Hawaii Health Systems Corporation

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

HAWAII HEALTH SYSTEMS CORPORATION

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HAWAII HEALTH SYSTEMS CORPORATION

INTRODUCTION

PURPOSE OF THE REPORT

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

SCOPE OF THE AUDIT

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

ORGANIZATION OF THE REPORT

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

- The first section presents this introduction.

- The second section presents the consolidated financial statements of HHSC as of and for the year ended June 30, 2002 and the independent auditors' report thereon. This section also presents management's discussion and analysis and supplemental financial information.

- The third section presents the independent auditors' report in accordance with *Government Auditing Standards* on HHSC's internal control and compliance with laws and regulations.

Deloitte & Touche LLP
Suite 1200
1132 Bishop Street
Honolulu, Hawaii 96813-2870

Tel: (808) 543-0700
Fax: (808) 526-0225
www.deloitte.com

Deloitte
& Touche

INDEPENDENT AUDITORS' REPORT

Board of Directors of Hawaii Health Systems Corporation:

We have audited the accompanying consolidated statement of net assets of Hawaii Health Systems Corporation (HHSC), a component unit of the State of Hawaii, as of June 30, 2002, and the related consolidated statements of revenues, expenses, and changes in net assets and of cash flows for the year then ended. These financial statements are the responsibility of HHSC's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audit.

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

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

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

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

The management's discussion and analysis information on pages 4 through 9 is not a required part of the basic financial statements but is supplementary information required by the GASB. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it.

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

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

Deloitte & Touche LLP

November 1, 2002

Overview of the Financial Statements

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

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

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

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

Financial Analysis

Consolidated Statements of Net Assets

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

HAWAII HEALTH SYSTEMS CORPORATION

CONSOLIDATED STATEMENT OF NET ASSETS
JUNE 30, 2002

ASSETS

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

(Continued)

HAWAII HEALTH SYSTEMS CORPORATION

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

LIABILITIES AND NET ASSETS

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

See notes to consolidated financial statements.

HAWAII HEALTH SYSTEMS CORPORATION

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

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

See notes to consolidated financial statements.

HAWAII HEALTH SYSTEMS CORPORATION

CONSOLIDATED STATEMENT OF CASH FLOWS
YEAR ENDED JUNE 30, 2002

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

HAWAII HEALTH SYSTEMS CORPORATION

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

RECONCILIATION OF LOSS FROM OPERATIONS TO NET CASH USED IN OPERATING ACTIVITIES:	
Loss from operations	$ (30,346,954)
Adjustments to reconcile loss from operations to net cash used in operating activities:	
Provision for doubtful accounts	12,265,438
Depreciation and amortization	13,835,128
Amortization of prepaid pension costs	6,206,461
Amounts released from restrictions	1,413,001
Change in operating assets and liabilities:	
Receivables	(21,276,875)
Supplies and other assets	(1,620,328)
Accounts payable, accrued expenses, and other liabilities	6,687,948
Accrued workers' compensation liability	1,516,063
Estimated third-party payor settlements	(2,065,827)
Accrued vacation	774,966
Net cash used in operating activities	$ (12,610,979)
SUPPLEMENTAL CASH FLOW INFORMATION:	
Interest paid, primarily on capital lease obligations, net of interest capitalized of $15,500	$ 2,312,522
Non-cash financing and investing activities:	
• Capital assets contributed by State of Hawaii	2,287,258
• Capital assets acquired under capital leases	15,445,269
• Capital asset purchases included in accounts payable	555,782
• Capital assets acquired through grants	585,084
• Contribution of capital assets	59,000
• Reclassification of deposits to capital assets	750,000

See notes to consolidated financial statements.

