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Hawaii Health Systems Corporation

Consolidated Financial Statements for the Years Ended June 30, 2004 and 2003, Supplemental Information for the Year Ended June 30, 2004 and Independent Auditors' Reports

HAWAII HEALTH SYSTEMS CORPORATION

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HAWAII HEALTH SYSTEMS CORPORATION

INTRODUCTION

PURPOSE OF THE REPORT

The purpose of this report is to present the consolidated financial statements of Hawaii Health Systems Corporation (HHSC) as of and for the years ended June 30, 2004 and 2003 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 years ended June 30, 2004 and 2003 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, 2004 and 2003, 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 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 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, 2004 and 2003 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, 2004, 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, 2004 and 2003 may be significantly different from those eventually included in the final settlement.

The management's discussion and analysis information on pages 4 through 13 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 31 and 32 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 33 through 35 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 December 13, 2004 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.

As discussed in Note 2, effective in fiscal year 2004, the provision for doubtful accounts has been offset against patient service revenue and interest expense has been reclassified from an operating expense to a nonoperating expense. The fiscal year 2003 financial statements have been reclassified to reflect these changes.

Deloitte & Touche LLP

December 13, 2004

HAWAII HEALTH SYSTEMS CORPORATION

MANAGEMENT'S DISCUSSION AND ANALYSIS
YEARS ENDED JUNE 30, 2004 AND 2003

Overview of the Financial Statements

This discussion and analysis information is 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. 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, 2004 and 2003 is as follows:

ASSETS	2004	2003
Current assets	$ 76,242,228	$ 74,377,026
Capital assets–net	189,288,485	186,775,282
Other assets	2,750,321	3,284,853
Total assets	$268,281,034	$264,437,161
LIABILITIES		
Current liabilities	$ 90,667,690	$ 87,994,090
Capital lease obligations–less current portion	25,787,410	24,367,818
Long-term debt–less current portion	11,904,730	12,594,445
Accrued vacation–less current portion	20,862,000	20,884,868
Due to the State of Hawaii	20,122,507	20,122,507
Other liabilities	702,190	770,340
Total liabilities	170,046,527	166,734,068
NET ASSETS		
Invested in capital assets–net of related debt	143,124,046	141,502,484
Temporarily restricted	949,595	2,130,506
Unrestricted	(45,839,134)	(45,929,897)
Total net assets	98,234,507	97,703,093
Total liabilities and net assets	$268,281,034	$264,437,161

At June 30, 2004 and 2003, HHSC's capital assets, net of accumulated depreciation, comprised approximately 71% of its total assets. These assets consist mainly of land, hospital buildings and equipment that are used in HHSC's operations. 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 Maui Memorial Medical Center (MMMC).

The fiscal year 2003 increase of approximately $10.6 million is due to capital asset additions of approximately $26.2 million, offset by depreciation expense of approximately $15.5 million. The primary reason for the increase is the acquisition of medical equipment and energy saving equipment of $14.5 million funded through HHSC's municipal leasing lines of credit and State-funded capital improvement projects of $6.2 million. The State-funded capital improvement projects consisted primarily of life-safety code improvements at HHSC's critical access hospitals (Kauai Veterans

Memorial Hospital, Kohala Hospital, Lanai Community Hospital, and Ka'u Hospital) and a nurse call system installation and electrical upgrades at MMMC.

A summary of HHSC's capital assets as of June 30, 2004 and 2003 is as follows:

	2004	2003
Land and land improvements	$ 5,083,354	$ 5,083,354
Buildings and improvements	214,386,005	205,427,870
Equipment	116,430,470	110,505,091
Construction in progress	22,810,939	22,835,068
	358,710,768	343,851,383
Less accumulated depreciation and amortization	(169,422,283)	(157,076,101)
Capital assets–net	$ 189,288,485	$ 186,775,282

