HAWAII HEALTH SYSTEMS
CORPORATION

"Touching Lives Everyday"

February 6, 2006

COO/CFO-06-009

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

Dear Governor Lingle:

It is with sincere appreciation for your tremendous support 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, community 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 have continued to improve our financial management and accounting systems throughout the year. Although in FY 1997 the Corporation received a qualified audit with many material weaknesses, we have now received our eighth consecutive "clean" unqualified audit with no material weaknesses for FY 2005, FY 2004, FY 2003, FY 2002, FY 2001, FY 2000, FY 1999 and FY 1998. The FY 2005 and FY 2004 comparative Audit Report is enclosed in accordance with H.R.S. Section 323F-22 (Attachment 1).

As a public hospital system, HHSC depends heavily on input and support from our local communities. Over this past year, over 1,000 community volunteers Statewide donated nearly 100,000 service hours to our facilities. The attached report details the donations of time and money from our communities in support of our facilities (Attachment 2).

In accordance with H.R.S. Section 323F-22, we are pleased to enclose the optional Annual Reports as submitted by our five Management Advisory Committees (MACs): East Hawaii, West Hawaii, Maui, Kauai, and Oahu (Attachment 3). Our Physicians Advisory Group (PAG) has also submitted an optional Annual Report (Attachment4). The continuing guidance and support of the MACs and PAG are tremendously important to the successful functioning of our system. Enclosed for your additional reference is a listing of our significant accomplishments, costs savings and enhancements to revenues in FY 2005. (Attachment 5).

We have continued to develop and improve our clinical and non-clinical quality programs consistently putting into practice our mantra that "Quality is Job One." The quality of our clinical operations was recognized by HMSA recently with $663,858.00 in checks to five HHSC

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facilities for our excellent results from participating in the HMSA Quality and Service Recognition Program (Attachment 6).

HHSC 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. Four HHSC acute facilities were recently surveyed in 2005 and successfully achieved full three-year re-accreditation by the Joint Commission on Accreditation of Healthcare Organizations (JCAHO). Using a new methodology, the surveyors provided a more rigorous and comprehensive evaluation on the actual delivery of patient care at our facilities. These facilities include Maui Memorial Medical Center, Hilo Medical Center, Kona Community Hospital and West Kauai Medical Center (as a critical access hospital). HHSC facilities will use these surveys to track efforts on continuously improving care processes, patient safety and quality outcomes. All other HHSC facilities fully passed all State licensure surveys and achieved full certification for both the Medicare program and the Medicaid program. HHSC continues to focus on quality improvements with the understanding that through enhanced quality care, we are achieving additional financial efficiency.

We are thankful for the support of the state of Hawaii for the critical access hospital (CAH) program. For several years four of our HHSC hospitals have benefited from cost-based reimbursement from Medicare for our acute care patients and from Medicaid for both our acute care patients and our long care patients in the distinct part skilled nursing facilities (SNF) associated with our four critical access hospitals: West Kauai Medical Center, Lanai Hospital, Kohala Hospital, and Ka`u Hospital. This cost-based stable funding has enhanced access to care and the quality of the care provided for the communities served by these four CAHs. We are excited to inform you that three more HHSC facilities have been qualified by certification inspections as critical access hospitals effective no later than the beginning of calendar year 2006: Kula Hospital, Hale Ho`ola Hamakua, and Samuel Mahelona Memorial Hospital. All three facilities have begun operating as CAHs, to include provision of 24 hours a day, 365 days per year access to emergency healthcare services. Our very excellent management and operating teams at all three new CAHs were able to complete the physical renovations and other changes to provide emergency services in cost worthy, creative ways. All three emergency departments are already being well utilized. Capital investments will be recovered as part of the cost-based reimbursements associated with CAHs. The staff of the Office of Healthcare Assurance (OHCA) of the Department of Health (DOH) was crucial to the successful establishment of the three new CAHs.

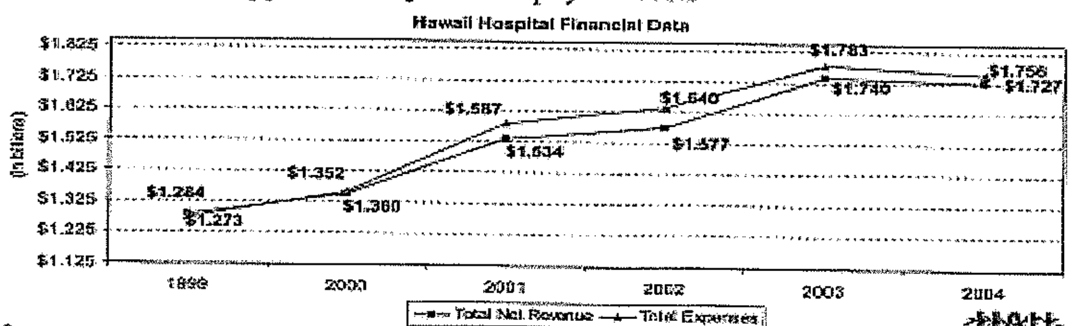
We are pleased to report that demolition of the old Hilo Hospital has been completed, making way for the construction of the Yukio Okutsu Veterans Care Home on the campus of Hilo Medical Center. The dramatically escalating costs of construction have created a need for additional funding that we hope will be resolved in the 2006 legislature and has been included in the administration's supplement budget request for fiscal year 2007. We are pleased to report that the U.S. Department of Veterans Affairs will pay for $1.8 million of the additional $5.0 million in cost. HHSC stakeholders are very grateful for the Capital Improvement Project (CIP) funding from the State of Hawaii for these important projects. News story on the groundbreaking for construction of the Yukio Okutsu Veterans Care Home attached for reference (Attachment 7).

Our stakeholders also are grateful for the $38 million in CIP funding for major renovation and expansion at Maui Memorial Medical Center. Construction and renovation efforts are proceeding well, although the dramatically escalating costs of construction have created a need for additional funding that we hope will be resolved in the 2006 legislature and has been included in the administration's supplement budget request for fiscal year 2007. News article on the "topping off" ceremony for the tower portion of the major renovation and expansion at Maui Memorial Medical Center is attached for reference. This project will provide for important improvements in access to and delivery of care (Attachment 8).

The hospital industry in Hawaii continues to struggle financially. Ernst & Young report commissioned by the Healthcare Association of Hawaii (HAH) shows that from 2000 through 2004 Hawaii hospitals' expenses have continued to exceed revenues. This trend cannot be sustained, because the asset values of Hawaii hospitals are being depleted by the cumulative annual operating losses. Since my report to you last year, a major hospital system (St. Francis Healthcare Systems) has decided to get out of the hospital business, and a statewide crisis has developed concerning the availability and affordability of specialty physicians for hospital emergency departments. In addition, the air ambulance system continues to struggle to provide timely transport of patients from neighbor island facilities to tertiary care on Oahu. As a result of these challenges, our neighbor island facilities now find it sometimes difficult to find accepting hospitals and physicians on Oahu for our patients who need higher level care, and, when accepting physicians and hospitals can be found, the air ambulance system may be unable to provide transport in a timely manner. This situation has placed great pressures on HHSC to provide specialty physician coverage on neighbor islands and to provide for air ambulance support for the neighbor islands.

Hawaii Hospital Financial Data

- Hawaii hospital financial data shows that expenses exceeded revenues beginning in 2000 with the losses continuing
- Hawaii hospitals in total experienced net losses since 2000
- Other operating (cafeteria, parking, etc.) and nonoperating revenues (interest and investment income, etc.) are needed in addition to net patient revenues to help cover expenses
- Personnel expenses comprise approximately 50% of hospital expenses and benefits are approximately 18% of payroll costs



Source: American Hospital Association, 2006 Hospital Statistics

HAH Healthcare Association of Hawaii

Last year I wrote to you "We will continue to dialogue with both the Administration and the Legislature on future directions for HHSC" and that "we all understand the need to find new, 'out of the box' solutions to providing services to the communities that we serve". The HHSC Board of Directors has embarked on a strategic planning initiative, pursuant to those thoughts in last year's letter and in response to the challenges facing the system and the needs identified by stakeholders in our communities. We will coordinate with the Administration and the Legislature on this strategic vision as more detailed planning information becomes available.

In order to provide full perspective on challenges and outcomes in FY 2005, copies of HHSC budget presentations for FY 2007 to both the House Committee on Finance (Executive Summary) and the Senate Committee on Ways and Means are attached (Attachments 9 & 10).

If you have any questions, please call me personally at 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: Consolidated Financial Statements for the Years Ended June 30, 2005 and 2004, Supplemental Information for the Year Ended June 30, 2004 and Independent Auditors' Reports
2. HHSC Volunteer Community Support
3. MAC Reports for East Hawaii, West Hawaii, Maui, Kauai, and Oahu
4. PAG Report
5. HHSC significant accomplishments, costs savings and enhancements to revenues in FY 2005
6. HMSA Quality and Service Recognition Program Report
7. Newspaper Story – Ground Breaking for State Veterans Home at Hilo
8. News paper Story – "Topping Off" Ceremony for Maui Memorial Medical Center
9. Executive Summary, January 13, 2006 Presentation to the House Committee on Finance on the FY 2007 HHSC Budget.
10. January 11, 2006 Presentation to the Senate Committee on Ways and Means on the FY 2007 HHSC Budget.

c: Legislative Reference Bureau

Deloitte.

Hawaii Health Systems Corporation

Consolidated Financial Statements as of and for the Years Ended June 30, 2005 and 2004, Supplemental Information as of and for the Year Ended June 30, 2005, and Independent Auditors' Reports

HAWAII HEALTH SYSTEMS CORPORATION

TABLE OF CONTENTS

HAWAII HEALTH SYSTEMS CORPORATION

INTRODUCTION

PURPOSE OF THE REPORT

The purpose of this report is to present the consolidated financial statements of Hawaii Health Systems Corporation (HHSC) as of and for the years ended June 30, 2005 and 2004 and the independent auditors' reports thereon.

SCOPE OF THE AUDIT

The audit was required to be performed in accordance with auditing standards generally accepted in the United States of America and Government Auditing Standards, issued by the Comptroller General of the United States. Those standards require that the auditors plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the HHSC's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the consolidated financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall consolidated financial statement presentation.

ORGANIZATION OF THE REPORT

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

- The first section presents this introduction.
- The second section presents the consolidated financial statements of HHSC as of and for the years ended June 30, 2005 and 2004 and the independent auditors' report thereon. This section also presents management's discussion and analysis and supplemental financial information.
- The third section presents the independent auditors' report in accordance with Government Auditing Standards on HHSC's internal control and compliance with laws and regulations.

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INDEPENDENT AUDITORS' REPORT

Board of Directors of Hawaii Health Systems Corporation:

We have audited the accompanying consolidated statements of net assets of Hawaii Health Systems Corporation (HHSC), a component unit of the State of Hawaii, as of June 30, 2005 and 2004, and the related consolidated statements of revenues, expenses, and changes in net assets and of cash flows for the years then ended. These financial statements are the responsibility of HHSC's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in Government Auditing Standards, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of HHSC's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, such consolidated financial statements present fairly, in all material respects, the financial position of HHSC at June 30, 2005 and 2004 and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

As discussed in Note 1, in fiscal year 1997, the administration of the facilities that comprise HHSC was transferred from the State Department of Health—Division of Community Hospitals (State) to HHSC. As of June 30, 2005, negotiations between the State and HHSC relating to the transfer of assets and liabilities (including amounts due to the State) still had not been finalized. Accordingly, the assets, liabilities and net assets reflected in the accompanying consolidated statements of net assets at June 30, 2005 and 2004 may be significantly different from those eventually included in the final settlement.

The management's discussion and analysis information on pages 4 through 14 is not a required part of the basic financial statements but is supplementary information required by the Governmental Accounting Standards Board. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it.

Our audit was conducted for the purpose of forming an opinion on the basic financial statements taken as a whole. The supplemental schedule on pages 34 and 35 is presented for the purpose of additional analysis and is not a required part of the basic financial statements. The supplemental combining and consolidating schedules on pages 36 through 38 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 our report dated November 14, 2005 on our consideration of HHSC's internal control over financial reporting and our tests of its compliance and other matters. The purpose of that report is to describe the scope of our testing, and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with Government Auditing Standards and should be read in conjunction with this report in considering the results of our audit.

Deloitte & Touche LLP

November 14, 2005

HAWAII HEALTH SYSTEMS CORPORATION

MANAGEMENT'S DISCUSSION AND ANALYSIS
AS OF AND FOR THE YEAR ENDED JUNE 30, 2005

OVERVIEW OF THE FINANCIAL STATEMENTS

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

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

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

Under the provisions of GASB No. 34, HHSC is considered to be a Special Purpose government entity. And, as a Special Purpose government entity engaged only in business-type activities, the only financial statements required to be presented are those for proprietary funds. Accordingly, HHSC's basic financial statements consist of a statement of net assets, a statement of revenues, expenses, and changes in net assets, a statement of cash flows, and notes to financial statements.

FINANCIAL ANALYSIS

Consolidated Statements of Net Assets

Summarized financial information of HHSC's consolidated statements of net assets as of June 30, 2005 and 2004 is as follows:

	2005	2004
ASSETS		
Current assets	$ 83,779,878	$ 76,242,228
Capital assets—net	195,793,055	189,288,485
Other assets	3,979,473	2,750,321
Total assets	$283,552,406	$268,281,034
LIABILITIES		
Current liabilities	$ 68,092,311	$ 90,667,690
Capital lease obligations—less current portion	27,351,486	25,787,410
Long-term debt—less current portion	11,536,119	11,904,730
Accrued vacation—less current portion	24,479,604	20,862,000
Advance from the State of Hawaii	14,000,000	
Due to the State of Hawaii	20,122,507	20,122,507
Other liabilities	731,072	702,190
Total liabilities	166,313,099	170,046,527
NET ASSETS		
Invested in capital assets—net of related debt	148,472,198	143,124,046
Restricted	1,302,537	949,595
Unrestricted	(32,535,428)	(45,839,134)
Total net assets	117,239,307	98,234,507
Total liabilities and net assets	$283,552,406	$268,281,034

At June 30, 2005, HHSC's capital assets, net of accumulated depreciation, comprised approximately 69% of its total assets. These assets consist mainly of land, hospital buildings and equipment that are used in HHSC's operations. The increase of approximately $6.5 million is due to property additions of $24.0 million, offset by depreciation expense of $16.9 million and retirements of $0.6 million. The primary reason for the increase is due to the acquisition of medical equipment, information systems, and energy-saving equipment of $9.3 million funded through HHSC's municipal leasing lines of credit and State-funded capital improvement projects of $10.1 million. The State-funded capital improvement projects consisted primarily of planning, design, and initial construction costs for the $38 million expansion of Maui Memorial Medical Center (MMMC).

The fiscal year 2004 increase of $2.5 million is due to capital asset additions of $19.0 million, offset by depreciation expense of approximately $16.2 million. The primary reasons for the increase are the acquisition of medical equipment and energy savings equipment of $9.6 million funded through HHSC's municipal leasing lines of credit and State-funded capital improvement projects of $5.4 million. The State-funded capital improvement projects consisted primarily of a nurse call system installation and electrical upgrades at Hilo Medical Center and design costs for the $38 million expansion of MMMC.

A summary of HHSC's capital assets as of June 30, 2005 and 2004 is as follows:

	2005	2004
Land and land improvements	$ 5,180,572	$ 5,083,354
Buildings and improvements	216,954,326	214,386,005
Equipment	122,668,591	116,430,470
Construction in progress	30,385,291	22,810,939
	375,188,780	358,710,768
Less accumulated depreciation and amortization	(179,395,725)	(169,422,283)
Capital assets—net	$ 195,793,055	$ 189,288,485

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

At June 30, 2004, HHSC's current assets approximated 28% of total assets. Current assets increased $1.9 million from the fiscal year 2003 balance primarily due to an increase in cash and cash equivalents. The increase in cash and cash equivalents was primarily due to the transfer of $1.5 million from the State of Hawaii general fund to HHSC's cash accounts with the State Treasury to pay for the retroactive pay raises for UPW bargaining unit 10. The other reason for the increase in cash and cash equivalents was the increase in cash collections for fiscal year 2004 as compared to the prior year. HHSC collected $291 million in fiscal year 2004 as compared to $277 million in fiscal year 2003 due to an increase in patient service revenues as a result of HHSC's investment in medical equipment at its three major acute facilities as well as HHSC's success in negotiating increases in reimbursement rates with third-party payors.

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

The primary reason for the fiscal year 2004 increase over fiscal year 2003 was an increase in the accrued workers' compensation liability of approximately $3.3 million. Although HHSC has been successful in reducing the amount of workers' compensation incidents from historical levels, HHSC has not been able to settle its outstanding claims as quickly due to its cash flow shortfall. Therefore, the claims are outstanding longer, and additional medical and legal costs are being incurred for each claim. As a result, the estimate of incurred but not reported claims has increased accordingly.

At June 30, 2005 and 2004, HHSC's total capital lease obligation balance increased approximately $1.3 million and $1.4 million from fiscal years 2004 and 2003, respectively. The primary reason for the increases is the acquisition of fixed equipment, medical equipment, and application systems (see explanation under capital assets above). HHSC has municipal leasing lines of credit with several municipal leasing companies, which allow HHSC to finance equipment purchases at interest rates below market rates.

At June 30, 2005, HHSC's long-term debt balances represented: 1) notes and term loans payable on the land, building, and medical equipment previously owned by Hilo Residency Training Program with a remaining balance of approximately $10.7 million, 2) a mortgage note payable relating to the acquisition of nursing cottages on the MMMC campus with a remaining balance of approximately $1.3 million, and 3) Kauai Veterans Memorial Hospital (KVMH) note of $252,000 for the purchase of a clinic.