1. ORGANIZATION

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

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

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

City and County of Honolulu:
- Leahi Hospital
- Maluhia

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

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

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

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

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

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

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Risk Management - HHSC is exposed to various risks of loss from torts; theft of, damage to and destruction of assets; business interruption; errors and omissions; employee injuries and illnesses; natural disasters; and employee health, dental and accident benefits. Commercial insurance coverage is purchased for claims arising from such matters. Settled claims have not exceeded this commercial coverage in any of the three preceding years. The facilities are self-insured for workers' compensation and disability claims and judgments as discussed in Note 9.

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

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

3. BOARD-DESIGNATED FUNDS

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

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

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

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

4. CAPITAL ASSETS

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

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

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

5. LONG-TERM LIABILITIES

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

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

Future capital lease payments were as follows:

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

HHSC has an arrangement with municipal lessors whereby HHSC enters into capital leases on behalf of the facilities. The capital lease obligation is recorded on HHSC-Corporate's (Corporate) financial statements. While the assets are being constructed, the amounts are recorded as construction in progress on Corporate's financial statements. Upon completion, the asset is transferred to the facility's financial statements. Corporate makes the capital lease payments, while the facility records depreciation on the capital asset. The facilities reimburse Corporate through the due from affiliates account.

6. LONG-TERM DEBT

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

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

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

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

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

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

Maturities of long-term debt are as follows:

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

7. FACILITY-BASED TECHNICAL SERVICE AGREEMENTS

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

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

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

8. EMPLOYEE BENEFITS

Defined Benefit Pension Plans

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

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

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

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

Post-Retirement Health Care and Life Insurance Benefits

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

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

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

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

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

Sick Leave

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

9. COMMITMENTS AND CONTINGENCIES

Professional Liability

HHSC maintains professional and general liability insurance with a private insurance carrier with a $30 million limit per claim. HHSC's General Counsel advises that, in the unlikely event any judgments rendered against HHSC exceed HHSC's professional liability coverage, such amount would likely be paid from an appropriation from the State's general fund.

Workers' Compensation Liability

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

Ceded Lands

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

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

Litigation

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

Asbestos Contamination

There is known asbestos contamination of the old hospital building located next to the Hilo Medical Center facility. Present estimates by management to demolish the building and remediate the asbestos contamination approach $2 million or more. No decision has yet been made by HHSC on how to proceed on this issue. The ultimate ownership of the old building is still in negotiation between the State of Hawaii and HHSC, since Act 262 did not specify which assets and liabilities would transfer to HHSC. As such, a liability for the cost of the remediation has not been recorded in HHSC's financial statements.

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HAWAI HEALTH SYSTEMS CORPORATION

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

	Appropriation Symbol	
CASH ON DEPOSIT WITH THE STATE OF HAWAII:		
SPECIAL FUNDS:		
	S-92-312-H	$ 484
	S-93-312-H	544
	S-93-359-H	5,681
	S-94-312-H	33,400
	S-94-359-H	12,905
	S-94-396-H	8,673
	S-95-396-H	19,636
	S-96-312-H	469
	S-96-359-H	23,019
	S-96-396-H	9,040
	S-97-359-H	5,878
	S-97-396-H	182
	S-98-396-H	1,687
	S-02-303-H	587
	S-02-312-H	32
	S-02-350-H	73,261
	S-02-351-H	11,418
	S-02-352-H	10,131
	S-02-353-H	16,845
	S-02-354-H	61,509
	S-02-355-H	73,193
	S-02-358-H	17,054
	S-02-359-H	38
	S-02-365-H	1
	S-02-371-H	29,737
	S-02-373-H	3,225
TRUST FUNDS:		
	T-02-906-H	2,512
	T-02-909-H	28,864
	T-02-910-H	63,106
	T-02-914-H	14,706
	T-02-918-H	1,272
	T-02-921-H	6,679
TOTAL PER STATE		535,768
RECONCILING ITEMS		(21,084)
TOTAL PER HHSC		$ 514,684