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 is 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 is 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, 2003, HHSC's current assets approximated 28% of total assets. Current assets increased by approximately $7.1 million from the fiscal year 2002 balance due to the increases in cash and cash equivalents of approximately $8.3 million and in supplies and other current assets of approximately $1.2 million, offset by a decrease in net patient accounts receivable of approximately $2.4 million. The increase in cash and cash equivalents is primarily due to the need to repay $5 million out of operating funds at the end of fiscal year 2002 to the State of Hawaii for an advance given to HHSC to fund its operating deficit for fiscal year 2002. The other reason for the increase in cash and cash equivalents is the increase in cash collections for fiscal year 2003 as compared to the prior year. HHSC collected $277 million in fiscal year 2003 as compared to $247 million in fiscal year 2002 due to an increase in patient services as a result of HHSC's investment in imaging equipment at its three major acute facilities.

At June 30, 2004, HHSC's other noncurrent assets were comparable to fiscal year 2003. At June 30, 2003, HHSC's other noncurrent assets increased approximately $2.4 million from fiscal year 2002. The primary reasons for the increase are the restricted contribution of $1.5 million received from the Harry & Jeanette Weinberg Foundation to fund the Hawaii Prescription Care Association program, and an increase of approximately $709,000 in HHSC's investment in the Clinical Laboratories of Hawaii LLP joint venture.

At June 30, 2004 and 2003, HHSC's current liabilities approximated 53% of total liabilities. The primary reason for the increase over fiscal year 2003 is 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. The fiscal year 2003 increase in current liabilities of $19.1 million is primarily due to the $14 million advance from the State of Hawaii (see explanation under general fund appropriations below) which is to be repaid in fiscal year 2005. Increases in accounts payable and accrued expenses over fiscal year 2002 were caused by a general delay in paying creditors, caused by operating cash flow shortages, resulting in an increase of approximately $4.7 million as of June 30, 2003. Increases in the current portion of the capital lease obligation over fiscal year 2002 of approximately $896,000 are due to the increase in the financing of the majority of HHSC's equipment purchases through municipal leasing lines (see further explanation below).

At June 30, 2004 and 2003, HHSC's total capital lease obligation balance increased approximately $1.4 million and $8.2 million from fiscal years 2003 and 2002, 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 Academic Capital Group, Inc. and Salem Capital Group, which allow HHSC to finance equipment purchases at interest rates below market rates.

At June 30, 2004 and 2003, 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 $10.9 million and $11.4 million, respectively, and a mortgage note payable relating to the acquisition of the nursing cottages on the MMMC campus with a remaining balance at June 30, 2004 and 2003 of approximately $1.5 million and $1.6 million, respectively.

At June 30, 2004 and 2003, the portion of HHSC's net assets that is reflected as its investment in capital assets, net of related debt, of approximately $143 million and $142 million, respectively, is larger than the total net assets of approximately $98 million. This means that HHSC's net operations since inception have resulted in losses of over $45.8 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, 2004 and 2003 is as follows:

	2004	2003
Operating expenses:		
Salaries and benefits	$203,064,758	$190,634,252
Purchased services and professional fees	37,488,569	39,626,721
Supplies and drugs	47,660,220	45,121,947
Depreciation and amortization	16,243,898	15,493,133
Other	22,335,182	23,358,616
Total operating expenses	326,792,627	314,234,669
Operating revenues	288,238,743	270,403,980
Loss from operations	(38,553,884)	(43,830,689)
Nonoperating revenues (expenses):		
General appropriations from State of Hawaii	31,220,000	13,300,000
Collective bargaining pay raise appropriation from State of Hawaii	3,831,469	12,394,468
Restricted contributions	2,329,565	2,447,524
Other nonoperating expenses–net	(3,721,800)	(538,618)
Nonoperating revenues–net	33,659,234	27,603,374
Loss before capital contributions	(4,894,650)	(16,227,315)
Capital assets contributed by State of Hawaii	5,426,064	6,228,402
Increase (decrease) in net assets	$ 531,414	$ (9,998,913)

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.