At June 30, 2005, the portion of HHSC's net assets that is reflected as its investment in capital assets, net of related debt, of approximately $148.5 million, is larger than the total net assets of approximately $117.2 million. This means that HHSC's net operations since inception have resulted in losses of over $32 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, 2005 and 2004 is as follows:

	2005	2004
Operating expenses:		
Salaries and benefits	$218,729,966	$203,064,758
Purchased services and professional fees	39,325,481	37,488,569
Supplies and drugs	51,691,250	47,660,220
Depreciation and amortization	16,905,894	16,243,898
Insurance	5,124,854	2,333,601
Other	21,991,837	20,001,581
Total operating expenses	353,769,282	326,792,627
Operating revenues	320,921,172	288,238,743
Loss from operations	(32,848,110)	(38,553,884)
Nonoperating revenues (expenses):		
General appropriations from State of Hawaii	27,569,984	31,220,000
Collective bargaining pay raise appropriation from State of Hawaii	10,837,961	3,831,469
Restricted contributions	2,695,069	2,329,565
Other nonoperating revenues (expenses)—net	(996,944)	(3,721,800)
Total nonoperating revenues (expenses)	40,106,070	33,659,234
Income (loss) before capital contributions, transfers, and special item	7,257,960	(4,894,650)
Contributed capital assets and transfers	15,273,967	5,426,064
Special item—demolition costs	(3,527,127)	
Increase in net assets	$ 19,004,800	$ 531,414

For the year ended June 30, 2005, HHSC's operating expenses exceeded its operating revenues by $32.8 million. The appropriations from the State of Hawaii for collective bargaining pay raises of $10.8 million, general fund appropriations from the State of Hawaii of $27.6 million, other nonoperating income of approximately $1.7 million, and contributed capital assets and transfers of $15.3 million, less special item expenditure of $3.5 million, resulted in an increase in net assets of $19 million.

Management believes that four factors impede the comparability of the fiscal year 2005 results with those of prior fiscal years: 1) capital contributions and transfers of $15.3 million, which represent payments made by the State of Hawaii for HHSC's construction projects funded by State of Hawaii general obligation bonds, 2) extraordinary third-party payor settlements for sole community hospital designation of HHSC's three acute care hospitals of $11.6 million (see comment below), 3) workers' compensation liability actuarial adjustment of $3.7 million, and 4) demolition costs of the old Hilo Hospital prior to the construction of the Yukio Okutsu Veterans Care Home of $3.5 million. Management believes that these four factors are neither controllable nor recurring, and may not reflect HHSC's true operating performance. The following chart shows the impact of these four factors on HHSC's financial performance.

Increase in net assets for the year ended June 30, 2005	$ 19,005,000
Adjustments to exclude noncontrollable or nonrecurring items:	
Contributed capital assets and transfers	(15,274,000)
Extraordinary cost report settlements received	(11,647,000)
Workers' compensation actuarial adjustment	3,735,000
Demolition costs	3,527,000
Total adjustments	(19,659,000)
Adjusted decrease in net assets for the year ended June 30, 2005	$ (654,000)

For the year ended June 30, 2004, HHSC's operating expenses exceeded its operating revenues by $38.6 million. The appropriations from the State of Hawaii for collective bargaining pay raises of $3.8 million, general fund appropriations from the State of Hawaii of $31.2 million, restricted contributions of $2.3 million, other nonoperating expenses of $3.7 million, and capital assets contributed by the State of Hawaii of $5.4 million resulted in an increase in net assets of $531,000.

Operating expenses in fiscal 2005 were approximately 8% higher than fiscal 2004. The increase was mainly in the categories of salaries and benefits, supplies and drugs, professional fees and purchased services, and insurance expense. Salaries and benefits expense increased 7.7% from fiscal year 2004, due primarily to collective bargaining pay raises for HHSC's union employees and an increase in the fringe benefit rate assessed to HHSC by the State of Hawaii. HHSC's union employees in Hawaii Government Employees Association (HGEA) bargaining unit 9 (consisting of registered nurses) and UPW bargaining units 1 and 10 (consisting of blue collar nonsupervisory employees and licensed practical nurses) received pay raises from the union's collective bargaining agreements with the State of Hawaii of 5% effective July 1, 2004. HHSC's employees in HGEA bargaining units 2, 3, 4, and 13 received step pay increases effective July 1, 2004, with a 5% pay increase effective January 1, 2005. These pay raises represented an additional $7 million in salaries and benefits expense over fiscal year 2004. Further, the fringe benefit rate assessed to HHSC by the State of Hawaii increased from 32.2% for fiscal year 2004 to 34.7% for fiscal year 2005. The primary reason for the increase is the increase in the required contribution to fund the State Employee Retirement System. The impact of the increase in fringe benefit rate on HHSC was approximately $3.6 million for fiscal year 2005. In fiscal year 2005, HHSC recorded an adjustment of $3.7 million to increase its accrued workers' compensation liability based on an actuarial study. The reason for the increase was primarily due to rising medical costs for each workers' compensation claim and HHSC's inability to generate sufficient cash flow to settle its claims in an expedient manner. The increase in supplies and drugs expense was primarily due to an 6.3% increase in utilization of drugs sold to patients, as well as an increase in the use of chemotherapy drugs, which are much more expensive than other types of drugs. Chemotherapy procedures increased 37% from fiscal year 2004 to 2005. Professional fees and purchased services expenses increased by 4.9% primarily due to an increase in the amount of physician contracts entered into by HHSC due to the acquisition of a clinic by KVMH on December 31, 2004, as well as the need to ensure that certain specialty physician services are provided to Hawaii's rural communities, such as orthopedic and OB/GYN services. Insurance expenses increased due to the increase in malpractice insurance premiums. In fiscal year 2005, HHSC's malpractice insurance premium was $4.3 million, as compared to $1.475 million in fiscal year 2004. The reason for the increase is that the insurance carrier that provided coverage to HHSC in fiscal year 2004 decided to exit the Hawaii market and no longer provide such coverage.

Operating expenses in fiscal year 2004 were approximately 4.0% higher than fiscal year 2003. The increase was mainly in the category of salaries and benefits expense. Salaries and benefits expense increased 6.5% from fiscal year 2003, due primarily to collective bargaining pay raises for HHSC's union employees and an increase in FTEs at MMMC. HHSC's union employees in HGEA bargaining unit 9 (consisting of registered nurses) and UPW bargaining unit 10 (consisting of licensed practical nurses) received pay raises from the union's collective bargaining agreements with the State of Hawaii of 5%. These pay raises represented an additional $3.8 million in salaries and benefits expense over fiscal year 2003. Further, as part of an effort to reduce MMMC's dependence on high-priced contract nurses and imaging techs to provide clinical services to the community, FTEs at MMMC increased from an average of 942 in fiscal year 2003 to an average of 1,014 in fiscal year 2004.

Operating revenues increased by approximately 11.3%, as a result of third-party payor settlements received for sole community hospital reimbursement (primarily at MMMC), increase in ER visits at HHSC's acute care hospitals, and increases in negotiated reimbursement rates from private third-party payors. In fiscal year 2005, HHSC received $11.6 million in cost report settlements from Medicare and HMSA 65C+ relating to the sole community hospital reimbursement for MMMC, Hilo Medical Center (HMC), and Kona Community Hospital, with $10.2 million of the total going to MMMC. The settlements covered the fiscal years 2002 through 2004. Sole community hospitals are hospitals that, because of factors such as isolated location, weather conditions, travel conditions, or absence of other hospitals, are the sole source of inpatient services reasonably available in a geographic area, or are located more than 35 road miles from another hospital. Sole community hospitals receive either hospital-specific prospective rates based on base year costs updated to the present or the federal prospective payment system (PPS) rate, whichever is higher. The sole community hospital status also resulted in an increase in Medicare and HMSA 65C+ reimbursement rates during fiscal year 2005. The acute care reimbursement rates for MMMC, HMC, and Kona Community Hospital increased 27%, 11%, and 8%, respectively, in fiscal year 2005. Emergency Room visits for HHSC's three acute care hospitals increased 4.5% from fiscal year 2004 to fiscal year 2005. The largest increase occurred at MMMC, where Emergency Room visits increased 8.6% from fiscal year 2004 to fiscal year 2005. The increase in negotiated reimbursement rates from private third-party payors primarily represented inflationary increases of varying percentages.

Fiscal year 2004 operating revenues increased by approximately 8.2% over fiscal year 2003 (before netting the provision for doubtful accounts against patient service revenues), as a result of increased sole community hospital reimbursements received by MMMC, a rate increase effective July 1, 2003 of 10%, and increases in negotiated reimbursement rates from third-party payors. The increase in revenues primarily came in the areas of emergency room, CT Scan, radiation therapy, respiratory therapy, acute psychiatry, clinical laboratory testing, and drugs sold to patients. The primary increase in operating revenues occurred at MMMC, partially due to an increase in emergency room visits of 7.3% and an increase in newborn patient days of 5%. The increase in sole community hospital reimbursements amounted to approximately $4 million in additional reimbursements to MMMC. The increase in negotiated reimbursement rates from third-party payors primarily represented inflationary increases of varying percentages.

After netting the provision for doubtful accounts against patient service revenues, fiscal year 2004 operating revenues increased by 6.6% over fiscal year 2003. Provision for doubtful accounts increased $5.7 million from fiscal year 2003, due to an increase of $3.7 million in provision for doubtful accounts at MMMC. In fiscal year 2004, management at MMMC made a concerted effort to focus the efforts of its business office staff on collecting on current bills and engaged several third-party collection agencies to focus on collecting the older outstanding receivables. As a result of this effort, numerous accounts over 151 days past due were written-off in an effort to focus on the more collectible accounts.

For the year ended June 30, 2005, General Fund Appropriations from the State of Hawaii consisted of $27.8 million approved for HHSC's operating purposes by the 2004 Legislature, reduced by approximately

$278,000 by the Governor for efficiency savings. For the year ended June 30, 2004, General Fund Appropriations from the State of Hawaii consisted of $31.2 million approved for HHSC's operating purposes by the 2003 Legislature.

HHSC's management believes that the significant excess of operating expenses over operating revenues in both 2005 and 2004, 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 2005, 61% of HHSC's total gross revenues were from government-type payors (approximately 23% from Medicare and approximately 27% from Medicaid and Med-Quest). In fact, government-type payors account for 90% of HHSC's long-term care revenues. Reimbursements from government-type payors has not kept up with the increasing costs of health care providers since the Balanced Budget Act of 1997 was passed, which dramatically reduced the level of reimbursements from government-type payors.

Further, management believes that there are two Medicaid reimbursement issues that will have a significant negative impact on the financial performance of HHSC: the implementation of Act 294 and the lack of Medicaid Disproportionate Share Hospital (DSH) provider reimbursements in the State of Hawaii. Act 294 was passed by the State Legislature in 1998, and requires that no later than June 30, 2003, there be no distinction in reimbursement rates between hospital-based and non-hospital-based long-term care facilities under the Medicaid program. Prior to the passage of Act 294, hospital-based long-term care facilities received a higher reimbursement than freestanding long-term care facilities under the Medicaid program, primarily due to the recognition that hospital-based long-term care facilities are subject to the compliance with EMTALA (Emergency Medical Treatment and Labor Act) requirements, which requires hospitals to accept all patients who come through an emergency room, regardless of the patient's ability to pay. Freestanding long-term care facilities are not subject to EMTALA requirements. Compliance with EMTALA requirements imposes additional costs on hospital-based long-term care facilities, primarily in staffing requirements and in bad debt expense. Six HHSC facilities would be negatively impacted by the implementation of Act 294, while one facility (Maluhia) would be positively impacted. Understanding the dramatic impact that implementation of Act 294 would have on HHSC, the Department of Human Services has authorized a phased implementation of Act 294 over six years. However, management estimates that even with a phased implementation, the cost to HHSC will be approximately $38 million over the six-year phase-in period. Once Act 294 is fully implemented, management estimates that the cost to HHSC will be approximately $13 million per year. Management believes that such large annual costs will simply serve to increase the amount of general fund appropriations that HHSC will be seeking from the State of Hawaii each year, as the amount of cost reductions/revenue enhancements that can be reasonably explored will not be enough to absorb such costs. In September 2003, the Center for Medicare and Medicaid Services approved Hawaii's Medicaid State Plan Amendment to provide relief payments to those nursing facilities negatively impacted by Act 294. Effective July 1, 2005 through June 30, 2008, all hospital-based nursing facilities will receive an additional transitional payment equal to a specified percentage of the difference between their acuity-based rate and their rate as calculated under the PPS methodology. While this will provide short-term relief for HHSC's facilities that are negatively impacted by Act 294, management is continuing to work with the State Department of Human Services to explore long-term alternative reimbursement solutions that would ease the burden of Act 294 on HHSC's long-term care facilities.

When the State of Hawaii implemented the Med-QUEST (QUEST) program in 1994, the federal funds provided to the State of Hawaii for Medicaid DSH payments to hospitals were eliminated. DSH payments are additional reimbursements that attempt to reflect additional costs incurred by providers who serve a significantly disproportionate number of low-income patients and/or significant number of Medicaid patients. HHSC's patient mix is such that it would have qualified for Medicaid DSH payments had the State of Hawaii not eliminated such payments. Such additional reimbursements would have reduced the amount of State subsidies needed to finance the operations of HHSC. Management estimates that if the State of Hawaii had maintained Medicaid DSH payments, HHSC would be receiving approximately $7 million more in reimbursements than it currently does. To illustrate the importance of Medicaid DSH payments to public hospital systems, the National Association of Public Hospitals' report on "America's Public Hospitals and Health Systems, 2003" states that in 2003, "Medicaid DSH also represented a critical funding source, financing almost a quarter of the unreimbursed care provided." In September 2005, the State Department of Human Services (DHS), in partnership with HHSC management, the Governor, the State of Hawaii Legislature, and the Healthcare Association of Hawaii (HAH), was able to use HHSC's fiscal years 2006 and 2007 projected losses from providing uncompensated care under the Medicaid fee-for-service program to draw down additional federal funding for all Hawaii hospitals. DHS has agreed to a direct payment to HHSC of over $8 million for fiscal year 2006, of which $2.2 million was paid to HHSC in October 2005. Because of this innovative approach to drawing down additional federal funds, HHSC was able to reduce its request for State general fund appropriations by $8.8 million. Management will continue to work with DHS, the State of Hawaii Legislature, and HAH to explore long-term reimbursement enhancements that could reduce HHSC's reliance on general fund appropriations.

Second, HHSC's facilities on the neighbor islands suffer from an insufficient supply of long-term care beds. 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 HMC and MMMC, have numerous patients initially admitted as acute patients, but who continue to occupy acute-care beds while awaiting long-term care beds to become available. Such patients are called "wait-list" patients. HHSC receives little to no reimbursement from insurers for such patients, as insurers will not reimburse providers for patients whose required level of care does not coincide with the type of bed the patient is occupying. Combined, HMC and MMMC have an average census of approximately 20-40 wait list patients per day. Management expects the wait-list problem to worsen as Hawaii's population continues to age and the State of Hawaii lags behind on a credible plan to address the long-term care crisis.

Third, HHSC's salaries and benefits expenses represent approximately 61% of its total operating expenses, and management continues to face several challenging issues regarding management of personnel and personnel costs. HHSC is bound by the collective bargaining agreements negotiated by the State of Hawaii and the public employee unions (HGEA and UPW). The collective bargaining agreements not only bind HHSC to the negotiated pay raises, but also to the union work regulations and benefit packages. Management believes that such arrangements do not allow HHSC to manage its resources as effectively as other health-care systems.

Also, since the majority of HHSC's facilities are in rural locations, management faces many recruitment and retention issues of key clinical personnel. Areas of acute shortage include RNs and LPNs, anesthetists, imaging technicians, physicians, surgery technicians, pharmacists and pharmacy technicians, and health information management specialists. These shortage areas are caused by several factors: 1) a nation-wide shortage of health care workers, 2) the inability of local colleges and universities to provide sufficient classes and teachers that can educate students in these areas, and 3) competition for these same types of positions with private hospitals, which can pay significantly higher wage rates than HHSC. In particular, the shortage of RNs and LPNs results in HHSC having to expend significant amounts for agency nurses, which are paid at significantly higher rates. For example, an HHSC nurse earns approximately $29 per hour, while an agency nurse can earn between $48 and $96 per hour depending on the specialty. Another issue compounding HHSC's nursing situation is the fact that all of HHSC's nurses are full-time salaried employees, while the nurses at the other private hospitals are hourly employees. This allows the private hospitals to increase or decrease their nurse staffing based on census; by contrast, HHSC facilities cannot decrease their nurse staffing if census is lower than budgeted.

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

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

On January 20, 2005, The State Procurement Office delegated to HHSC's President/Chief Executive Officer limited authority to make certain decisions under the State Procurement Code up to July 1, 2005 (this delegation was subsequently extended through June 30, 2006 by a letter from the State Procurement Office dated June 29, 2005). Even with the delegation of limited authority, HHSC has incurred significant costs in its attempt to comply with the provisions of HRS 103(d). The most troubling cost is in the area of delayed medical care due to the delay in obtaining needed medical equipment. This results in more pain for the patient and the likelihood of a detrimental outcome increases. An example of this involves two people who needed shoulder replacement surgery at HMC. The equipment necessary for the procedure could not be procured in a timely manner because of the time needed to comply with the onerous requirement of HRS 103(d). The patients in this example ended up having to go to Oahu to have their surgery performed at a later date, and suffered through a longer recovery period as a result. Another cost is that the medical staffs at HHSC's hospitals are upset about the implementation of the code. These physicians are being forced to spend an inordinate amount of time justifying the purchase of a specific piece of essential medical equipment on a piece-by-piece basis, which is time that could better be spent providing care to their patients. Given the shortage of certain physician specialists on the neighbor islands, anything that would cause frustration to these physicians could result in a loss of certain specialty care in neighbor island communities should these physicians choose to leave. The medical staffs are also upset that preferences of a surgeon in using particular brands of medical equipment require extensive justification under HRS 103(d). Further, the State Procurement Office is having a difficult time providing answers to questions and training to HHSC personnel due to their limited staff and the difficulty in reconciling the provisions of HRS 323(f) (the statute that delineates the powers and governance of HHSC) and HRS 103(d). Finally, HHSC has incurred costs in increasing procurement/legal staff to handle the increased workload of complying with the requirements of HRS 103(d), as well as the cost of increased employee time to handle the increased paperwork and number of requests for proposal (RFPs) that are required under the code. Management estimates that HHSC will be required to perform 150 more RFPs/Invitation for Bid (IFBs) each year due to the requirements of HRS 103(d).

