the State of Hawaii. On the neighbor islands, HHSC provides the "safety net" for healthcare as our rural hospitals are generally the only source for emergency, acute and long-term hospital care. With 1,250 acute care beds and 750 long-term care beds, HHSC is the largest healthcare provider in the State of Hawaii. In fact, with 12 hospitals on 5 islands, HHSC is the 4th largest healthcare safety net system in the United States. Please consider that HHSC hospitals are often the only source on the neighbor islands for:

- Childbirth and neonatal services.
- Diagnostic imaging, including MRI.
- Cardiology services, including echocardiography and angiography.
- Emergency Surgical Services
- Cancer treatment, including chemotherapy and radiation therapy.
- Inpatient psychiatric services.

Nearly 70,000 emergency patients are seen at Hilo, Maui, Kona and Kauai Veterans annually.

We urge you to continue funding HHSC. With $300 million in annual revenues, HHSC earns enough to cover approximately 90% of our operating expenses. In the first 5 years of its existence, HHSC has reduced losses by approximately $150 million. Under reimbursement by Medicare, Medicaid and Quest approximates $35 million per year, and Congress is currently planning to further reduce reimbursements. Care for uninsured patients approximated $14 million in 2001. A comparative analysis shows Honolulu County with 0.7% of the population uninsured while the figures on the neighbor islands range from 10% on Maui to over 15% on Kauai. Our financial outlook is further compromised by a severe shortage of long-term care beds on the neighbor islands. Patients waiting for transfer to long-term care facilities occupy approximately 100 acute care beds per day. These "wait-listed" patients account for $1,500.00 per bed per day in lost revenue. At Maui Memorial Medical Center alone, an estimated $10 million in revenue is lost annually from the shortage of long-term care beds.

The Physicians Advisory Group would like to thank CEO Tom Driskill, his Executive Management team, the HHSC Board of Directors, the Regional CEOs and their administrative staff, and the Regional Management Advisory Committees for their continued support in 2002. We hope 2003 will bring improved understanding by the Legislature of what HHSC stands for as the "safety net for healthcare" in the State of Hawaii. With your continued support, we will continue to provide quality medical care for the residents of Hawaii.

Sincerely,

T. Manoukian.

Anthony Manoukian, M.D.
Pathologist, Maui Memorial Medical Center
Chairman, HHSC Physicians Advisory Group
Maui Memorial Medical Center
221 Mahalani Street
Wailuku, Hawaii 96793

HAWAII HEALTH SYSTEMS CORPORATION

FUNCTIONAL ACCOMPLISHMENTS OF HAWAII'S SAFETY-NET HEALTH SYSTEM

- System-Wide
  - ❒ Achieved An Absolute Standard of Quality Care Across All 12 Facilities By Establishing a Quality System Managed by the HHSC Board of Directors
  - ❒ Achieved System-Wide JCAHO Quality Accreditation (with commendation)
  - ❒ Automated Personnel System
  - ❒ Energy Conservation through Co-Generation
  - ❒ Established Customer Satisfaction Benchmarks and Training
  - ❒ Established Four Critical Access Hospitals
  - ❒ Established Quality Performance Review System
  - ❒ Established Laboratory Joint Venture
  - ❒ Established Material/Equipment Standardization Teams
  - ❒ Established Two Subsidiary Corporations: 1) Assisted Living Facility; 2) System Foundations
  - ❒ Established Union Partnership
  - ❒ Established Veterans Administration Partnership
  - ❒ Fire/Safety Upgrade Compliant
  - ❒ Teleradiology
  - ❒ Video Teleconference

- Maui Memorial Medical Center
  - ❒ Magnetic Resonance Imaging Replacement
  - ❒ New Computerized Tomography Scanner
  - ❒ New Monitoring Systems
  - ❒ New Neurosurgery Service

- Hilo Medical Center
  - ❒ New Angiography Suite
  - ❒ New Call-System Replacement
  - ❒ New Cancer Center Service with Linear Accelerator
  - ❒ New Cardiac Cath Lab

- Kona Community Hospital
  - ❒ Established Hospitalist Program
  - ❒ Increased Total Licensed Beds from 75 to 94
  - ❒ New Magnetic Resonance Imaging
  - ❒ New Behavioral Health Unit
  - ❒ New Chemotherapy Clinic
  - ❒ New Computerized Tomography Scanner
  - ❒ New Lithrotripsy (HMC too)
  - ❒ New Nuclear Medicine Service

- Lanai Community Hospital

    - New Renal Dialysis Service
    - Nurse Call System Replacement

- Kauai Veterans Memorial Hospital

    - Added New 24-Hour Ultrasound Service
    - Established First Critical Access Hospital in Hawaii
    - Established Kauai's First Federally Qualified Health Center (Partnership with Ho'ola and Primary Care)
    - Established Two New Community Clinics
    - Expanded Outpatient Dialysis Service
    - Expanded Obstetrics Service