For the year ended June 30, 2003, HHSC's operating expenses exceeded its operating revenues by approximately $43.8 million. The collective bargaining pay raise appropriation from the State of Hawaii of approximately $12.4 million, general fund appropriations from the State of Hawaii of $13.3 million, restricted contributions of $2.4 million, other nonoperating expenses of $0.5 million, and capital assets contributed by the State of Hawaii of $6.2 million resulted in a decrease in net assets to $10 million.

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 Hawaii Government Employees Association (HGEA) bargaining unit 9 (consisting of registered nurses) and United Public

Workers (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 expenses in fiscal year 2003 were approximately 12% higher than fiscal year 2002 (before netting the provision for doubtful accounts against patient service revenues and reclassification of interest expense). The increase was mainly in the categories of salaries and benefits expense, purchased services and professional fees, and the provision for doubtful accounts. Salaries and benefits expense increased 12% from fiscal year 2002, due primarily to an increase in the fringe benefit rate charged to all State agencies from 21.2% to 32.2%. The increase in the fringe benefit rate was due primarily to an increase in the required contribution to the Employee Retirement System (ERS) from 0% to 8.9%. The impact of the fringe benefit increases for the ERS, Retiree Health Insurance, and Employee Health Fund was an additional $14 million in salaries and benefits expense to HHSC in fiscal year 2003. Further, HHSC's union employees received pay raises from the unions' collective bargaining agreements with the State of Hawaii, ranging from 2-5%. These pay raises represented an additional $6.2 million in salaries and benefits expense over fiscal year 2002. Purchased services and professional fees increased 14.4% from fiscal year 2002, primarily due to increased use of registry nurses and clinical laboratory services at MMMC, driven by larger than expected patient volume throughout the year. Provision for doubtful accounts increased by approximately $4.5 million from fiscal year 2002, primarily due to an increase of $5.4 million in provision for doubtful accounts at MMMC. While the facility's business office was fairly successful in keeping up with billing and collecting the fiscal year 2003 patient accounts, it was unable to maintain its collection efforts on fiscal year 2002 and older patient accounts. As a result, the facility's accounts receivable aging deteriorated substantially in fiscal year 2003. The facility's accounts receivable aged current to 60 days past due decreased 13% from June 30, 2002 to June 30, 2003; while the accounts receivable aged 151 days and older increased 12% from June 30, 2002 to June 30, 2003. Therefore, a substantially higher provision for doubtful accounts was necessary to account for the diminished likelihood of collection on the older patient accounts receivable.

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. Sole community hospitals are hospitals that, because of factors such as isolated location, weather conditions, travel conditions, or absence of other hospitals, are the sole source of inpatient services reasonably available in a geographic area, or are located more than 35 road miles from another hospital. Sole community hospitals receive either hospital-specific prospective rates based on base year costs updated to the present or the federal PPS rate, whichever is higher. 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 efforts on the more collectible accounts.

Operating revenue in fiscal year 2003 increased by approximately 7.9% over fiscal year 2002 (before netting the provision for doubtful accounts against patient service revenues), as a result of a 1.3% increase in patient days, a 5% rate increase effective July 1, 2002, and continued revenue enhancements as a result of HHSC's imaging initiatives that began in fiscal year 2002. The increase in revenues primarily came in the areas of major surgery, emergency room, imaging (including MRI, diagnostic radiology services, and CT Scan), clinical laboratory testing, and drugs sold to patients. The primary increase in operating revenues occurred at MMMC, primarily due to a 5.3% increase in emergency room visits, a 4.7% increase in newborn patient days, and a 2.3% increase in acute patient days.

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.