Management believes that exemption from HRS 103(d) is appropriate for HHSC in order for HHSC to provide timely medical services to the communities it serves in an efficient and effective manner. In the alternative, management believes that Chief Procurement Officer authority should be given to HHSC with some revisions to HRS 103(d) in order for HHSC to continue to operate under all competitive tenets of the State procurement code, while achieving a level of improved efficiency not currently available.

Finally, HHSC serves as the "safety-net" provider of health care for 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, MMMC is the primary acute care facility on the island of Maui, and HMC and Kona Community Hospital are the only acute care facilities with more than 50 acute beds on the island of Hawaii. In addition, Leahi Hospital functions as the primary tuberculosis hospital for the State of Hawaii. Also, HHSC's long-term care facilities provide the primary source of long-term care services for elderly people who cannot afford private care or nursing homes and do not have family that can care for them. Given all of the above, management believes that HHSC has a vital role in ensuring that the people of the State of Hawaii have access to quality health care.

HAWAII HEALTH SYSTEMS CORPORATION

CONSOLIDATED STATEMENTS OF NET ASSETS AS OF JUNE 30, 2005 AND 2004

	2005	2004
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents:		
On deposit with the State of Hawaii	$ 9,805,315	$ 9,864,299
On deposit with banks and on hand (Note 3)	10,748,445	8,764,360
Patient accounts receivable, less allowances of $82,083,403 and $93,591,425 for contractual adjustments and doubtful accounts	50,342,937	49,537,926
Supplies and other current assets	8,908,486	8,075,643
Estimated third-party payor settlements	3,974,695	
Total current assets	83,779,878	76,242,228
CAPITAL ASSETS—Net (Notes 4, 6, 7 and 14)	195,793,055	189,288,485
ASSETS LIMITED AS TO USE	1,706,212	1,312,093
OTHER ASSETS (Notes 11 and 13)	2,273,261	1,438,228
TOTAL	$283,552,406	$268,281,034

(Continued)

HAWAII HEALTH SYSTEMS CORPORATION

CONSOLIDATED STATEMENTS OF NET ASSETS AS OF JUNE 30, 2005 AND 2004

LIABILITIES AND NET ASSETS	2005	2004
CURRENT LIABILITIES:		
Accounts payable and accrued expenses (Note 11)	$ 33,001,707	$ 42,823,960
Accrued workers' compensation liability (Note 10)	25,282,963	21,854,000
Current portion of capital lease obligations (Note 6)	7,738,765	7,958,701
Current portion of accrued vacation (Note 6)	829,121	1,365,261
Current portion of long-term debt (Note 7)	694,487	513,598
Other current liabilities	545,268	758,550
Advance from the State of Hawaii (Note 5)		14,000,000
Estimated third-party payor settlements		1,393,620
Total current liabilities	68,092,311	90,667,690
CAPITAL LEASE OBLIGATIONS—Less current portion (Note 6)	27,351,486	25,787,410
LONG-TERM DEBT—Less current portion (Note 7)	11,536,119	11,904,730
ACCRUED VACATION—Less current portion (Note 6)	24,479,604	20,862,000
ADVANCE FROM THE STATE OF HAWAII (Note 5)	14,000,000	
DUE TO THE STATE OF HAWAII	20,122,507	20,122,507
PATIENTS' SAFEKEEPING DEPOSITS AND DEFERRED INCOME—Restricted contributions	403,675	362,498
OTHER LIABILITIES	327,397	339,692
Total liabilities	166,313,099	170,046,527
NET ASSETS:		
Invested in capital assets—net of related debt	148,472,198	143,124,046
Restricted (Note 12)	1,302,537	949,595
Unrestricted (Note 3)	(32,535,428)	(45,839,134)
Total net assets	117,239,307	98,234,507
TOTAL	$283,552,406	$268,281,034

See notes to consolidated financial statements.

(Concluded)

HAWAII HEALTH SYSTEMS CORPORATION

CONSOLIDATED STATEMENTS OF REVENUES, EXPENSES, AND CHANGES IN NET ASSETS FOR THE YEARS ENDED JUNE 30, 2005 AND 2004

	2005	2004
OPERATING REVENUES:		
Net patient service revenues (Note 8)	$ 315,092,101	$ 283,296,884
Other operating revenues (Notes 8 and 11)	5,829,071	4,941,859
Total operating revenues	320,921,172	288,238,743
OPERATING EXPENSES:		
Salaries and benefits (Notes 8 and 9)	218,729,966	203,064,758
Medical supplies and drugs	39,450,011	36,927,252
Purchased services (Notes 8 and 11)	34,738,569	34,508,122
Depreciation and amortization	16,905,894	16,243,898
Other supplies	12,241,239	10,732,968
Utilities	7,556,158	7,161,330
Repairs and maintenance	6,426,571	5,335,109
Insurance	5,124,854	2,333,601
Professional fees (Notes 8 and 11)	4,586,912	2,980,447
Rent and lease	3,915,669	3,840,882
Other	4,093,439	3,664,260
Total operating expenses	353,769,282	326,792,627
LOSS FROM OPERATIONS	(32,848,110)	(38,553,884)
NONOPERATING REVENUES (EXPENSES):		
General appropriations from State of Hawaii	27,569,984	31,220,000
Collective bargaining pay raise appropriation from State of Hawaii	10,837,961	3,831,469
Restricted contributions (Note 12)	2,695,069	2,329,565
Interest and dividend income	253,227	118,223
Interest expense (net of capitalized interest) (Note 6)	(3,166,566)	(2,871,484)
Other nonoperating revenues (expenses)—net (Note 12)	1,916,395	(968,539)
Total nonoperating revenues (expenses)	40,106,070	33,659,234
INCOME (LOSS) BEFORE CAPITAL CONTRIBUTIONS, TRANSFERS, AND SPECIAL ITEM	7,257,960	(4,894,650)
CONTRIBUTED CAPITAL ASSETS AND TRANSFERS (Notes 4 and 14)	15,273,967	5,426,064
SPECIAL ITEM—Demolition costs (Note 14)	(3,527,127)	
INCREASE IN NET ASSETS	19,004,800	531,414
NET ASSETS—Beginning of year	98,234,507	97,703,093
NET ASSETS—End of year	$ 117,239,307	$ 98,234,507

See notes to consolidated financial statements.

HAWAII HEALTH SYSTEMS CORPORATION

CONSOLIDATED STATEMENTS OF CASH FLOWS FOR THE YEARS ENDED JUNE 30, 2005 AND 2004

	2005	2004
OPERATING ACTIVITIES:		
Receipts from government, insurance and patients	$ 308,918,775	$ 284,065,854
Payments to employees	(211,002,445)	(197,019,766)
Payments to suppliers and others	(127,570,320)	(110,261,774)
Other receipts—net	5,016,641	5,493,078
Net cash used in operating activities	(24,637,349)	(17,722,608)
NONCAPITAL FINANCING ACTIVITIES:		
Appropriations from State of Hawaii	38,407,945	35,051,469
Other nonoperating revenues—net	1,224,168	1,072,082
Net cash provided by noncapital financing activities	39,632,113	36,123,551
CAPITAL AND RELATED FINANCING ACTIVITIES:		
Repayments on capital lease obligations	(7,927,543)	(8,204,207)
Capital expenditures	(2,228,181)	(3,723,404)
Payments on long-term debt	(439,722)	(553,450)
Interest on capital lease obligations and long-term debt	(3,166,566)	(2,871,484)
Proceeds from sale of capital assets	47,730	1,772
Deposit on noncurrent asset	(25,000)	
Loss on disposal of capital assets—net	565,459	258,627
Net cash used in capital and related financing activities	(13,173,823)	(15,092,146)
INVESTING ACTIVITIES:		
Distributions received from the Clinical Laboratories of Hawaii partnership	212,160	48,960
Purchase of clinic assets	(108,000)	
Net cash provided by investing activities	104,160	48,960
NET INCREASE IN CASH AND CASH EQUIVALENTS	1,925,101	3,357,757
CASH AND CASH EQUIVALENTS—Beginning of year	18,628,659	15,270,902
CASH AND CASH EQUIVALENTS—End of year	$ 20,553,760	$ 18,628,659

(Continued)

HAWAII HEALTH SYSTEMS CORPORATION

CONSOLIDATED STATEMENTS OF CASH FLOWS
FOR THE YEARS ENDED JUNE 30, 2005 AND 2004

	2005	2004
RECONCILIATION OF LOSS FROM OPERATIONS TO NET CASH USED IN OPERATING ACTIVITIES:		
Loss from operations	$ (32,848,110)	$ (38,553,884)
Adjustments to reconcile loss from operations to net cash used in operating activities:		
Provision for doubtful accounts	16,057,850	22,397,079
Depreciation and amortization	16,905,894	16,243,898
Amounts released from restrictions	824,486	474,064
Change in operating assets and liabilities:		
Patient accounts receivable	(16,862,861)	(21,455,743)
Supplies and other assets	(812,430)	551,219
Accounts payable, accrued expenses, and other liabilities	(9,044,290)	(1,062,998)
Accrued workers' compensation liability	3,428,963	3,354,000
Estimated third-party payor settlements	(5,368,315)	(172,366)
Accrued vacation	3,081,464	502,123
Net cash used in operating activities	$ (24,637,349)	$ (17,722,608)
SUPPLEMENTAL CASH FLOW INFORMATION:		
Interest paid, primarily on capital lease obligations	$ 3,166,566	$ 3,123,893
NONCASH FINANCING AND INVESTING ACTIVITIES:		
• Capital assets acquired under capital leases	9,271,683	8,284,428
• Prior year capital assets in accounts payable funded through capital lease		1,364,870
• Capital assets contributed by State of Hawaii	10,104,946	5,426,064
• Capital asset purchases included in accounts payable	659,091	1,452,737
• Capital asset purchases included in other liabilities		209,894
• Contribution of capital assets	212,848	255,937
• Capital assets acquired with restricted assets	1,517,641	138,461
• Rental income contributed to Clinical Laboratories of Hawaii partnership	732,606	719,616
• Capital assets contributed by the State of Hawaii for the Yukio Okutsu Veterans Care Home	1,641,894	
• Demolition costs funded by transfers from the State of Hawaii	3,527,127	
• Acquisition of clinic assets:		
Goodwill	$ 243,000	
Intangible asset	55,000	
Inventory	12,000	
Equipment	50,000	
Less cash paid	(108,000)	
Assets purchased through the issuance of long-term debt	$ 252,000	

See notes to consolidated financial statements.

(Concluded)

1. ORGANIZATION

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

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

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

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, 2005. Accordingly, the assets, liabilities and net assets of HHSC reflected in the accompanying consolidated statements of net assets may be significantly different from those eventually included in the final settlement.

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

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

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

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

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

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

Cash and Cash Equivalents—Cash and cash equivalents include short-term investments with original maturities of three months or less. It also includes amounts held in the State Treasury. The State Director of Finance is responsible for the safekeeping of all moneys paid into the State Treasury (cash pool). HHSC's portion of this cash pool at June 30, 2005 and 2004 is indicated in the accompanying consolidated statements of net assets as "Cash and cash equivalents on deposit with the State of Hawaii." The Hawaii Revised Statutes authorize the Director of Finance to invest in obligations of, or guaranteed by, the U.S. Government, obligations of the State, federally-insured savings and checking accounts, time certificates of deposit, and repurchase agreements with federally-insured financial institutions. Cash and deposits with financial institutions are collateralized in accordance with State Statutes. All securities pledged as collateral are held either by the State Treasury or by the State's fiscal agents in the name of the State.

HHSC has cash in financial institutions that is in excess of available depository insurance coverage. The amount of uninsured and uncollateralized deposits totaled $9,510,484 and $10,662,511 at June 30, 2005 and 2004, respectively.

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

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

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

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

At June 30, 2005, assets limited as to use consisted of restricted cash of $1,346,771 and a receivable from the Kona Hospital Foundation of $359,441 (see Note 12). At June 30, 2004, the entire balance of assets limited as to use consisted of restricted cash.

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

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

Net Patient Service Revenues—Net patient service revenues are recorded on an accrual basis in the period in which the related services are provided at established rates, less contractual adjustments and provision for doubtful accounts. HHSC, as a safety net provider, provides charity care to certain patients; the specific cost of such care is not determinable for the years ended June 30, 2005 and 2004.

HHSC has agreements with third-party payors that provide for payments at amounts different from their established rates. Payment arrangements include prospectively determined rates per discharge, reimbursed costs, discounted charges, and per diem payments. Net patient service revenues are reported at the estimated net realizable amounts from patients, third-party payors, and others for services rendered, including estimated retroactive adjustments under reimbursement agreements with third-party payors. Retroactive adjustments are recorded on an estimated basis in the period the related services are rendered and adjusted in future periods as final settlements are determined. The adjustments to the final settlements did not have a significant impact on the fiscal year 2005 and 2004 financial statements.

The estimated third-party payor settlement receivable of $3,974,695 as of June 30, 2005 and an estimated third-party payor settlement payable of $1,393,620 as of June 30, 2004 are based on estimates, because complete information is not currently available to determine the final settlement amounts for certain cost report years. Management has used its best effort, judgment, and certain methodologies to estimate the anticipated final outcome.

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

- ***Medicare***—Inpatient acute services rendered to Medicare program beneficiaries are paid at prospectively determined rates per discharge. Effective August 1, 2000, certain inpatient services and all hospital outpatient services rendered to Medicare beneficiaries are paid at prospectively determined rates per discharge. These rates vary according to a patient classification system that is based on clinical, diagnostic and other factors. Inpatient non-acute services and defined capital and medical education costs related to Medicare beneficiaries are paid based upon a cost reimbursement methodology. HHSC is reimbursed at a tentative rate with final settlement determined after submission of annual cost reports and audits thereof by the Medicare fiscal intermediary. The appropriateness of admissions is subject to an independent review by peer review organizations under contract with HHSC. Medicare cost reports for the various HHSC facilities have been audited by the Medicare fiscal intermediary through fiscal year 2003.

- ***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.

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

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

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

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

Bond Interest—HHSC reports as nonoperating expense the interest paid by the State for general obligation bonds whose proceeds were used for hospital construction. A corresponding contribution from the State is reported as nonoperating revenues. The bonds are obligations of the State, to be paid by the State's general fund, and are not reported as liabilities of HHSC. For the years ended June 30, 2005 and 2004, the amount of bond interest allocated to HHSC was approximately $2,665,000 and $2,608,000, respectively.

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

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

Concentration of Credit Risk—Patient accounts receivable consists of amounts due from insurance companies and patients for services rendered by facilities. The facilities grant credit without collateral to their patients, most of whom are local residents and are insured under third-party payor arrangements. The mix of receivables from patients and third-party payors at June 30, 2005 and 2004 was as follows:

	2005	2004
Medicare	13%	12%
Medicaid	16	17
HMSA	11	12
Other third-party payors	28	21
Patients and other	32	38
	100%	100%

Reclassifications—Certain amounts in the 2004 financial statements have been reclassified to conform to the 2005 presentation.

3. BOARD-DESIGNATED FUNDS

As of June 30, 2005 and 2004, HHSC's Board of Directors had designated cash reserves as follows:

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

During the years ended June 30, 2005 and 2004, HHSC's Board of Directors did not release any of the designated cash reserves for use in operations.

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

4. CAPITAL ASSETS

Transactions in the capital assets accounts for the years ended June 30, 2005 and 2004 were as follows:

	Beginning of Year	Additions	Retirements	Transfers	End of Year
2005					
Assets Not Subject to Depreciation:					
Land and land improvements	$ 5,083,354	$ 16,875	$ (22,006)	$ 102,349	$ 5,180,572
Construction in progress	22,810,939	16,680,644	(209,894)	(8,896,398)	30,385,291
Assets Subject to Depreciation:					
Buildings and improvements	214,386,005	914,657	(4,430,315)	6,083,979	216,954,326
Major moveable equipment	74,983,042	6,277,197	(1,841,417)	10,216	79,429,038
Fixed equipment	41,447,428	134,280	(1,042,009)	2,699,854	43,239,553
	358,710,768	24,023,653	(7,545,641)	-	375,188,780
Less accumulated depreciation and amortization	(169,422,283)	(16,905,894)	6,932,452		(179,395,725)
Capital assets—net	$ 189,288,485	$ 7,117,759	$ (613,189)	$ -	$ 195,793,055
2004					
Assets Not Subject to Depreciation:					
Land and land improvements	$ 5,083,354	$ -	$ -	$ -	$ 5,083,354
Construction in progress	22,835,068	12,798,140	(18,191)	(12,804,078)	22,810,939
Assets Subject to Depreciation:					
Buildings and improvements	205,427,870	1,406,844	(95,339)	7,646,630	214,386,005
Major moveable equipment	73,323,823	4,005,473	(3,778,719)	1,432,465	74,983,042
Fixed equipment	37,181,268	807,043	(265,866)	3,724,983	41,447,428
	343,851,383	19,017,500	(4,158,115)	-	358,710,768
Less accumulated depreciation and amortization	(157,076,101)	(16,243,898)	3,897,716		(169,422,283)
Capital assets—net	$ 186,775,282	$ 2,773,602	$ (260,399)	$ -	$ 189,288,485

In 2005 and 2004, the State Department of Accounting and General Services transferred capital assets, including construction in progress, aggregating $11,746,840 and $5,426,064, respectively, to HHSC as a contribution of capital.