HAWAI HEALTH SYSTEMS CORPORATION

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

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

HAWAII HEALTH SYSTEMS CORPORATION

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

	Facilities														
ASSETS	**Hilo Medical Center**	**Kona Community Hospital**	**Maui Memorial Medical Center**	**Ka'u Hospital**	**Kula Hospital**	**Kauai Veterans Memorial Hospital**	**Samuel Mahelona Memorial Hospital**	**Hale Ho'ola Hamakua**	**Kohala Hospital**	**Leahi Hospital**	**Maluhia**	**Lanai Community Hospital**	**Total Facilities**	**Corporate**	**Reclassifi-cations and Elimi-nations**
CURRENT ASSETS:															
Cash and cash equivalents:															
On deposit with the State of Hawaii	$ 85,688	$ 61,509	$ 117,608	$ 16,717	$ 29,737	$ 47,521	$ 3,225	$ 11,815	$ 16,845	$ 63,793	$ 1	$ 17,054	$ 471,513	$ 43,171	
On deposit with banks and on hand	138,380	173,111	5,052	9,663	3,086	8,257	12,561	500	11,935	286,095	95,231	18,833	762,704	5,276,628	
Patient accounts receivable - less allowances for contractual adjustments and doubtful accounts	12,206,009	6,330,432	21,409,401	442,189	2,265,757	2,558,517	1,191,724	765,499	594,129	2,593,660	2,134,607	422,506	52,914,430		
Supplies and other current assets	1,992,436	1,429,766	2,270,774	42,488	146,353	434,747	55,207	92,393	30,549	493,497	102,662	44,738	7,135,610	292,291	
Total current assets	14,422,513	7,994,818	23,802,835	511,057	2,444,933	3,049,042	1,262,717	870,207	653,458	3,437,045	2,332,501	503,131	61,284,257	5,612,090	
DUE FROM AFFILIATES - Net			9,724,336										9,724,336	86,092,758	$ (95,817,094)
CAPITAL ASSETS - Net	35,922,030	28,168,878	49,489,076	903,838	5,124,257	9,354,336	3,969,972	14,677,262	763,610	7,460,293	4,222,285	567,648	160,623,485	15,537,423	
ASSETS LIMITED AS TO USE	38,327	99,047		5,221	64,118	7,598	32,677	8,249	5,638	152,391	87,196	1,646	502,108	41,748	
OTHER ASSETS	30,564	10,699	15,520	523	436			625	600				58,967	97,822	
TOTAL	$ 50,413,434	$ 36,273,442	$ 83,031,767	$ 1,420,639	$ 7,633,744	$ 12,410,976	$ 5,265,366	$ 15,556,343	$ 1,423,306	$ 11,049,729	$ 6,641,982	$ 1,072,425	$ 232,193,153	$ 107,381,841	$ (95,817,094)