For the year ended June 30, 2003, General Fund Appropriations from the State of Hawaii is comprised of $14 million approved for HHSC's operating purposes by the 2002 Legislature, which was reduced by $700,000 due to a budget restriction imposed by the Governor of the State of Hawaii. During fiscal year 2003, HHSC communicated to the State Department of Budget and Finance and the Governor of the State of Hawaii that due to unanticipated increases in the amounts assessed to HHSC for employee retirement system contributions and other health benefit costs, the level of general fund appropriations HHSC was to receive for fiscal year 2003 would be insufficient to support its operations. The Governor agreed to loan HHSC $14 million, with the understanding that HHSC would seek an emergency appropriation from the 2003 Legislature to repay the loan. The 2003 Legislature did not support HHSC's emergency appropriation request; accordingly, the balance of the $14 million loan from the Governor is reflected as "Advance from the State of Hawaii" on the statement of net assets.

HHSC's management believes that the significant loss from operations in both 2004 and 2003, 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 2004, 60% 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, government-type payors account for 84% of HHSC's long-term care revenues. Reimbursements from government-type payors have 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.

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. Management is working with the State Department of Human Services to explore 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 Safety Net Hospitals and Health Systems, 2001" states that in 2001, "Medicaid DSH once again proved to be a critical funding source, financing 25 percent of unreimbursed costs." The 2003 Legislature passed a resolution requesting the State Department of Human Services to work with Hawaii's congressional delegation to aggressively advocate for the restoration of DSH payments from the Centers for Medicare and Medicaid Services to compensate Hawaii hospitals for care provided to the uninsured.

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 Hilo Medical Center 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. Hilo Medical Center and MMMC both 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 62% 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 healthcare workers, 2) the inability of local colleges and universities to provide sufficient classes and teachers that can educate students in these areas, 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, who 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 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 was not subject to HRS 103(d).

Management believes that the State procurement code is effective in doing what it was designed to do, which is to prevent graft and abuse of public funds. However, management does not believe that the State procurement code is effective in addressing the needs of commercial enterprises like HHSC that operate in today's rapidly changing business environment. The State procurement code is much more stringent and onerous than HHSC's current procurement policies. Today's business environment is moving more toward e-commerce, where more and more transactions and procurement are being done through the internet, and the State procurement code has not kept up with the advances in technology, which are changing the way commercial enterprises are doing business. Further, management believes that the removal of HHSC's exemption from 103(d) will result in significant additional cost to the State in terms of additional contracting personnel needed to comply with the provisions of the procurement code and in terms of discounts lost as a result of the extended period of time necessary to complete a contract under chapter 103(d). When HHSC's procurement exemption was removed, the law did not provide for any official of HHSC to be named its Chief Procurement Officer. Therefore, any exceptions to HRS 103(d) must be approved by the State of Hawaii Procurement Office. Given the volume of purchases that HHSC makes in a fiscal year and the small size of the State Procurement Office staff, management believes that procurement of many unique medical goods and services may be inordinately delayed. Management does not believe that the State procurement code is adequate to address the needs of a dynamic healthcare organization like HHSC, where the ability to quickly procure medical goods and services to handle emergency medical situations is critical to ensure the public health of the communities that HHSC serves.

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 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 STATEMENTS OF NET ASSETS
JUNE 30, 2004 AND 2003

ASSETS	2004	2003
CURRENT ASSETS:		
Cash and cash equivalents:		
On deposit with the State of Hawaii	$ 9,864,299	$ 8,158,638
On deposit with banks and on hand (Note 3)	8,764,360	7,112,264
Patient accounts receivable–less allowances of $93,591,425 and $108,974,531 for contractual adjustments and doubtful accounts	49,537,926	50,479,262
Supplies and other current assets	8,075,643	8,626,862
Total current assets	76,242,228	74,377,026
CAPITAL ASSETS—Net (Notes 4, 6 and 7)	189,288,485	186,775,282
ASSETS LIMITED AS TO USE	1,312,093	2,517,281
OTHER ASSETS (Note 11)	1,438,228	767,572
TOTAL	$268,281,034	$264,437,161

(Continued)