During fiscal years 2005 and 2004, $1,517,641 and $138,461, respectively, of capital assets were purchased with funds contributed by outside organizations.

5. ADVANCE FROM THE STATE OF HAWAII

In fiscal year 2003, HHSC received a $14,000,000 advance from the State of Hawaii to relieve its cash flow shortfall. At June 30, 2004, management had intended to repay the advance in fiscal year 2005 through either an emergency appropriation from the Legislature or an administrative procedure by the Governor of the State of Hawaii. At June 30, 2005, management did not have the ability, and thus does not intend to repay the advance. Furthermore, management does not expect the State of Hawaii to demand payment of the advance in fiscal year 2006. Accordingly, the advance is classified as a noncurrent liability at June 30, 2005.

6. LONG-TERM LIABILITIES

Among HHSC's long-term liabilities are accrued vacation and capital lease obligations. Transactions in these accounts during the years ended June 30, 2005 and 2004 were as follows:

	Beginning of Year	Additions	Reductions	End of Year	Current Portion	Noncurrent Portion
2005						
Accrued vacation	$ 22,227,261	$ 6,024,307	$(2,942,843)	$ 25,308,725	$ 829,121	$ 24,479,604
Capital lease obligations	33,746,111	9,271,683	(7,927,543)	35,090,251	7,738,765	27,351,486
2004						
Accrued vacation	$ 21,725,138	$ 1,867,384	$(1,365,261)	$ 22,227,261	$ 1,365,261	$ 20,862,000
Capital lease obligations	32,301,020	9,649,298	(8,204,207)	33,746,111	7,958,701	25,787,410

Future capital lease payments were as follows:

Years Ended June 30	
2006	$ 10,404,400
2007	9,389,170
2008	6,719,881
2009	4,945,353
2010	3,727,825
2011-2015	11,711,677
2016-2019	167,411
Total future minimum payments	47,065,717
Less amount representing interest	(11,975,466)
Total capital lease obligations	35,090,251
Current portion	(7,738,765)
Noncurrent portion	$ 27,351,486

HHSC has an arrangement with lessors whereby HHSC enters into capital leases on behalf of the facilities. The capital lease obligation is recorded on HHSC-Corporate's (Corporate) financial statements. While the assets are being constructed, the amounts are recorded as construction in progress on the financial statements of either Corporate or the facilities. Corporate makes the capital lease payments and incurs the interest expense, while the facilities record depreciation on the capital asset. Corporate also computes capitalized interest on construction in progress and transfers the capitalized interest asset to the facilities. The facilities reimburse Corporate through the due from affiliates account for the capital lease payments, interest expense, and capitalized interest. For the years ended June 30, 2005 and 2004, interest capitalized for Corporate and all facilities was $685,290 and $826,305, respectively.

7. LONG-TERM DEBT

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

Maui Memorial Medical Center Nurses' Cottages—During fiscal year 2003, HHSC acquired buildings for $1,690,000 on behalf of Maui Memorial Medical Center (MMMC) for use in its operations. During fiscal year 2003, Corporate transferred the buildings to MMMC, but retained the loan payable in its accounting records. The loan payable is collateralized by a security interest in the capital assets acquired.

Long-term debt as of June 30, 2005 and 2004 consisted of the following:

	2005	2004
Loan payable to Central Pacific Bank; $9,500,000; interest at 5.75% at June 30, 2005 (interest at weekly average of 5-year U.S. Treasury Securities rate plus 250 basis points); monthly principal and interest payments of $64,975; due December 1, 2027	$ 8,598,940	$ 8,780,726
Loan payable to Central Pacific Bank; $319,000; interest at 5.875% at June 30, 2005 (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	189,544	215,614
Loan payable to Academic Capital; $1,690,900; interest at 6.3%; monthly principal and interest payments of $19,028; due November 4, 2012	1,338,193	1,477,429
Note payable to United States Department of Agriculture (USDA); $1,250,000; interest at 4.75%; monthly principal and interest payments of $6,188; due June 24, 2034	1,153,106	1,161,383
Note payable to USDA; $1,000,000; interest at 4.75%; monthly principal and interest payments of $8,170; due August 13, 2014	718,370	783,176
Notes payable to two individuals; $252,000; interest at 5% at June 30, 2005; monthly principal and interest payments of $22,745; due January 1, 2008 (see Note 13)	232,453	
Total	12,230,606	12,418,328
Less current portion	(694,487)	(513,598)
Noncurrent portion	$11,536,119	$11,904,730

Transactions in long-term debt during the years ended June 30, 2005 and 2004 were as follows:

	Beginning of Year	Additions	Reductions	End of Year
2005				
Long-term debt	$12,418,328	$ 252,000	$ (439,722)	$12,230,606
2004				
Long-term debt	$12,971,778	$ -	$ (553,450)	$12,418,328

Maturities of long-term debt are as follows:

Years Ending June 30	Principal	Interest	Total
2006	$ 694,487	$ 662,120	$ 1,356,607
2007	632,340	640,173	1,272,513
2008	543,435	606,150	1,149,585
2009	504,911	576,305	1,081,216
2010	534,737	546,475	1,081,212
2011-2015	2,425,947	2,273,197	4,699,144
2016-2020	2,089,898	1,684,345	3,774,243
2021-2025	2,773,269	1,000,974	3,774,243
2026-2030	1,852,886	217,365	2,070,251
2031-2034	178,696	30,212	208,908
Total	$12,230,606	$8,237,316	$20,467,922

8. FACILITY-BASED TECHNICAL SERVICE AGREEMENTS

HHSC has facility-based technical service agreements relating to certain ancillary services. These arrangements are generally related to administrative services, clinical personnel, space rental, and clinical services. Reimbursement arrangements vary by contractor and range from fixed amounts per month to 100% reimbursements of charges. Amounts charged by the contractors are included in operating expenses in purchased services, and aggregated approximately $9,616,000 and $11,215,000 (excluding Clinical Laboratories of Hawaii partnership fees of approximately $11,211,000 and $11,504,000 as disclosed in Note 11) during fiscal years 2005 and 2004, respectively.

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

HHSC charges the contractors for use of the premises, supplies, and laundry. These amounts are included in other nonoperating revenues and aggregated approximately $1,008,000 and $976,000 during fiscal years 2005 and 2004, respectively. In addition, HHSC charges the contractors for the use of clinical personnel employed in the facilities. These amounts are netted against salaries and benefits expense and totaled approximately $751,000 and $848,000 during fiscal years 2005 and 2004, respectively.

9. EMPLOYEE BENEFITS

Defined Benefit Pension Plans

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

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

HHSC's contribution to the ERS for the years ended June 30, 2005 and 2004 was approximately $14,126,000 and $12,457,000, respectively, equal to the required contribution.

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

Post-Retirement Health Care and Life Insurance Benefits

In addition to providing pension benefits, the State 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 $10,835,000 and $10,123,000 for the years ended June 30, 2005 and 2004, respectively.

Sick Leave

Accumulated sick leave as of June 30, 2005 and 2004 was approximately $46,105,000 and $41,224,000, respectively. Sick leave accumulates at the rate of 14 hours for each month of service, as defined, without limit. Sick pay can be taken only in the event of illness and is not convertible to pay upon termination of employment. Accordingly, no liability for sick pay is recorded in the accompanying consolidated financial statements.

10. COMMITMENTS AND CONTINGENCIES

Professional Liability

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

Workers' Compensation Liability

HHSC is self-insured for workers' compensation claims. HHSC pays a portion of wages for injured workers (as required by law), medical bills, judgments as stipulated by the State's Department of Labor, and other costs. HHSC's facilities also directly provide treatment for injured workers. The estimated liability is based on actuarial projections of costs using historical claims-paid data. Estimates are continually monitored and reviewed and, as settlements are made or estimates adjusted, differences are reflected in current operations. HHSC accrued a liability of $25,282,963 and $21,854,000 for unpaid claims as of June 30, 2005 and 2004, respectively.

Ceded Lands

The Office of Hawaiian Affairs (OHA) and the State of Hawaii are presently in negotiation 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, 2005, the outcome of the negotiation 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 State Legislature would appropriate funds to cover any amounts allocated to HHSC.

Litigation

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

Asbestos Contamination

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

Construction Commitment

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

11. CLINICAL LABORATORIES OF HAWAII PARTNERSHIP

On May 1, 2002, HHSC entered into a Partnership Agreement with Clinical Laboratories of Hawaii, Inc., St. Francis Healthcare Enterprises, Inc., and Kapiolani Service Corporation to form Clinical Laboratories of Hawaii, LLP ("Partnership"). The primary purpose of the Partnership is to provide clinical laboratory services within the State of Hawaii. On June 1, 2002, HHSC contributed the use of the laboratory space and related ancillary services in seven of its facilities (Hilo Medical Center, Kona Community Hospital, MMMC, Hale Ho'ola Hamakua, Ka'u Hospital, Kohala Hospital, and Kula Hospital) in exchange for a less than controlling interest in the Partnership. Ordinary distributions from the Partnership are to be made at least annually from the Partnership's "Available Cash" (as defined in the Partnership Agreement). In fiscal years 2005 and 2004, HHSC received partnership distributions of $212,160 and $48,960, respectively.

HHSC's investment in the Partnership and related contribution of laboratory space and ancillary services are being recorded over the life of the Partnership Agreement. The contributed space and services recognized in fiscal year 2005 and 2004 amounted to $732,606 and $719,616, respectively, and the investment balance as of June 30, 2005 and 2004 was $1,959,156 and $1,438,228, respectively. The contributed space and services are included in other nonoperating revenues in the consolidated statements of revenues, expenses and changes in net assets, and the investment balance is included in other assets in the consolidated statements of net assets.

In addition, HHSC charges the Partnership for the use of clinical personnel employed in the facilities, and certain routine tests referred to a facility's laboratory by the Partnership. Amounts billed to the Partnership totaled approximately $1,522,000 and $1,635,000 during fiscal years 2005 and 2004, respectively. Amounts due from the Partnership for such charges aggregated approximately $605,000 and $506,000 as of June 30, 2005 and 2004, respectively.

HHSC contracts with the Partnership to provide clinical laboratory and pathology services at its facilities. Amounts charged by the Partnership aggregated approximately $11,211,000 and $11,504,000 during fiscal years 2005 and 2004, respectively. Amounts due to the Partnership aggregated approximately $1,314,000 and $5,866,000 as of June 30, 2005 and 2004, respectively.

Kauai Veterans Memorial Hospital (KVMH) and Samuel Mahelona Memorial Hospital contract with the Partnership to provide various services, but did not contribute the use of laboratory space and ancillary services to the Partnership. Amounts charged by the Partnership were approximately $81,000 and $41,000 during fiscal years 2005 and 2004, respectively. In addition, the Partnership contracts with

KVMH to perform certain routine tests referred to the KVMH laboratory by the Partnership. Amounts billed to the Partnership were approximately $102,000 and $105,000 during fiscal years 2005 and 2004, respectively. There were no amounts due from or due to the Partnership as of June 30, 2005 and 2004.

12. TEMPORARILY RESTRICTED NET ASSETS

Changes in temporarily restricted net assets for the years ended June 30, 2005 and 2004 were as follows:

	2005	2004
Balance, beginning of year	$ 949,595	$2,130,506
Restricted contributions received	2,695,069	2,329,565
Expenditures for restricted purposes	(824,486)	(474,064)
Capital assets purchased	(1,517,641)	(138,461)
Transfers of restricted net assets		(2,897,951)
Balance, end of year	$ 1,302,537	$ 949,595

In fiscal year 2005, HHSC received a pledge from an affiliated foundation of $1,818,840 to build a new radiation therapy unit at Kona Community Hospital. At June 30, 2005, $359,441 of the pledge still remained outstanding.

In fiscal years 2004 and 2003, HHSF received $3,000,000 in grants from a not-for-profit organization to administer a patient assistance and drug assistance program, which would provide prescription drugs and nutritional supplements to indigent families. HHSF partnered with HHSC, the State of Hawaii, and two health care associations to operate the program. In fiscal year 2004, all of the partners formed a separate not-for-profit organization to take over the administration of the program. Accordingly, HHSF transferred the remaining net assets of the program to the not-for-profit organization. The $2,897,951 of net assets transferred is included in other nonoperating expenses in the consolidated statements of revenues, expenses, and changes in net assets.

13. PURCHASE OF CLINIC ASSETS

In December 2004, the Facility purchased certain assets of a clinic operated by certain physicians for $360,000. The assets purchased included office equipment, supplies, a trademark/service mark, and noncompete agreements for two physicians. No existing liabilities of the clinic were assumed.

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

The noncompete agreements were valued at $55,000 and are being amortized over the three-year period of the agreements. Since the purchase price exceeded the estimated fair value of the purchased assets, goodwill of $243,000 was recorded. Both the noncompete agreements and goodwill are included in other assets in the consolidated statements of net assets.

14. VETERANS HOME

In fiscal year 2005, HHSC received $5,169,021 from the State of Hawaii for construction of the new veterans' long-term care facility. Of this amount, $1,641,894 was expended for planning and design costs, and is included in construction in progress in the consolidated statements of net assets. The remaining $3,527,127 was expended to demolish an old, existing building on the campus site, and is included as a special item in the consolidated statements of revenues, expenses, and changes in net assets, due to the infrequent nature of such expenditures by HHSC.

* * * * * *

HAWAI HEALTH SYSTEMS CORPORATION

SUPPLEMENTAL SCHEDULE OF RECONCILIATION OF CASH ON DEPOSIT WITH THE STATE OF HAWAII AS OF JUNE 30, 2005

	Appropriation Symbol	
CASH ON DEPOSIT WITH THE STATE OF HAWAII:		
SPECIAL FUNDS:		
	S-93-359-H	$ 2,818
	S-94-356-M	8,673
	S-95-396-H	19,636
	S-96-359-H	2,007
	S-96-396-H	9,039
	S-97-359-H	3,556
	S-97-396-H	182
	S-98-396-H	1,687
	S-05-303-H	7,792
	S-04-312-H	40,292
	S-05-320-H	9,000,000
	S-05-350-H	565
	S-04-351-H	12,182
	S-05-352-H	17,845
	S-04-353-H	23,561
	S-05-354-H	272,906
	S-05-355-H	279,623
	S-05-358-H	10,021
	S-05-359-H	31,827
	S-05-365-H	7,860
	S-03-371-H	66,305
	S-04-373-H	16,089
TRUST FUNDS:		
	T-05-906-H	50
	T-04-907-H	200
	T-05-907-H	1,500
	T-04-918-H	1,273
	T-04-921-H	6,679
	T-04-923-H	4,129
TOTAL PER STATE		9,848,297
RECONCILING ITEMS		(42,982)
TOTAL PER HHSC		$9,805,315

(Continued)

HAWAI HEALTH SYSTEMS CORPORATION

SUPPLEMENTAL SCHEDULE OF RECONCILIATION OF CASH ON DEPOSIT WITH THE STATE OF HAWAII AS OF JUNE 30, 2005

	Appropriation Symbol	
ASSETS LIMITED AS TO USE:		
PATIENT TRUST FUNDS:		
	T-05-909	$ 23,973
	T-04-911-H	81,174
	T-05-915-H	12,763
	T-04-919-H	1,044
	T-05-925-H	112,842
	T-05-926-H	10,604
TOTAL PER STATE		242,400
RECONCILING ITEMS:		
Restricted accounts receivable		359,441
Patients' safekeeping deposits held by financial institutions		552,012
Restricted net assets held by financial institutions		554,001
Other		(1,642)
TOTAL PER HHSC		$ 1,706,212

(Concluded)

HAWAII HEALTH SYSTEMS CORPORATION

SUPPLEMENTAL COMBINING AND CONSOLIDATING STATEMENT OF NET ASSETS INFORMATION
AS OF JUNE 30, 2005

	Facilities																				
ASSETS	Hilo Medical Center	Kona Community Hospital	Maui Memorial Medical Center	Ka'u Hospital	Kula Hospital	Kauai Veterans Memorial Hospital	Samuel Mahelona Memorial Hospital	Hale Ho'ola Hamakua	Kohala Hospital	Leahi Hospital	Maluhia	Lanai Community Hospital	Yukio Okutsu Veterans Care Home	Total Facilities	Corporate	Reclassifi-cations and Elimi-nations	HHSC Combined	Hawaii Health Systems Founda-tion	Alii Com-munity Care	Reclassifi-cations and Elimi-nations	HHSC Consolidated
CURRENT ASSETS:																					
Cash and cash equivalents:																					
On deposit with the State of Hawaii	$ 1,643	$ 272,906	$ 279,623	$ 24,524	$ 66,305	$ 3,772	$ 14,294	$ 13,505	$ 23,561	$ 40,292	$ 7,860	$ 10,021	$ -	$ 758,306	$ 9,047,009	$ -	$ 9,805,315	$ -	$ -	$ -	$ 9,805,315
On deposit with banks and on hand	264,056	49,314	168,663	6,815	6,337	52,216	84,148	10,364	19,713	447,391	468,036	23,064		1,600,117	8,458,690		10,058,807	665,540	24,098		10,748,445
Patient accounts receivable - less allowances for contractual adjustments and doubtful accounts	9,298,733	6,847,684	22,703,353	783,180	1,256,172	3,100,968	1,310,786	420,117	407,622	2,620,878	1,340,531	252,913		50,342,937			50,342,937				50,342,937
Supplies and other current assets	2,079,048	2,052,551	2,694,307	70,152	227,644	467,714	96,854	93,051	37,353	658,019	86,786	71,277		8,634,756	61,579		8,696,335		212,151		8,908,486
Estimated third-party payor settlements	834,120	485,979	3,257,036	38,587	(10,000)	(749,937)	68,931	(29,881)	188,650	(94,672)	(5,000)	(8,518)		3,974,695			3,974,695				3,974,695
Total current assets	12,477,600	9,708,434	29,102,982	923,258	1,546,458	2,874,733	1,575,013	507,156	676,299	3,671,908	1,898,213	348,757		65,310,811	17,567,278		82,878,089	665,540	236,249		83,779,878
DUE FROM AFFILIATES - Net			6,498,168											6,498,168	179,037,925	(178,750,441)	6,785,652			(6,785,652)	-
CAPITAL ASSETS - Net	39,444,861	31,209,703	62,531,256	1,269,579	4,595,445	14,273,355	3,869,702	13,295,217	2,117,158	5,664,060	3,327,911	955,808	1,669,556	184,223,611	11,217,609		195,441,220	249	351,586		195,793,055
ASSETS LIMITED AS TO USE	35,259	375,179	293,913	13,104	65,664	38,413	62,672	11,061	2,471	158,646	104,086	1,923		1,162,392			1,162,392	543,820			1,706,212
OTHER ASSETS	1,015,235	355,394	515,531	17,350	40,233	288,833		20,763	19,922					2,273,261	97,822		2,371,083			(97,822)	2,273,261
TOTAL	$ 52,972,955	$ 41,648,710	$ 98,941,850	$ 2,223,291	$ 6,247,800	$ 17,475,334	$ 5,507,388	$ 13,834,197	$ 2,815,850	$ 9,494,614	$ 5,330,210	$ 1,306,488	$ 1,669,556	$ 259,468,243	$ 207,920,634	$ (178,750,441)	$ 288,638,436	$ 1,209,609	$ 587,835	$ (6,883,474)	$ 283,552,406