- Leahi Hospital

    - Adult Daycare Health Service Expansion

HAWAII HEALTH SYSTEMS CORPORATION

SYSTEM EFFICIENCIES OF HAWAII'S SAFETY-NET HEALTH SYSTEM

- Laboratory contract re-negotiation - $5 million dollars per year
- Insurance re-negotiation - $1 million dollars per year
- Re-negotiation of third-party payer contracts - (proprietary)
- Supply costs reduction by 20 percent - $4 million dollars per year
- Increased cash collections - $75 – 80 million dollars per year
- 340B pharmaceutical program (federal discount program for safety-net patients) - $200,000 dollars per year
- Foundation expansion - from 3 to 9 HHSC facilities
- Embrace community support - 100,000 volunteer hours per year
- Consolidate equipment maintenance support - $500,000 per year
- Workers compensation reduction - from 21.5 claims (per 100 employees) FY 97 to 7.8 claims in FY 02
- Reestablish hospital radiology services at four HHSC facilities - $2 million dollars per year
- Implement restructuring plans under Volunteer Separation Incentive Program

Attachment 6

HAWAII HEALTH SYSTEMS
C O R P O R A T I O N

"Touching Lives Everyday"

January 13, 2003

TO: Information Paper

FROM: Kelley Roberson
Chief Operation Officer and Chief Financial Officer

Re: HMSA payments for Quality Services and Recognition Program

Hawaii Health Systems Corporation has received payments totaling $503,557.02 from Hawaii Medical Services Association (HMSA) for achievement's at 5 facilities from participating in the 2002 Quality Services and Recognition Program. The memo to Maui Memorial Medical Center from HMSA on December 23, 2002 results is provided as an example of the memo sent to each of the 5 participating HHSC hospitals. Also, attached is a summary of payments made to the 5 facilities.

Attachment(s)

3675 KILAUEA AVENUE • HONOLULU, HAWAII 96816 • PHONE: (808) 733-4020 • FAX: (808) 733-4028

HILO • HONOKAA • KAU • KONA • KOHALA • WAIMEA • KAPAA • WAILUKU • KULA • LANAI • HONOLULU

HMSA 2002 Hospital Quality and Service Recognition Program

23-Dec-02

Provider	Maximum Award	Percent of Total Eligible Points	Percentage Applied to Maximum Award	Baseline HQSR Award Payment	Correction to FY 2001	Total FY 2002 HQSR Award Payment
Maui Memorial Medical Center	318152	0.8572	85.72	272719.8944	8506	$ 281,225.89
Hilo Medical Center	162068	0.8784	87.84	142360.5312	4568	$ 146,928.53
Kona Community Hospital	67821	0.9002	90.02	61052.4642	1752	$ 62,804.46
Kauai Veterans Memorial Hospital	13039	0.8521	85.21	11110.5319	255	$ 11,365.53
Samuel Mahelona Memorial Hospital	1479	0.8334	83.34	1232.5986	0	$ 1,232.60
	$ 562,559.00			$ 488,476.02	$ 15,081.00	$ 503,557.02
				86.83%	Effective Percentage Of Total Maximum	89.51%

Checks delivered to Kelley Roberson on Monday, December 23, 2002 by Marvin Hanson

JCAHO Survey Results

	Survey Scores
• Hilo Medical Center	
Hospital	90
Long Term Care	93
Home Health	98
• Kona Community Hospital	
Hospital	90
Long Term Care	96
• Maui Memorial Medical Center	
Hospital	87
• Kauai Veterans Memorial Hospital	
Hospital/Long Term Care	98

Attachment 8

HAWAII HEALTH SYSTEMS CORPORATION
ACTUAL CAH BENEFIT FY 02

Actual based on FY 02 C/R as filed	Projected CAH Impact							
	(a)				(b)			(a) + (b)
IMPACT TO HHSC FACILITIES	Medicare at Cost Based Reimb	HMSA 65C+ at Cost Based Reimb	Medicaid Acute & LTC at Cost Based Reimb	Total CAH Impact at 100% Cost Based Reimb	Medicaid LTC Limited to 200% RCL	Federal Share of 200% RCL	State Share funded by HHSC of 46.15%	Total Reimb. Impact to HHSC
Kau Hospital (2)	-		36,000	36,000	36,000	19,000	17,000	19,000
Kauai Veterans Memorial Hospital	1,177,000	545,000	565,000	2,287,000	565,000	304,000	261,000	2,026,000
Kohala Hospital (2)	-		100,000	100,000	100,000	54,000	46,000	54,000
Lanai Hospital (1) (2)	-		186,000	186,000	186,000	100,000	86,000	100,000
Total HHSC facilities	1,177,000	545,000	887,000	2,609,000	887,000	477,000	410,000	2,199,000

Assumptions:

1) Lanai CAH designatation effective 12/9/01, therefore, benefit amounts reflects 12/9/01 - 6/30/02 service dates.

2) Kau, Kohala and Lanai has filed low medicare utilization cost report to Medicare. In other words, we accept the interim rates as final reimbursement amount for the services rendered. For all of the CAH facilities, the interim rates were adjusted to cost based on latest available cost report available at that time. Since Medicare and HMSA 65C+ acute, swing and outpatient volume of business is relatively low at these facilties, did not compute CAH benefit for these facilities.