HAWAII HEALTH SYSTEMS CORPORATION

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

LIABILITIES AND NET ASSETS	Facilities: Hilo Medical Center	Kona Community Hospital	Maui Memorial Medical Center	Ka'u Hospital	Kula Hospital	Kauai Veterans Memorial Hospital	Samuel Mahelona Memorial Hospital	Hale Ho'ola Hamakua	Kohala Hospital	Leahi Hospital	Maluhia	Lanai Community Hospital	Total Facilities	Corporate	Reclassifi-cations and Elimi-nations
CURRENT LIABILITIES:															
Accounts payable and accrued expenses	$ 11,499,715	$ 4,122,294	$ 14,818,920	$ 181,642	$ 946,160	$ 1,668,708	$ 496,680	$ 352,599	$ 184,638	$ 1,140,219	$ 1,185,626	$ 139,091	$ 36,736,292	$ 2,700,482	
Accrued workers' compensation liability	5,491,474	2,051,024	4,032,298	147,490	1,947,407	790,785	455,572	494,175	227,388	1,456,373	924,220	138,450	18,156,656	343,344	
Current portion of capital lease obligations	413,094	24,028			4,235	2,466	22,060				6,055		471,938	6,564,943	
Estimated third-party payor settlements	1,212,577	218,288	360,083	41,482	59,653	(355,109)	3,998	36,690	219,647	55,000	70,000	56,240	1,978,549		
Current portion of accrued vacation	125,546	47,288	139,249		97,370	20,875	17,432	51,233	8,336	81,777	104,748	5,309	699,163	19,991	
Current portion of long-term debt	193,423					375,000							568,423		
Other current liabilities	218,940	4,033				143,204							366,177		
Total current liabilities	19,154,769	6,466,955	19,350,550	370,614	3,054,825	2,645,929	995,742	934,697	640,009	2,733,369	2,290,649	339,090	58,977,198	9,628,760	
CAPITAL LEASE OBLIGATIONS - Less current portion	808,739						19,479				6,069		834,287	16,215,664	
LONG-TERM DEBT - Less current portion	11,423,465												11,423,465		
ACCRUED VACATION - Less current portion	4,378,489	2,247,769	4,348,545	165,758	931,609	1,015,478	958,851	348,688	274,117	1,530,985	1,294,446	205,151	17,699,886	585,640	
DUE TO AFFILIATES - Net	7,547,166	11,106,824		5,480,069	6,008,883	26,085,765	9,085,562	309,742	4,534,967	6,047,921	13,337,853	6,096,469	95,641,221		$ (95,817,094)
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		
PATIENTS' SAFEKEEPING DEPOSITS	38,327	5,877		5,221	64,118	7,598	29,633	8,249	5,638	152,391	62,661	1,646	381,359		
OTHER LIABILITIES	2,348	23,113	42,299	10,932		45,400	2,430	19,841		45,005	14,902	13,900	220,170	301,694	
Total liabilities	43,353,303	27,455,743	23,741,394	6,032,594	11,173,699	30,843,515	13,508,847	2,127,370	5,982,880	16,926,462	17,498,030	6,656,256	205,300,093	26,731,758	(95,817,094)
NET ASSETS:															
Invested in capital assets - net of related debt	23,083,309	28,144,850	49,489,076	903,838	5,120,022	9,351,870	3,928,433	14,677,262	763,610	7,460,293	4,210,161	567,648	147,700,372	(7,243,184)	
Unrestricted	(16,023,178)	(19,420,321)	9,801,297	(5,515,793)	(8,659,977)	(27,784,409)	(12,174,958)	(1,248,289)	(5,323,184)	(13,337,026)	(15,090,744)	(6,151,479)	(120,928,061)	87,851,519	
Restricted		93,170					3,044				24,535		120,749	41,748	
Total net assets	7,060,131	8,817,699	59,290,373	(4,611,955)	(3,539,955)	(18,432,539)	(8,243,481)	13,428,973	(4,559,574)	(5,876,733)	(10,856,048)	(5,583,831)	26,893,060	80,650,083	
TOTAL	$ 50,413,434	$ 36,273,442	$ 83,031,767	$ 1,420,639	$ 7,633,744	$ 12,410,976	$ 5,265,366	$ 15,556,343	$ 1,423,306	$ 11,049,729	$ 6,641,982	$ 1,072,425	$ 232,193,153	$ 107,381,841	$ (95,817,094)

HAWAII HEALTH SYSTEMS CORPORATION

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

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

Deloitte & Touche LLP
Suite 1200
1132 Bishop Street
Honolulu, Hawaii 96813-2870

Tel: (808) 543-0700
Fax: (808) 526-0225
www.deloitte.com

Deloitte & Touche

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

Board of Directors of Hawaii Health Systems Corporation:

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

Compliance

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

Internal Control over Financial Reporting

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

- Reconciliations of the capital lease obligation and capital assets accounts are not performed on a timely basis.

- Inadequate segregation of duties over the payables cycle.

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

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

Deloitte & Touche LLP

November 1, 2002