(Continued)

HAWAII HEALTH SYSTEMS CORPORATION

SUPPLEMENTAL COMBINING AND CONSOLIDATING STATEMENT OF NET ASSETS INFORMATION
AS OF JUNE 30, 2005

LIABILITIES AND NET ASSETS (DEFICIT)	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	Yukio Okutsu Veterans Care Home	Total Facilities	Corporate	Reclassifications and Eliminations	HHSC Combined	Hawaii Health Systems Foundation	Alii Community Care	Reclassifications and Eliminations	HHSC Consolidated
CURRENT LIABILITIES:																					
Accounts payable and accrued expenses	$ 7,318,575	$ 4,999,458	$ 11,170,791	$ 368,138	$ 1,025,203	$ 1,788,170	$ 649,637	$ 443,250	$ 306,296	$ 1,449,611	$ 1,034,161	$ 295,035	$ -	$ 30,848,325	$ 2,073,651	$ -	$ 32,921,976	$ -	$ 79,724	$ 7	33,001,707
Accrued workers' compensation liability	7,152,000	2,984,000	6,103,000	217,000	2,276,000	1,118,785	792,572	779,175	353,388	1,627,373	1,229,220	174,450		24,806,963	476,000		25,282,963				25,282,963
Current portion of capital lease obligations	59,805													59,805	7,678,960		7,738,765				7,738,765
Current portion of accrued vacation	249,530	67,364	189,411	8,501	43,827	65,739	6,146	9,178	37,269	53,483	35,095	44,520		810,063	19,058		829,121				829,121
Current portion of long-term debt	465,402					80,820								546,222	148,265		694,487				694,487
Other current liabilities	59,287	3,983				81,925		3,016						148,211			148,211	283,306	113,751		545,268
Total current liabilities	15,304,599	8,054,805	17,463,202	593,639	3,345,030	3,135,439	1,448,355	1,234,619	696,953	3,130,467	2,298,476	514,005		57,219,589	10,395,934		67,615,523	283,306	193,475	7	68,092,311
CAPITAL LEASE OBLIGATIONS Less current portion														-	27,351,486		27,351,486				27,351,486
LONG-TERM DEBT Less current portion	10,194,558					151,633								10,346,191	1,189,928		11,536,119				11,536,119
ACCRUED VACATION Less current portion	5,790,230	3,182,550	6,402,996	270,438	1,201,597	1,176,387	1,392,524	575,290	268,865	1,845,067	1,564,015	165,883		23,635,842	843,762		24,479,604				24,479,604
DUE TO AFFILIATES Net	37,513,789	28,749,044		7,481,556	13,308,715	37,693,928	11,929,016	789,417	6,856,283	8,419,620	17,950,695	8,030,616	27,662	178,750,441		(178,750,441)	-	357,674	6,427,985	(6,785,659)	-
ADVANCE FROM THE STATE OF HAWAII														-	14,000,000		14,000,000				14,000,000
DUE TO THE STATE OF HAWAII		7,605,205			1,114,264	1,043,345	2,417,150	506,153	528,149	6,416,791	491,450			20,122,507			20,122,507				20,122,507
PATIENTS' SAFEKEEPING DEPOSITS AND DEFERRED INCOME Restricted contributions	35,259	3,679		13,104	65,664	6,998	25,319	11,061	2,471	158,646	79,551	1,923		403,675			403,675				403,675
OTHER LIABILITIES	10,862		9,476			7,278	10,620	13,478		45,007	13,296			110,017	217,380		327,397				327,397
Total liabilities	68,849,297	47,595,283	23,875,674	8,358,737	19,035,270	43,215,008	17,022,984	3,130,018	8,352,821	20,015,598	22,397,483	8,712,427	27,662	290,588,262	53,998,490	(178,750,441)	165,836,311	640,980	6,621,460	(6,785,652)	166,313,099
NET ASSETS (DEFICIT):																					
Invested in capital assets net of related debt	28,725,096	31,209,703	62,531,256	1,269,579	4,595,445	14,040,902	3,869,702	13,295,217	2,117,158	5,664,060	3,327,911	955,808	1,669,556	173,271,393	(25,151,030)		148,120,363	249	351,586		148,472,198
Restricted		371,500	293,913			31,415	37,354				24,535			758,717			758,717	543,820			1,302,537
Unrestricted	(44,601,438)	(37,527,776)	12,241,007	(7,405,025)	(17,382,915)	(39,811,991)	(15,422,652)	(2,591,038)	(7,654,129)	(16,185,044)	(20,419,719)	(8,361,747)	(27,662)	(205,150,129)	179,073,174		(26,076,955)	24,560	(6,385,211)	(97,822)	(32,535,428)
Total net assets (deficit)	(15,876,342)	(5,946,573)	75,066,176	(6,135,446)	(12,787,470)	(25,739,674)	(11,515,596)	10,704,179	(5,536,971)	(10,520,984)	(17,067,273)	(7,405,939)	1,641,894	(31,120,019)	153,922,144	-	122,802,125	568,629	(6,033,625)	(97,822)	117,239,307
TOTAL	$ 52,972,955	$ 41,648,710	$ 98,941,850	$ 2,223,291	$ 6,247,800	$ 17,475,334	$ 5,507,388	$ 13,834,197	$ 2,815,850	$ 9,494,614	$ 5,330,210	$ 1,306,488	$ 1,669,556	$ 259,468,243	$ 207,920,634	$ (178,750,441)	$ 288,638,436	$ 1,209,609	$ 587,835	$ (6,883,474)	$ 283,552,406

(Concluded)

HAWAII HEALTH SYSTEMS CORPORATION

SUPPLEMENTAL COMBINING AND CONSOLIDATING STATEMENT OF REVENUES, EXPENSES, AND CHANGES IN NET ASSETS (DEFICIT) INFORMATION
FOR THE YEAR ENDED JUNE 30, 2005

	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	Yukio Okutsu Veterans Care Home
OPERATING REVENUES:													
Net patient service revenues	$ 80,279,175	$38,685,304	$119,113,134	$ 2,976,575	$ 10,261,163	$15,231,402	$ 7,450,774	$ 4,924,993	$ 3,603,342	$16,703,924	$12,969,710	$ 2,892,605	$ -
Other operating revenues	1,173,330	733,814	1,321,794	11,548	76,660	822,046	154,803	15,797	29,471	372,029	23,653	24,480	
Total operating revenues	81,452,505	39,419,118	120,434,928	2,988,123	10,337,823	16,053,448	7,605,577	4,940,790	3,632,813	17,075,953	12,993,363	2,917,085	
OPERATING EXPENSES:													
Salaries and benefits	54,218,661	26,812,984	63,392,565	2,810,590	11,584,259	10,612,252	6,981,921	4,701,803	2,864,795	15,328,284	11,715,261	1,903,452	
Medical supplies and drugs	12,741,732	6,193,628	16,003,899	99,402	778,497	1,231,600	383,536	180,220	97,351	858,901	746,178	135,067	
Purchased services	8,174,250	4,515,858	15,167,248	210,113	706,056	3,254,925	550,578	161,562	489,666	547,403	924,254	384,698	
Depreciation and amortization	3,803,116	2,608,769	4,618,039	97,290	323,543	749,143	309,123	508,431	230,419	855,127	293,719	75,649	
Other supplies	3,179,322	940,389	4,051,541	86,493	734,185	466,134	320,960	235,763	159,968	924,008	645,545	118,768	
Utilities	1,264,603	849,786	2,177,006	90,289	212,066	767,958	322,459	397,425	82,847	615,851	394,605	84,534	
Repairs and maintenance	2,145,686	1,107,600	2,026,723	20,615	84,883	265,342	115,484	94,547	24,526	223,264	150,498	62,696	
Insurance	1,542,167	908,725	1,732,997	18,382	100,535	245,491	72,135	45,018	41,342	143,134	99,530	31,942	
Professional fees	720,228	677,476	418,638	43,597	26,043	416,705	160,746	115,209	94,927	101,085	25,354	144,544	
Rent and lease	548,123	252,345	1,124,548	11,429	15,412	199,261	7,731	16,195	23,716	24,473	6,887	2,738	
Other	967,271	683,137	933,217	52,855	98,647	290,427	67,611	32,776	64,318	90,241	197,610	37,381	
Total operating expenses	89,305,159	45,550,697	111,646,421	3,541,055	14,664,126	18,499,238	9,292,284	6,488,949	4,173,875	19,711,773	15,199,441	2,981,469	
INCOME (LOSS) FROM OPERATIONS	(7,852,654)	(6,131,579)	8,788,507	(552,932)	(4,326,303)	(2,445,790)	(1,686,707)	(1,548,159)	(541,062)	(2,635,820)	(2,206,078)	(64,384)	
NONOPERATING REVENUES (EXPENSES)													
General appropriations from State of Hawaii													
Collective bargaining pay raise appropriation from State of Hawaii	2,694,749	1,361,871	3,158,533	109,272	618,743	465,469	360,285	260,216	147,165	819,932	665,569	96,833	
Restricted contributions		1,818,840				9,500	1,729						
Interest and dividend income	15,171	2,416	34,872	1,326		105	116			1,611	395	5	
Interest expense (net of capitalized interest)	(631,378)	(65,178)	(23,706)		(3,503)	(3,215)	(767)	(1,871)	(3,007)	(4,703)	(267)		
Corporate allocation expense	(2,986,120)	(1,476,968)	(3,666,405)	(117,134)	(487,874)	(609,417)	(316,623)	(207,884)	(132,490)	(655,179)	(513,715)	(96,438)	
Other nonoperating revenues (expenses)—net	689,368	191,498	372,434	5,926	84,703	185,034	223,278	141,408	43,303	273,423	(1,660)	32,647	
Total nonoperating revenues (expenses)	(218,210)	1,832,479	(124,272)	(610)	212,069	47,476	268,018	191,869	54,971	435,084	150,322	33,047	
INCOME (LOSS) BEFORE CAPITAL CONTRIBUTIONS, TRANSFERS, AND SPECIAL ITEM	(8,070,864)	(4,299,100)	8,664,235	(553,542)	(4,114,234)	(2,398,314)	(1,418,689)	(1,356,290)	(486,091)	(2,200,736)	(2,055,756)	(31,337)	
CONTRIBUTED CAPITAL ASSETS AND TRANSFERS	136,374		8,943,084		230	478,789	471,469		75,000				5,169,021
SPECIAL ITEM—Demolition costs													(3,527,127)
INCREASE (DECREASE) IN NET ASSETS	$ (7,934,490)	$ (4,299,100)	$ 17,607,319	$ (553,542)	$ (4,114,004)	$ (1,919,525)	$ (947,220)	$ (1,356,290)	$ (411,091)	$ (2,200,736)	$ (2,055,756)	$ (31,337)	$ 1,641,894

	Total Facilities	Corporate	Reclassifications and Eliminations	HHSC Combined	Hawaii Health Systems Foundation	Alii Community Care	Reclassifications and Eliminations	HHSC Consolidated
OPERATING REVENUES:								
Net patient service revenues	$315,092,101	$ -	$ -	$315,092,101	$ -	$ -	$ -	$315,092,101
Other operating revenues	4,759,425		(288,547)	4,470,878		1,358,193		5,829,071
Total operating revenues	319,851,526		(288,547)	319,562,979		1,358,193		320,921,172
OPERATING EXPENSES:								
Salaries and benefits	212,926,827	5,721,704		218,648,531	81,435			218,729,966
Medical supplies and drugs	39,450,011			39,450,011				39,450,011
Purchased services	35,086,613	193,240	(558,021)	34,721,832		16,737		34,738,569
Depreciation and amortization	14,472,368	2,334,008		16,806,376	402	99,116		16,905,894
Other supplies	11,863,076	197,257		12,060,333	15,156	165,750		12,241,239
Utilities	7,259,429	85,051		7,344,480		211,678		7,556,158
Repairs and maintenance	6,321,864	75,807		6,397,671		28,900		6,426,571
Insurance	4,981,398	20,068		5,001,466		123,388		5,124,854
Professional fees	2,944,552	180,500		3,125,052	12,600	1,449,260		4,586,912
Rent and lease	2,232,858	56,861	(33,810)	2,255,909		1,659,760		3,915,669
Other	3,515,491	211,011		3,726,502	238,584	128,053		4,093,139
Total operating expenses	341,054,487	9,075,507	(591,831)	349,538,163	348,477	3,882,642		353,769,282
INCOME (LOSS) FROM OPERATIONS	(21,202,961)	(9,075,507)	303,284	(29,975,184)	(348,477)	(2,524,449)		(32,848,110)
NONOPERATING REVENUES (EXPENSES)								
General appropriations from State of Hawaii	-	27,569,984		27,569,984				27,569,984
Collective bargaining pay raise appropriation from State of Hawaii	10,758,637	79,324		10,837,961				10,837,961
Restricted contributions	1,830,069			1,830,069	865,000			2,695,069
Interest and dividend income	56,017	183,240		239,257	10,323	3,647		253,227
Interest expense (net of capitalized interest)	(737,595)	(2,428,971)		(3,166,566)				(3,166,566)
Corporate allocation expense	(11,266,247)	11,266,247		-				-
Other nonoperating revenues (expenses)—net	2,241,362	(18,803)	(303,284)	1,919,275	(2,880)			1,916,395
Total nonoperating revenues (expenses)	2,882,243	36,651,021	(303,284)	39,229,980	872,443	3,647		40,106,070
INCOME (LOSS) BEFORE CAPITAL CONTRIBUTIONS, TRANSFERS, AND SPECIAL ITEM	(18,320,718)	27,575,514	-	9,254,796	523,966	(2,520,802)		7,257,960
CONTRIBUTED CAPITAL ASSETS AND TRANSFERS	15,273,967			15,273,967				15,273,967
SPECIAL ITEM—Demolition costs	(3,527,127)			(3,527,127)				(3,527,127)
INCREASE (DECREASE) IN NET ASSETS	$ (6,573,878)	$ 27,575,514	$ -	$ 21,001,636	$ 523,966	$ (2,520,802)	$ -	$ 19,004,800

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

Board of Directors of Hawaii Health Systems Corporation:

We have audited the consolidated financial statements of Hawaii Health Systems Corporation (HHSC) as of and for the years ended June 30, 2005 and 2004, and have issued our report thereon dated November 14, 2005. We conducted our audits in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in Government Auditing Standards, issued by the Comptroller General of the United States.

Internal Control over Financial Reporting

In planning and performing our audits, we considered HHSC's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the consolidated financial statements and not to provide assurance on the internal control over financial reporting. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control over financial reporting that might be material weaknesses. A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements in amounts that would be material in relation to the consolidated financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We noted no matters involving the internal control over financial reporting and its operation that we consider to be material weaknesses.

Compliance and Other Matters

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

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

Deloitte & Touche LLP

November 14, 2005

FISCAL YEAR 2005
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**
  - 100 active volunteers
    - Nearly 26,000 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
    - Grants twenty (20) $500 nursing scholarship annually to nursing students at both UHH and HCC - $10,000
  - Hilo Medical Center Foundation contributed with the following
    - In FY 2004-2005, the HMCF netted $375,298.38. As of June 30, 2005, a total of $1,221,095 was raised for the Emergency Department (pledges and gifts) and $35,558 was raised for the State Veterans Home (pledges and gifts).
- **Hale Ho'ola Hamakua**
  - 38 active volunteers
    - Nearly 12,000 volunteered service hours each year

- Auxiliary donations included:
  - Two $250 scholarships
  - T-shirts for every HHH employee for National Nursing Week, $705
  - Volunteer Appreciation Luncheon, $535
  - Salad bar for Dietary, $1,130
  - Equipment for Activity Room, $416
  - Other auxiliary-sponsored programs, $1,146

- **Ka'u Hospital**

  - 52 active volunteers
    - Nearly 1620 volunteered service hours each year
  - Hospital Auxiliary and Red Hatters donations included:
    - Bake sale for emergency room equipment, $4,000
    - Health notes – one pager in Ka'u Monthly Calendar (stuffed newspaper for a $2,000 discount, $4,000)
  - Ka'u Hospital Charitable Foundation
    - Contributed mechanical repair and painting supplies for refurbished bus, $3,100

WEST HAWAII REGION

- **Kona Community Hospital**

  - 80 active volunteers and still growing
    - Nearly 4,630 volunteered service hours
  - Auxiliary donated $825 to Kalani Ola, $825 to Long-Term Care patient use, and $1200 for physician workroom
  - Auxiliary donated four nursing scholarships totaling $6,000
  - The Auxiliary Bake Sale netted over $5,000 for the Nursing Scholarship Program

- Various donations to the Auxiliary included:
  - Nursing scholarships, $4,127
  - In memory of Tom Koontz, Auxiliary past president, $500
  - JCAHO Employee Party, $200
  - Other cash donations, $1,542
- The Kona Community Hospital Foundation 4th Annual Gala Benefit and Golf Tournament netted close to $200,000 toward the Radiation Oncology Clinic at Kona Community Hospital

- **Kohala Hospital**
  - 20 active volunteers monthly
    - Nearly 2,415 volunteered service hours each year
  - Kohala Hospital Foundation raised $59,400 through silent auction to purchase 27 electric beds
  - The Kohala Hospital Auxiliary donated $11,053 for equipment, supplies, furniture, renovations, and seminars
  - The Kohala Hospital Auxiliary donated (2) $1000 scholarships
  - In-kine donations totaled $10,000
  - Auxiliary participated in the Blood Bank Drive, assisted with the Kohala Hospital Charitable Foundation's Silent Auction Fundraiser, and coordinates Christmas activities for residents

KAUAI REGION

- **Kauai Veterans Memorial Hospital**
  - 48 active volunteers
    - Nearly 4,100 volunteered service hours each year
    - Auxiliary raised more than $28,500
      - $19,000 in Gift Shop sales
      - $3,800 in commission sales (vending machines)

- $5,700 gross profit from the Annual Christmas Craft Fair

- Auxiliary purchases includes ($24,720):

    - Two full-sized sheet cakes and fruit punch for awards and recognition gathering, $170
    - Pediatric monitor for the OB Department, $10,000
    - Thermometers for the OB Department, $300
    - Recliner chair for the ICU Department, $800
    - Bookcases for Quality Assurance/Utilization Review Department, $1,100
    - Label maker and supplies for Administration, $150
    - Typewriter for Business Office, $800
    - Desks and office chairs for Central Supply/Purchasing, $700
    - Exam table for Radiology, $5,000
    - Filing cabinets for Human Resources, $300
    - Card-Ex cart for charts for Long-Term Care, $5,000
    - Refrigerator for resident activity room Long-Term Care, $400
    - Shelving in Dietary Department, $1,800
    - Microwave oven for Dietary Department, $480

- KVMH Charitable Foundation received the following donations:

    - Tateishi Family for Nursing Department, $1000
    - Mrs. Ethel Oyama for Physical Therapy Department, $1,000
    - Personal donations, $1,700
    - Mini Mall Fund Drive, $2,100
    - Mrs. Betsy Toulon for new imaging machine, $100,000

- **Samuel Mahelona Memorial Medical Center**

  - 55 active volunteers

    - Nearly 4,000 volunteered service hours each year
    - Kubota Family donation to refurbish Resident Lounge, $1,000

- Hiranaka Family donation to refurbish Resident Lounge, $$1,000

- Auxiliary purchases totaled more than $15,000

  - 2 artificial Christmas trees and lobby decorations
  - 4 imprinter/addressographs
  - 2 console receivers
  - 10 vinyl bed pads
  - 10 vinyl bed chairs
  - 5 shower chairs
  - 4 wicker chairs
  - 4 bed stands plus bed and floor lamps
  - 12 miscellaneous patient care equipment
  - 9 bed spreads for Psychiatric Unit beds
  - Christmas gifts and wrapping supplies for residents and patients, $1,625
  - Christmas Light Parade decorations, $500

- Kauai Electric for Petting Zoo, $250

- Kauai Orchid Society for Petting Zoo, $250

MAUI REGION

- **Maui Memorial Medical Center**

  - 55 active volunteers

    - Nearly 10,000 volunteered service hours each year

    - Donated over $26,500 for the purchase of 18 new basinets/layettes for the Nursery

    - Donated $8,000 in nursing scholarships for continuing education

    - Donated close to $3,600 for patient care

    - Raised close to $8,000 at the annual Harvest Sale

    - The Gift Shop raised over $25,000 through sales proceeds

- The MMMC Foundation raised over $900,000
    - Challenge Grant Dowling Foundation, $125,000
    - Valley Isle Motors, $100,000
    - Clinical Labs, $100,000
    - Dorvin Leis, Co., $300,000
    - Yokouchi Foundation $10,000
    - Hawaii Community Foundation, $6,000
    - National Breast Cancer Foundation, $25,000
    - Grateful Patient Gifts Combined, $25,000
    - Maui Hotel Association Grant, $25,000
    - Special Grant – OR Waiting Room Renovation, $5,000
    - Special Grant – Patient Room Renovation, $15,000
    - Alexander & Baldwin - Wall of Life, $5,000
    - Cookbook Sales – Wall of Life, $25,000
    - Entrak for the ENT Department – Equipment, $74,250
    - Ultrasound for Emergency Department - Equipment, $15,755
    - Patient Information Software – Equipment, $13,944
    - Bariatric Life for Large Patients – Equipment, $6,785

- **Kula Hospital**
    - 27 Active Volunteers
        - Nearly 8,000 volunteer hours last year
        - Auxiliary purchases totaled more than $25,000
            - 1 sewing machine
            - 1 loveseat
            - 1 ES UP shade tent
            - 2 seat covers
            - 4 19-inch televisions
            - 3 cordless head phones including batteries
            - 4 bed overlays
            - 6 king-sized pillows
            - 1 card table
            - 2 airline fares
            - 10 patient room signs
            - 4 television headphones
            - 4 cordless extensions
            - 3 DVDs
            - 2 VCRs
            - 4 television remote controls

- 3 television stands
- 2 refrigerators
- 1 television/DVD
- 1 Norelco razor
- Activity Room furniture
- 1 set of inserts
- 5 Landing bedside mats
- 4 round tables
- 4 table height bases
- 1 5-drawer cart
- Miscellaneous lotions
- 1 4-drawer cart
- 1 Nordic treadmill
- 1 karaoke machine
- 1 Canon copier
- 1 band saw
- 2 outdoor tents
- 1 weed eater
- 1 tent fumigation

- The Kula Hospital Auxiliary donated over $3,000 towards scholarships/workshops/continuing education

- The Kula Hospital Auxiliary raised over $30,000 through donations and Kala Iki Thrift Shop sales

- **Lanai Community Hospital**

  - 26 active volunteers

    - Nearly 1,900 volunteered service hours each year

    - Castle and Cooke donated furniture and floor coverings totaling close to $3,000

    - Miscellaneous community donations included: paintings and prints for hallways and patient rooms; toys, infant equipment and clothing for WIC program; wheelchairs and walkers; fresh fruits; handmade Afghan blankets for residents; books and magazines; and compact discs.

OAHU REGION

- **Leahi Hospital**

  - 70 active volunteers

- Nearly 8.844 volunteered service hours each year

- 196 active group volunteers

  - Nearly 1,359 volunteered service hours for group volunteers

- Leahi Hospital Auxiliary (Thrift Shop) raises more than $20,000 each year

  - Donated $27,697 for van purchase to transport residents on recreational outings

  - Donated $9,000 for recreational equipment and supplies

  - Donated $416 for new large-screen television

  - In kind donations totaled $3,532

  - Monetary donations totaled $285

  - Monetary donations for new van totaled $2,100

Maluhia

- 70 active volunteers

  - Nearly 16,000 volunteered service hours each year

  - Gift Shop raises more than $11,000 per year

  - Monetary donations totaled $1,200

  - Friends of Maluhia donated over $7,000 for the following items:

    - Washer and dryer unit for Occupational Therapy
    - Television for Dayroom
    - Dr. Harvey's monthly Music Therapy session
    - Recreational Therapy cooking supplies
    - Recreational Therapy arts and crafts supplies
    - Planter tables for horticulture therapy program
    - Hearing loss amplifiers
    - Aquarium supplies

- The Leahi-Maluhia Foundation was able to raise over $100,000 in donations in FY 05.

East Regional Management Advisory Report
HHSC Annual Report
December 2005

The East Hawaii Region had a dynamic and interesting fiscal year. All three facilities show diverse growth and continued progress with projects that give outreach in community healthcare. Ka`u Hospital, Hilo Medical Center, and Hale Ho`ola Hamakua, are very excited about new partnerships and projects that will ensure better health care in the eastern region of Hawaii.

Ka`u Hospital has successfully showed progress within its second year as a combined CAH Rural Clinic and Hospital. The hospital has successfully hired two doctors for clinic primary care and one ER specialist, providing 24/7 in ER coverage and doubling the coverage that was available in the past. Swing bed days have advanced exponentially with parallel growth in observation hours and acute care days. During this year's growth, cost effectiveness has been maintained to ensure continuation of affordable health care.

Hale Ho`ola Hamakua has followed Ka`u with success in becoming a CAH. The request for capital improvement funds (CIP) has become critical for the expansion of 50 more beds in its LTC. The partnership with University of Hawaii, North Campus for its satellite learning center in the old state hospital has come a reality and classes have already begun, enabling the community to take advantage of educational opportunities.

Hilo Medical Center has been busy securing federal funds for the first Veterans State Hospital on the hospital campus. Through the support of the Honorable Senator Daniel K. Inouye funds were secured for the improvement of the second busiest ER in the State. The Hilo Medical Foundation has worked hard securing additional funds through community support for both projects.

The East Hawaii Region continues to be challenged by the Medicare/Medicaid/Quest coverage for a majority of its patients. Together with the assistance of the corporate staff and the support of the Board, the Regional facilities continue to build and grow with its services for our communities, meeting challenges face to face and finding solutions together as a team.

Respectfully Submitted,

Marge Elwell

Marge Elwell
Hawaii Region Management Advisory Committee Chair

West Hawaii Public Health Facility Management Advisory Committee
Hawaii Health Systems Corporation
Annual Report to the Hawaii State Legislature
December 2005

On behalf of the West Hawaii MAC, I appreciate again the opportunity to provide to you this summary. 2005 was a year filled with both challenges and opportunities.

With regard to the former, in light of a number of unfounded physician criticisms, our biggest challenge was assuring our communities that the HHSC West Hawaii region facilities continue to provide quality healthcare, in addition to the diligent and committed hospital employees and medical staff. Our posture was underscored with the results of our most recent JCAHO inspection in October.

We are pleased to welcome aboard Jerry Walker, Kona Community Hospital acting chief executive officer. Mr. Walker brings to us a wealth of health-business experience, in addition to a wide range of administrative/managerial skills. He also is extremely familiar with the functions of both the public and private sectors and the various cultural intricacies.

At this point, the KCH CEO recruitment efforts are aggressively moving forward, thanks to a well-established selection committee comprised of representatives of the hospital's immediate stakeholders. The WHMAC envisions a furthering of healing phase for all of the hospital's constituents with the realization that we share common goals and common processes for addressing issues.

Financially, for the fiscal year ended June 30, 2005, the West Hawaii Region incurred a net loss of approximately $4,710,000, which was $203,000 worse than budgeted. Despite generating operating revenues of $43,052,000 (which was approximately $2.8 million better than budgeted), the West Hawaii Region incurred operating expenses of $49,725,000 (which was approximately $4 million worse than budgeted). The primary reasons for the negative variance from budget is due to substantial increases in malpractice insurance premiums, medical drugs and supplies costs, and unbudgeted collective bargaining wage increases and workers compensation actuarial adjustments.

Given the growing population of West Hawaii, we will continue to examine the healthcare needs of our communities and in turn, address how we can best respond to these needs. Our major focus will continue to explore new services and infrastructure such as the PMC-21.

HHSC, including the West Hawaii region, will continue to depend on your support in 2006. The WHMAC greatly appreciates your commitment to uphold quality healthcare in Hawaii.

Respectfully submitted,

Reginald

Reginald Morimoto
Chairman
West Hawaii Region Management Advisory Committee

Maui Region Public Health Facility Management Advisory Committee
Hawaii Health Systems Corporation
Annual Report to the Hawaii State Legislature
December 2005

On behalf of the Maui MAC, I wish to thank you for this opportunity to submit this year-end summary as an attachment to the HHSC annual report for 2005.

During fiscal year 2005, Maui Memorial Medical Center managed to report an operating profit of $8.8 million. In FY05, MMMC accrued $9.8 million in additional revenue, due to one-time final settlement of prior-year cost reports submitted to third-party payers, including Medicare and Medicaid. Operationally, gross patient service revenue remained consistent with FY04 due to unchanged billing rates and comparable patient activity.

Operating expenses increased 6.2% from FY04, primarily due to increases in salaries and benefits, attributable to pay increases of collective bargaining unit employees and additions in personnel contracted in the prior fiscal year. Insurance costs also increased by approximately $896,000 in FY05. MMMC has made significant improvement in the revenue cycle management area, reducing days in accounts receivable and increasing cash collections.

The $42 million expansion and renovation of MMMC was initiated in the winter of 2004 and is well on track to being finalized by the spring of 2007. Concurrently, improvements were made to the Emergency Department Nursing Station, and the ED expansion project is into the design phase with a goal for construction to begin in 2007. MMMC is also continuing to evaluate ways to maximize its role within the HHSC system, as well as the entire state of Hawaii, with regards to improving healthcare delivery for the neighbor islands.

Significant challenges relating to call coverage were presented at the end of fiscal year 2005, and we expect this to be one of the major issues of 2006 as we seek solutions to providing physician specialty coverage in a fiscally responsible manner.

At the same time, a new top management team is in place, based on a totally regional selection and decision-making process. As a result, the Maui MAC is confident that, in spite of the healthcare challenges in 2006, the Maui region will be able to respond effectively.

I humbly ask for your continued support of the Hawaii Health Systems Corporation so we can continue to fulfill our safety net, community hospital mission in 2006. The Maui MAC greatly appreciates your commitment to uphold quality healthcare in Hawaii.

Respectfully submitted,

Herbert Sakakihara
Chairman
Maui Region Management Advisory Committee

Kauai Region
Public Health Facilities Management Advisory Committee
P.O. Box 337
Waimea, HI 96796
Phone (808) 338-9431 Fax (808) 338-9420

Annual Report 2005
(CY January 1, 2005 to December 31, 2005)

Aloha and Happy New Year!

I would like to share the exceptional events and activities that have occurred in the Kauai Region for the year 2005. The Kauai Region Senior Management Team continues to focus their efforts on managing the various hospital departments and clinics effectively.

The Kauai Region consists of two hospitals, the West Kauai Medical Center/KVMH and the Mahelona Medical Center/SMMH, and the West Kauai Clinics located in the vicinities of Waimea, Eleele, and Kalaheo.

Kauai Region Milestones:

In 2004, we entered into discussions with Drs. Robert and Linda Weiner along with our healthcare consultants regarding the sale of the Kalaheo Clinic to the West Kauai Clinics. After many discussions and consultations, the realization of the Kalaheo Clinic into the West Kauai Clinics family was finalized. Kalaheo Clinic became the West Kauai Clinic – Kalaheo on January 1, 2005.

Jeffrey Wong, D.O., Obstetrician/Gynecologist joined the West Kauai Clinics in February 2005. With his arrival, the Obstetrical and Gynecological program is blooming beautifully. We have witnessed an increase in deliveries as well as an increase in patient volume. Like Dr. Chatkupt, Dr. Wong has been welcomed into the community, a plus for the West Kauai Clinics and KVMH.

KVMH continues to benefit financially from the Critical Access Hospital (CAH) Program.

SMMH completed and submitted an application to the State Office of Rural Health Critical Access Hospital Reviewing Committee to be considered for CAH designation.

Renovations/improvements began on the construction of the "emergency room" at SMMH to be ready for CAH.

SMMH was surveyed by Medicare/Medicaid to receive licensure under CAH Designation. Under the State survey, SMMH received CAH designation. We await word from the Centers for Medicare/Medicaid (Federal Department) on their approval.
Dr. Richard Goding, orthopedic surgeon, began seeing patients in Lihue at the Kuhio Medical Center (one day a week) in addition to seeing patients at the West Kauai Clinics, Waimea. His patient volume has increased tremendously along with the continuous growth of orthopedic surgeries done. This service is another added plus for our community.
The Radiology Department replaced its original Computed Tomography Scanner (installed in 1997) with a new "16-slice" unit that is able to do cardiac readings in addition to all of the great imaging tests.
The Emergency Department continues to witness a high volume of utilization. This year we have seen 4750 as compared to 4100 last year.
The Kauai Region capitalizes its mission to carry out initiatives implemented to improve its cash collections. The regional management team truly strives to ensure that targets are met.
KVMH and SMMH have maintained its State Licensures and Medicare/Medicaid certifications.
KVMH received accreditation from the Joint Commission on Accreditation of Hospital Organizations (JCAHO) for its Laboratory and its Critical Access Hospital.

As part of the Hawaii Health Systems Corporation, the Kauai Region plays an integral role as a quality healthcare provider for the communities we serve. As we venture into the year 2006, the citizens of Hawaii will realize the impact of why the legislature saw the necessity to have a Hawaii health system which adheres to their health needs.

I sincerely thank you for your continued support of the Hawaii Health Systems Corporation and the Kauai Region.

Yours truly,

M. Jean Odo

M. Jean Odo
Chair, Kauai Region PHFMAC

Oahu Region Management Advisory Report

HHSC Annual Report

December 2005

The HHSC Oahu region (i.e., Maluhia and Leahi Hospital) faced another challenging year but was able to effectively respond to opportunities within its on-going commitment to improve quality care. Through the concerted effort of employees, medical staff, volunteers, and management, a number of achievements were realized.

The HHSC Oahu region performed well in Fiscal Year 2005. The patient mix was better than target and was better than the previous year. Likewise, the occupancy rate was slightly ahead of target. Revenues exceeded budgeted goals and expenses were under control.

Cash collections exceeded its goal by $790,000. Total operating revenue exceeded its goals by $490,000. The region was also below its budgeted operating loss by $1.2 million, as of June 30, 2005.

FY05 was another exciting year for the HHSC Oahu region. Leahi Hospital, thanks to the support of the Legislature and Administration, was able to repair the damaged roof and ceiling area of the Sinclair Building, in addition to a deteriorated stairwell of the Atherton Building. The Leahi Hospital Outpatient clinic exceeded previous census expectations of serving the needs to the elderly in the Kaimuki area. In May 2005, Leahi Hospital hosted a Centennial-Plus Birthday celebration for two of its oldest residents, Eunice Kim, 104, and Fujie Hasegawa, 101. The gala affair drew statewide media coverage. Unfortunately, Mrs. Kim passed away shortly after the event.

Maluhia was also able to achieve significant accomplishments. A new cooling tower was installed. The $500,000 project is expected to provide substantial energy savings over the life of the equipment. The Alewa Heights facility conducted successful disaster drills and is prepared to handle stand-alone operations for as long as seven days in the event of a major catastrophe.

Other highlights in FY 05, the HHSC Oahu region was able to offer its employees rank and file an educational opportunity, Compassionate Caring and Continuous Quality Improvement Program, enhancing their understanding and appreciation for long-term care issues.

The Leahi-Maluhia Foundation continues to build financial resources through creative fundraising activities and donations. At the end of 2005, total donations raised exceeded $100,000.

At the same time, like many other state agencies, the HHSC Oahu region is responding as best as it can to on-going challenges such as aged infrastructure and staff shortages.

Your continued assistance will help the Oahu region address these issues, pursue more cost efficiencies and help to preserve the excellence we have achieved as we move towards the challenges of our New Year 2006. Your continued support most certainly enhances our pursuit to continually improving the services we offer our communities.

Aloha and Mahalo,

Cliff Cisco, Vice Chair
Oahu Region Management Advisory Committee

PHYSICIANS ADVISORY GROUP
HAWAII HEALTH SYSTEMS CORPORATION
ANNUAL REPORT ATTACHMENT
2005

HHSC is experiencing a shortage of physicians to provide specialty emergency medical services, particularly in the areas of orthopedic surgery, neurosurgery, and psychiatry. The shortage of physicians who assist emergency room physicians with patients needing specialty care is becoming a major concern in Hawaii and across the nation.

Today's high demands for specialty emergency services, coupled with increasing physician shortages pose a significant challenge for our emergency rooms. Factors such as declining government and third party payer reimbursements and escalating malpractice costs confound the situation.

The Physicians Advisory Group, consisting of over 800 physicians throughout the State of Hawaii and HHSC began addressing these issues more than a year ago. Dramatic measures will be needed for the coming year that will require continued involvement of all of the acute hospital systems throughout the state, third-party payers such as HMSA, and lawmakers.

In light of these concerns and as part of a disaster management effort, the PAG and HHSC have also begun discussion on the development of a new comprehensive Neighbor Island Referral Center on Maui – focused on level-two trauma, with open-heart surgery and other emergency services.

The PAG recognizes the important role the Hawaii Health Systems Corporation plays in maintaining our safety-net medical mission throughout the Islands. Consequently, the PAG will continue to work closely with HHSC to ensure that quality care continues to be maintained.

At the same time, the Neighbor Island communities will need your understanding and support to successfully meet these challenges. Your support will continue to provide our Community Hospital System with the resources needed to meet our varied and growing health care needs.

Sincerely,

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

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

"Touching Lives Everyday"

Hawaii Health Systems Corporation
2005 Functional Accomplishments

- Completion of the demolition of the old Hilo hospital and groundbreaking for construction of the $33 million Yukio Okutsu Veterans Care Home on the grounds of Hilo Medical Center.
- Topping off ceremony for the $42 million renovation and expansion of Maui Memorial Medical Center.
- Successful Certification of three more HHSC hospitals as critical access hospitals (CAH): Kula Hospital, Hale Ho`ola Hamakua, Samuel Mahelona Memorial Hospital.
- 32 slice CT machine installed and running in the summer of 2005 at Hilo Medical Center.
- 2 Phillips iU22 Ultrasound machines installed and running in the fall of 2005 at Hilo Medical Center.
- Opening of Radiation Oncology Service at Kona Community Hospital in June 2005.
- Constructed new helipad and parking lot, with funding provided by Kona Hospital Foundation.
- Leahi Hospital regionalized food service, environmental services, and security, reducing costs and improving services.
- Increased the active medical staff of the West Kauai Medical Center/KVMH by five members with the addition of the Kalaheo Clinic to the West Kauai Clinic family on January 1, 2005, enabling the Kauai Region to provide service to our secondary market.
- 16-slice CT machine installed and running at the West Kauai Medical Center (late winter/early spring 2005).
- West Kauai Medical Center/KVMH's orthopedist was trained and is utilizing the Knee Navigation (computerized) System for bilateral corrective knee surgery. He is the first in the state to be utilizing this system.

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

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

"Touching Lives Everyday"

January 20, 2006

Kelley Roberson
Chief Operating Officer & Chief Financial Officer
Hawaii Health Systems Corporation
3675 Kilauea Avenue
Honolulu, Hawaii 96816

SUBJECT: HMSA Quality and Service Recognition Program Report

Dear Mr. Roberson:

Hawaii Health System Corporation was awarded $663,858 from the Hawaii Medical Service Association (HMSA) in recognition of its efforts to improve the quality of hospital care over the past year.

Now in its sixth year, HMSA's Hospital Quality and Service Recognition Program (HQSR) recognizes delivery of high-quality and cost-effective patient care in hospitals providing general, medical, surgical and maternity services. The program is part of HMSA's overall Patient Safety Initiatives to improve the quality of care for its more than 600,000 members.

Individual facility performance awards were given to six hospitals in the health system. They include Hilo Medical Center, Kauai Veterans Memorial Hospital, Kona Community Hospital, Maui Memorial Hospital, Lanai Community Hospital, and Samuel Mahelona Memorial Hospital. This is the fourth consecutive year that participating HHSC facilities have received recognition for quality improvements.

<u>**Methodology**</u>

HMSA's HQSR program is the result of a collaborative effort between Hawaii's hospitals, HMSA, and Health Benchmarks, Inc., a national health care research company. The program develops medical performance standards that reflect high standards of patient care and service.

Hospitals volunteering to be part of HQSR are evaluated and compared to one another and receive points based on achieving these standards. HHSC and other hospitals are involved in developing the reporting tools used to support their quality improvement efforts. The tools include a software application with patient-level information on complications and length of stay, a detailed report and an executive summary with actionable information for improvement.

Clinical improvement indicators are monitored through hospital-generated information or claims data analysis. Surveys are used to evaluate service satisfaction including (1) patient satisfaction with emergency room and inpatient care; and (2) physician satisfaction with hospital facilities, operations and staff.

The Hawaii Medical Service Association (HMSA), with input from participating hospitals, continues keep the program relevant to our changing quality improvement environment. For example, the Centers for Medicare and Medicaid Services (CMS) and the Leapfrog Group's Hospital Rewards Program (endorsed by JCAHO) have core measures that have been included in the HQSR program while also including physician satisfaction surveys. These are reflective of their efforts to measure quality, efficiency and continual improvement. Over the last four years, there have been marked improvements statewide in several areas of care that are measured in HQSR, including complications, length of stay (LOS), internal quality initiatives and the current "Get with the Guidelines" initiative on coronary artery disease.

If you have any questions, please feel free to contact me.

Sincerely,

STEPHEN CHONG
Corporate Quality Officer
Hawaii Health Systems Corporation

Attachment 7

Hawaii Tribune Herald

One for the soldiers

Center to be named for veteran

by Peter Sur
Tribune-Herald Staff Writer

The new $32.5 million state veterans care home will be named after Medal of Honor recipient Yukio Okutsu.

During the groundbreaking ceremony, Gov. Linda Lingle and others recognized the tireless effort that community members expended to bring the 95-unit facility to construction.

"It's our opportunity to say thank you (to the veterans), to say we didn't forget," Lingle said. "We didn't just say 'thanks' when we needed you, but we said 'thanks' when you needed us. This is indeed a great privilege. I've watched the community throughout this process. I know how much this meant to the people of Hilo, and I think it says a lot about all of you."

Included in the crowd were war veterans and elected officials. They stood on the grounds of the former Hilo Hospital, which was demolished to make room for the new veterans home. Large piles of gray rubble formed the backdrop to the ceremony.

Among the veterans was Frank Anakalapalani, who served 18 months during the Korean War.

To him, the care home represented "security for veterans" so that they could have a place to go.

"So many veterans on the streets, and they don't deserve that kind of life," Anakalapalani said after the ceremony. "I just hope that the hospital will be run with compassion, not just a dumping ground for old people."

Speakers at the ceremony echoed that sentiment.

Mayor Harry Kim pledged to make "a home and not an institution." Veterans from across the state would be proud to live there, he said, because the community would welcome them.

"In January we have 3,000 soldiers coming back from Iraq. Many are with the 2nd of the 299th, your own outfit," said retired Col. Edward Cruickshank, director of the state Office of Veterans Services. "And I can tell you this -- when they come back, they're going to be veterans. And I will tell you, they're performing fabulously in Iraq, and you should be very, very proud of them."

Ron Schurra, the East Hawaii Regional CEO for the Hawaii Health Systems Corp. and head of Hilo Medical Center, announced that Okutsu's name was initially recommended by the community and received unanimous approval. He said the HHSC was not yet ready to announce the official name of the facility, except that it would be dedicated to Okutsu.

However, Hilo Medical Center spokeswoman Joni Urasaki said the hospital would be named the "Yukio Okutsu Veterans Care Home-Hilo."

Okutsu, a Kauai native who lived in Hilo, died in 2003. In 1945, he was a member of the 442nd Regimental Combat Team. While surrounded by German machine guns, he stood up in the middle of a shower of bullets and threw two grenades into the nests of German snipers. He kept throwing the grenades, and when it was over he singlehandedly captured four German soldiers. Okutsu received the Medal of Honor in 2000.

During the actual groundbreaking, Lingle and 10 other dignitaries simultaneously dug into a small pile of dirt with koa digging sticks.

Construction of the hospital will begin next month. The hospital, which will be finished by January 2007, was built with $20 million in federal funds and $10 million in state funds, with the remainder coming from private donations.

Hawaii is one of only three states without a veterans center.

"It means a lot to me, because I'm a veteran, and this is long-awaited. Actually, I'm hopeful for what I heard, they can extend it. I don't think 95 beds is enough," said Jesus Del Mar, an operating room assistant who said he was representing the other veterans working at the hospital who couldn't attend. Del Mar served during the Vietnam War and would have been in Iraq now if he hadn't retired from the Hawaii National Guard in 1999.

Peter Sur can be reached at psur@hawaiitribune-herald.com.

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Hospital CEO anticipates October for 'topping off ceremony'

By BRIAN PERRY, Assistant City Editor

Tuesday, August 23, 2005 10:51 AM

WAILUKU – A new four-story north wing at Maui Memorial Medical Center has reached the 30 percent completion point, hospital Chief Executive Officer Wesley Lo reported last week.

While the frame of the $42 million project is done, workers for contractor Hawaiian Dredging Construction Co. will be turning their attention to filling in the building's interior, Lo said.

"You can't see it from the road, but the first floor panels, the walls are coming up," he said, adding that concrete already has been poured for all the new floors.

Workers were spraying fire retardant to fireproof steel, and, after they finish that, they'll be working on plumbing, putting in pipes and hanging air-conditioning ducts.

Lo said he expects the hospital will have a "topping off ceremony" in October when the new building's roof has been completed.

"We'll see basically an enclosed building in October," he said.

Then, by the fall of next year, hospital officials hope to get a partial certificate of occupancy, which would allow the opening of 29 new beds, increasing the maximum census for Maui's only acute-care hospital from 202 to 231 patients occupying beds.

The additional beds will come as a welcome relief for hospital administrators who often find the facility struggling to meet patient demand. The demand rises especially during high seasonal periods, such as flu season or when part-time residents are here in the winter.

Earlier this summer, hospital officials acknowledged operating over capacity, with patients held up in the Emergency Department.

Lo said those patients eventually were accommodated without compromises in quality of care or safety.

On Friday, he said the number of patients needing beds has "slowed down a little bit" from the high level the hospital staff had been coping with for the last month and a half or so.

"It's nothing like it was earlier in the year," he said.

With construction workers making steady progress on the new hospital wing, Lo and other hospital administrators are busy coming up with staffing and other plans to open it.

"We're starting to figure our staffing patterns, (and) what training we're going to do," he said. "We're preparing for that right now.

"It's daunting when you see that steel come up," he said. "You realize . . . now, we've got to do our work and get ready to get this thing operational as soon as they finish construction."

While Lo said it was premature to say exactly how many new staff members will be needed, he said it's certain the hospital will need more nurses, housekeepers, maintenance workers, clerks and therapists.

The hospital rarely hires doctors directly; instead it provides the facility for their use, but Lo said administrators are active in working with Maui's medical community to make sure the island has enough doctors to serve patient needs.

"We need to have more doctors for our increasing population," he said.

Aside from housing new hospital beds, the new 75,000-square-foot wing also will feature a new entrance and lobby area; physical and occupational therapy units; surgical support and recovery areas; and new procedure rooms, according to Lo.

Hospital administrators also are working with state legislators to make a $22 million appropriation available for construction of a multistory parking garage with 700 stalls.

Lo said the funding was approved by lawmakers this year, but there was a flaw in how the measure was crafted as a revenue bond. He said he expects the appropriation's problem would be cleared up during the next legislative session, clearing the way for design of the parking structure. Once completed, the parking garage will address longtime shortages of parking at the hospital as well as serve patrons and staff of a new medical office building being developed by Pacific Medical Buildings and Everett Dowling.

The exact location of the new parking structure has not been determined, Lo said.

Brian Perry can be reached at bperry@mauinews.com.

"Touching Lives Everyday"
HAWAII HEALTH SYSTEMS
CORPORATION

Hawaii Health Systems Corporation, HHSC
Informational Budget Briefing on
Requests for Biennium Budget 2006-2007

Presented to the

House Finance Committee

Friday, 13 January 2006
Room # 211, Hawaii State Capitol

Program I.D. and Title: HTH 210 – Community Hospitals

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Quality, accessible and affordable healthcare efficiently provided by HHSC facilities to all communities served. Details available upon request.

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D. Discuss actions taken by each program to improve its performance results.

HHSC has established system and individual accountability by organizing, within and across regions, setting objectives, and targeting resources to improve processes and outcomes and has introduced new systems to achieve noteworthy performance improvements in both finance and quality.

E. Please identify all modifications to your system's performance measures and discuss the rationale for these modifications.

As necessary, HHSC internal reporting / performance measures are continually adjusted and revamped to meet the ever-changing needs of today's fluid healthcare environment. Some examples are in annual reporting measures on workers compensation; new revenue enhancing measures; and additional quality measures involving patient safety. Details available upon request.

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A. Discussion of problems and issues encountered if any.

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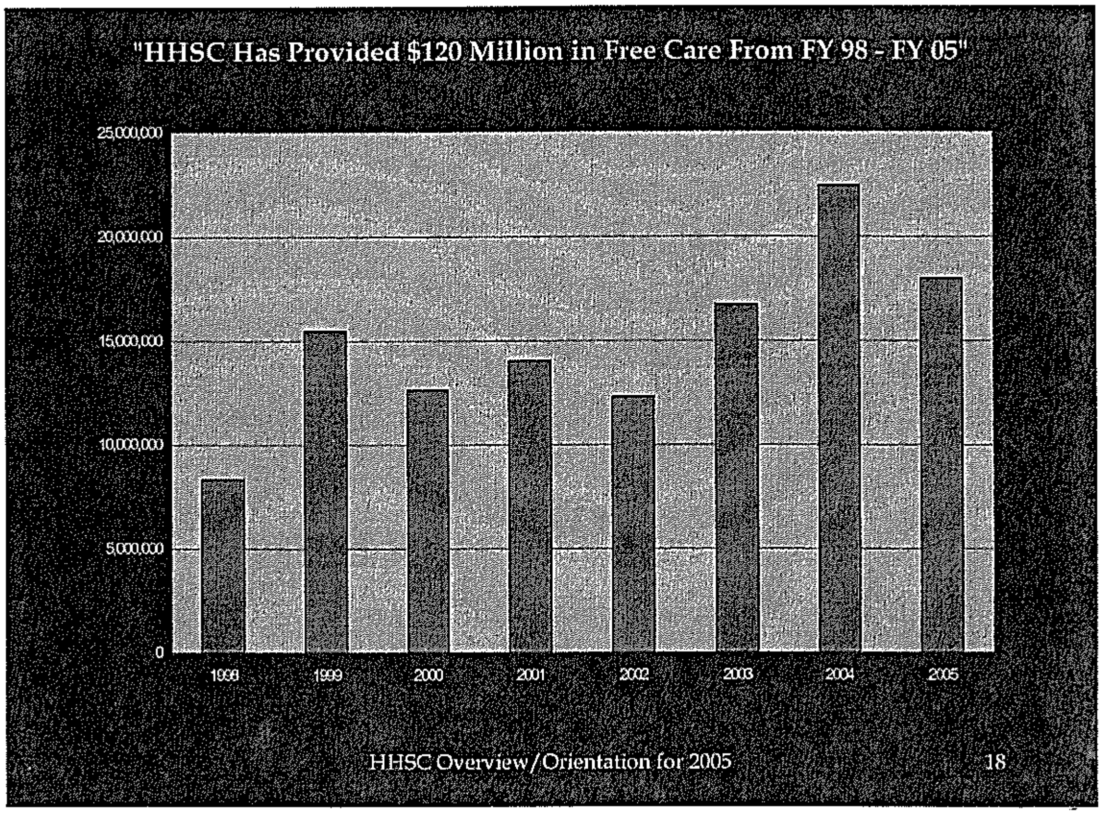
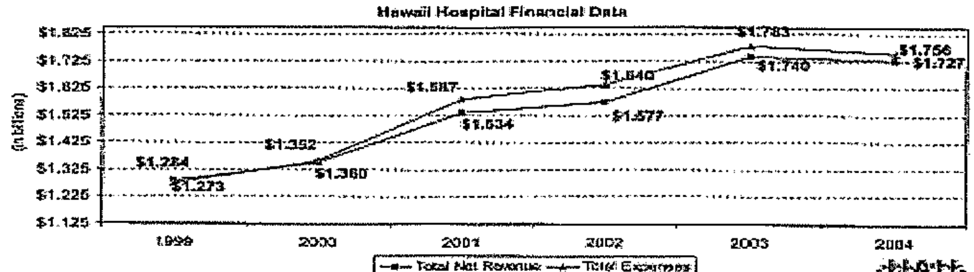


Hawaii Hospital Financial Data

- Hawaii hospital financial data shows that expenses exceeded revenues beginning in 2000 with the losses continuing
- Hawaii hospitals in <u>total</u> experienced net losses since 2000
- Other operating (cafeteria, parking, etc.) and nonoperating revenues (interest and investment income, etc.) are needed in addition to net patient revenues to help cover expenses
- Personnel expenses comprise approximately 50% of hospital expenses and benefits are approximately 18% of payroll costs



Source: American Hospital Association, 2006 Hospital Statistics

Healthcare Association of Hawaii 5

B. Program change recommendations to remedy problems.

The HHSC Board of Directors and management are committed to continuing the transformation of HHSC into a healthcare system that provides access to quality healthcare for all patients in our communities regardless of their ability to pay. In order to continue being the quality system that our communities deserve, and reduce State's payments for services provided by HHSC, HHSC must be afforded much more autonomy, with support to address concerns beyond HHSC control.

C. Identify any program issues or problems that have affected or will affect the implementation of the program, and the corrective measures or remedies established or planned.

Please note that all problems mentioned in paragraph III A do have an impact on implementation of the HHSC program. However the following three points deserve special concern and comment.

- A new challenge in FY06 is the requirement for HHSC to operate under the State Procurement Code. The new operational requirements of the Code, along with additional requirements imposed upon HHSC by the State Procurement Office plus other non-tangible costs, such as lost opportunity for savings because of the limitations imposed by the code and State Procurement Office requirements, will cost HHSC approximately $5 million more in FY06 than was required in previous years to accomplish HHSC procurement functions. The remedy is to request legislation support for Chief Procurement Officer authority for now, with future consideration to reestablish exemption from the code
- Compensation for Physician On-Call coverage at the 12 HHSC hospitals will greatly increase overall operational costs. HHSC is compensating for the situation by recruiting, hiring and contracting with physician specialists to provide covering for our Emergency Rooms.

- Uniform provision of specialty medical care on the Neighbor Islands has been increasingly difficult to maintain. In light of its challenges, its commitment to provide quality care to the Neighbor Islands, its ongoing obligation to enhance present disaster preparedness, and its response to maintain crucial specialty care at the emergency-care level, HHSC has begun preliminary discussion on a comprehensive referral center.

  We will be meeting with legislators to update them on the progress on this long-term planning effort.

IV. Expenditures for Fiscal Year 2005-2006

	Act 178/2005 FY 2006	C/B	Net Allocation	Est. Total Expenditures
(posn count)	(2836.25)		(2836.25)	(2836.25)
Personal Svcs	231,733,000	5,474,354	237,207,354	237,207,354
Current Exp.	134,990,978	-	134,990,978	134,990,978
Equipment		-	-	
Motor Vehicles		-	-	
TOTAL	366,723,978	5,474,354	372,198,332	372,198,332
(posn count)	(2836.25)		(2836.25)	(2836.25)
Special	334,443,937		334,443,937	334,443,937
General	32,280,041	5,474,354	37,754,395	37,754,395
Other			-	
	366,723,978	5,474,354	372,198,332	372,198,332

V. Supplemental Budget Request for Fiscal Year 2006-2007:

	Act 178/2005 FY 2007	Supplemental Request	Est. Total Expenditures
(posn count)	(2836.25)		(2836.25)
Personal Svcs	231,733,000		231,733,000
Current Exp.	134,990,978		134,990,978
Equipment			-
Motor Vehicles			-
TOTAL	366,723,978	-	366,723,978
(posn count)	(2836.25)		(2836.25)
Special	332,569,937		332,569,937
General	34,154,041		34,154,041
	366,723,978	-	366,723,978

Workload or Program Request:

HHSC is not submitting a workload or program request.

VI. Capital Improvement Requests for Fiscal year 2006-2007

1. LEAHI HOSPITAL, ROOF AND ELEVATORS REPLACEMENT, OAHU

DESIGN AND CONSTRUCTION TO REPLACE THE ATHERTON BUILDING ROOF, SINCLAIR BUILDING ROOF AND THE YOUNG BUILDING ELEVATORS

	FY 2007
Design	320 C
Construction	690 C

Explanation and Scope of Project

Design and construction to re-roof the Atherton and Sinclair buildings and replace the existing elevators in the Young building.

Justification for the Project

Additional funding is required to cover the cost overruns associated with this project. Funding will be used to complete the Atherton building roof replacement, Sinclair building roof replacement and the replacement of Young building elevators that were originally appropriated in Act 178, SLH 2005.

Senate District 10 **House District** 19

2. HAWAII HEALTH SYSTEMS FOUNDATION, VETERANS HOME, HAWAII

CONSTRUCTION FOR A LONG-TERM CARE VETERANS HOME LOCATED ON THE CAMPUS OF HILO MEDICAL CENTER

	FY 2007
Construction	3200 C
Construction	1800 N

Explanation and Scope of Project

This a joint venture between the Veterans Administration (VA) and HHSC to build and equip a long-term care (LTC) facility on the grounds of Hilo Medical Center. The old Hilo Hospital that has not been used for direct patient care for 15 years has been demolished. The new VA LTC facility will be available for use first by veterans in need of extended healthcare and second by all others in the community who are in need of the same extended health care.

Justification for the Project

Additional funding is required to cover the cost overruns associated with the Veterans Home located on the campus of Hilo Medical Center due to the rapidly escalating costs for construction materials and work. Veterans Home project was authorized in Act 200, SLH 2003 as amended by Act 41, SLH 2004.

Senate District	02	**House District**	02

3. MAUI MEMORIAL MEDICAL CENTER, EXPANSION PROJECT, MAUI

CONSTRUCTION FOR THE EXPANSION OF MAUI MEMORIAL MEDICAL CENTER

	FY 2007
Construction	5300 C

Explanation and Scope of Project

Construction for the expansion of the Maui Memorial Medical Center. The project will add additional square footage in the new wing. The new wing will have four levels. This project will improve Maui's ability to take care of the health care needs of the community. Patient care will improve and the new wing will provide rooms and treatment areas that are up to current health care standards.

Justification for the Project

Additional funding is required to cover the cost overruns associated with the expansion project at Maui Memorial Medical Center. Increase in funding is partly due to the escalating price of material, labor cost and overall construction cost increases. The expansion project was authorized in Act 259, SLH 2001 as amended by Act 177, SLH 2002.

Senate District	05	**House District**	09

VII. Proposed Lapses of Capital Improvement Program Projects:

None

"Touching Lives Everyday"
HAWAII HEALTH SYSTEMS
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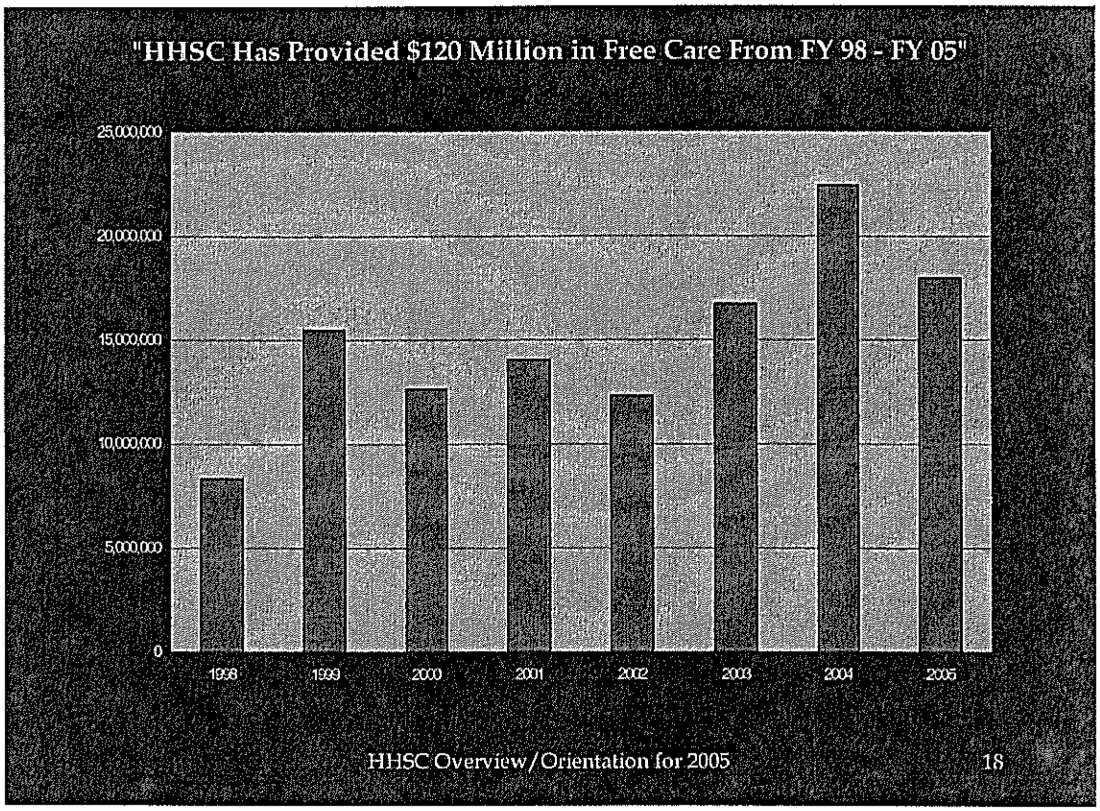
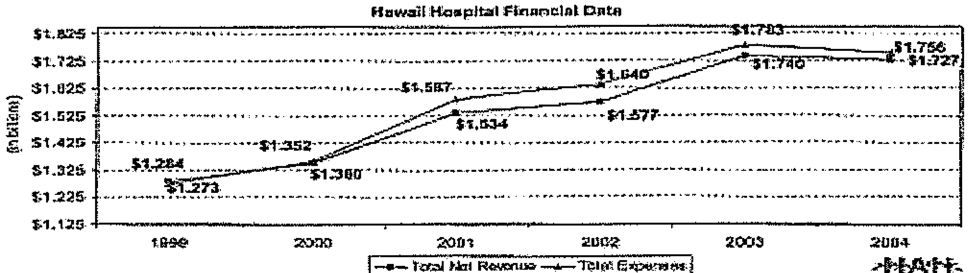
12. Federal Over-Regulation of Healthcare Resulting in Huge Compliance Cost.
13. HHSC Inherited Substantial Liabilities from the State.



Hawaii Hospital Financial Data

- Hawaii hospital financial data shows that expenses exceeded revenues beginning in 2000 with the losses continuing
- Hawaii hospitals in <u>total</u> experienced net losses since 2000
- Other operating (cafeteria, parking, etc.) and nonoperating revenues (interest and investment income, etc.) are needed in addition to net patient revenues to help cover expenses
- Personnel expenses comprise approximately 50% of hospital expenses and benefits are approximately 18% of payroll costs



Source: American Hospital Association, 2006 Hospital Statistics 5

B. **Program change recommendations to remedy problems.**

The HHSC Board of Directors and management are committed to continuing the transformation of HHSC into a healthcare system that provides access to quality healthcare for all patients in our communities regardless of their ability to pay. In order to continue being the quality system that our communities deserve, and reduce State's payments for services provided by HHSC, HHSC must be afforded much more autonomy, with support to address concerns beyond HHSC control.

C. **Identify any program issues or problems that have affected or will affect the implementation of the program, and the corrective measures or remedies established or planned.**

Please note that all problems mentioned in paragraph III A do have an impact on implementation of the HHSC program. However the following three points deserve special concern and comment.

- A new challenge in FY06 is the requirement for HHSC to operate under the State Procurement Code. The new operational requirements of the Code, along with additional requirements imposed upon HHSC by the State Procurement Office plus other non-tangible costs, such as lost opportunity for savings because of the limitations imposed by the code and State Procurement Office requirements, will cost HHSC approximately $5 million more in FY06 than was required in previous years to accomplish HHSC procurement functions. The remedy is to request legislation support for Chief Procurement Officer authority for now, with future consideration to reestablish exemption from the code
- Compensation for Physician On-Call coverage at the 12 HHSC hospitals will greatly increase overall operational costs. HHSC is compensating for the situation by recruiting, hiring and contracting with physician specialists to provide covering for our Emergency Rooms.

- Uniform provision of specialty medical care on the Neighbor Islands has been increasingly difficult to maintain. In light of its challenges, its commitment to provide quality care to the Neighbor Islands, its ongoing obligation to enhance present disaster preparedness, and its response to maintain crucial specialty care at the emergency-care level, HHSC has begun preliminary discussion on a comprehensive referral center.

  We will be meeting with legislators to update them on the progress on this long-term planning effort.

IV. Expenditures for Fiscal Year 2005-2006

	Act 178/2005 FY 2006	C/B	Net Allocation	Est. Total Expenditures
(posn count)	(2836.25)		(2836.25)	(2836.25)
Personal Svcs	231,733,000	5,474,354	237,207,354	237,207,354
Current Exp.	134,990,978	-	134,990,978	134,990,978
Equipment		-	-	
Motor Vehicles		-	-	
TOTAL	366,723,978	5,474,354	372,198,332	372,198,332
(posn count)	(2836.25)		(2836.25)	(2836.25)
Special	334,443,937		334,443,937	334,443,937
General	32,280,041	5,474,354	37,754,395	37,754,395
Other			-	
	366,723,978	5,474,354	372,198,332	372,198,332

V. Supplemental Budget Request for Fiscal Year 2006-2007:

	Act 178/2005 FY 2007	Supplemental Request	Est. Total Expenditures
(posn count)	(2836.25)		(2836.25)
Personal Svcs	231,733,000		231,733,000
Current Exp.	134,990,978		134,990,978
Equipment			-
Motor Vehicles			-
TOTAL	366,723,978	-	366,723,978
(posn count)	(2836.25)		(2836.25)
Special	332,569,937		332,569,937
General	34,154,041		34,154,041
	366,723,978	-	366,723,978

Workload or Program Request:

HHSC is not submitting a workload or program request.

VI. Capital Improvement Requests for Fiscal year 2006-2007

1. LEAHI HOSPITAL, ROOF AND ELEVATORS REPLACEMENT, OAHU

DESIGN AND CONSTRUCTION TO REPLACE THE ATHERTON BUILDING ROOF, SINCLAIR BUILDING ROOF AND THE YOUNG BUILDING ELEVATORS

	FY 2007
Design	320 C
Construction	690 C

Explanation and Scope of Project

Design and construction to re-roof the Atherton and Sinclair buildings and replace the existing elevators in the Young building.

Justification for the Project

Additional funding is required to cover the cost overruns associated with this project. Funding will be used to complete the Atherton building roof replacement, Sinclair building roof replacement and the replacement of Young building elevators that were originally appropriated in Act 178, SLH 2005.

Senate District 10 **House District** 19

2. HAWAII HEALTH SYSTEMS FOUNDATION, VETERANS HOME, HAWAII

CONSTRUCTION FOR A LONG-TERM CARE VETERANS HOME LOCATED ON THE CAMPUS OF HILO MEDICAL CENTER

	FY 2007
Construction	3200 C
Construction	1800 N

Explanation and Scope of Project

This a joint venture between the Veterans Administration (VA) and HHSC to build and equip a long-term care (LTC) facility on the grounds of Hilo Medical Center. The old Hilo Hospital that has not been used for direct patient care for 15 years has been demolished. The new VA LTC facility will be available for use first by veterans in need of extended healthcare and second by all others in the community who are in need of the same extended health care.

Justification for the Project

Additional funding is required to cover the cost overruns associated with the Veterans Home located on the campus of Hilo Medical Center due to the rapidly escalating costs for construction materials and work. Veterans Home project was authorized in Act 200, SLH 2003 as amended by Act 41, SLH 2004.

Senate District	02	**House District**	02

3. MAUI MEMORIAL MEDICAL CENTER, EXPANSION PROJECT, MAUI

CONSTRUCTION FOR THE EXPANSION OF MAUI MEMORIAL MEDICAL CENTER

	FY 2007
Construction	5300 C

Explanation and Scope of Project

Construction for the expansion of the Maui Memorial Medical Center. The project will add additional square footage in the new wing. The new wing will have four levels. This project will improve Maui's ability to take care of the health care needs of the community. Patient care will improve and the new wing will provide rooms and treatment areas that are up to current health care standards.

Justification for the Project

Additional funding is required to cover the cost overruns associated with the expansion project at Maui Memorial Medical Center. Increase in funding is partly due to the escalating price of material, labor cost and overall construction cost increases. The expansion project was authorized in Act 259, SLH 2001 as amended by Act 177, SLH 2002.

Senate District	05	**House District**	09

VII. Proposed Lapses of Capital Improvement Program Projects:

None