HAWAII HEALTH SYSTEMS CORPORATION

CONSOLIDATED STATEMENTS OF NET ASSETS
JUNE 30, 2004 AND 2003

LIABILITIES AND NET ASSETS	2004	2003
CURRENT LIABILITIES:		
Accounts payable and accrued expenses (Note 11)	$ 42,823,960	$ 44,324,301
Accrued workers' compensation liability (Note 10)	21,854,000	18,500,000
Advance from the State of Hawaii (Note 5)	14,000,000	14,000,000
Current portion of capital lease obligations (Note 6)	7,958,701	7,933,202
Estimated third-party payor settlements	1,393,620	1,565,986
Current portion of accrued vacation (Note 6)	1,365,261	840,270
Current portion of long-term debt (Note 7)	513,598	377,333
Other current liabilities	758,550	452,998
Total current liabilities	90,667,690	87,994,090
CAPITAL LEASE OBLIGATIONS—Less current portion (Note 6)	25,787,410	24,367,818
LONG-TERM DEBT—Less current portion (Note 7)	11,904,730	12,594,445
ACCRUED VACATION—Less current portion (Note 6)	20,862,000	20,884,868
DUE TO THE STATE OF HAWAII	20,122,507	20,122,507
PATIENTS' SAFEKEEPING DEPOSITS	362,498	386,775
OTHER LIABILITIES	339,692	383,565
Total liabilities	170,046,527	166,734,068
NET ASSETS:		
Invested in capital assets–net of related debt	143,124,046	141,502,484
Temporarily restricted (Note 12)	949,595	2,130,506
Unrestricted (Note 3)	(45,839,134)	(45,929,897)
Total net assets	98,234,507	97,703,093
TOTAL	$ 268,281,034	$ 264,437,161

See notes to consolidated financial statements. (Concluded)

HAWAII HEALTH SYSTEMS CORPORATION

CONSOLIDATED STATEMENTS OF REVENUES, EXPENSES, AND CHANGES IN NET ASSETS YEARS ENDED JUNE 30, 2004 AND 2003

	2004	2003
OPERATING REVENUES:		
Net patient service revenues (Note 8)	$283,296,884	$267,007,883
Other operating revenues (Notes 8 and 11)	4,941,859	3,396,097
Total operating revenues	288,238,743	270,403,980
OPERATING EXPENSES:		
Salaries and benefits (Notes 8 and 9)	203,064,758	190,634,252
Medical supplies and drugs	36,927,252	32,868,916
Purchased services (Notes 8 and 11)	34,508,122	36,251,437
Depreciation and amortization	16,243,898	15,493,133
Other supplies	10,732,968	12,253,031
Utilities	7,161,330	7,314,622
Repairs and maintenance	5,335,109	5,349,702
Rent and lease	3,840,882	3,502,585
Professional fees (Notes 8 and 11)	2,980,447	3,375,284
Insurance	2,333,601	3,327,248
Other	3,664,260	3,864,459
Total operating expenses	326,792,627	314,234,669
LOSS FROM OPERATIONS	(38,553,884)	(43,830,689)
NONOPERATING REVENUES (EXPENSES):		
General appropriations from State of Hawaii	31,220,000	13,300,000
Collective bargaining pay raise appropriation from State of Hawaii	3,831,469	12,394,468
Restricted contributions	2,329,565	2,447,524
Interest and dividend income	118,223	221,396
Interest expense (net of capitalized interest) (Note 6)	(2,871,484)	(2,374,538)
Other nonoperating revenues (expenses)–net	(968,539)	1,614,524
Nonoperating revenues–net	33,659,234	27,603,374
LOSS BEFORE CAPITAL CONTRIBUTIONS	(4,894,650)	(16,227,315)
CAPITAL ASSETS CONTRIBUTED BY STATE OF HAWAII (Note 4)	5,426,064	6,228,402
INCREASE (DECREASE) IN NET ASSETS	531,414	(9,998,913)
NET ASSETS, BEGINNING OF YEAR	97,703,093	107,702,006
NET ASSETS, END OF YEAR	$ 98,234,507	$ 97,703,093

See notes to consolidated financial statements.

HAWAII HEALTH SYSTEMS CORPORATION

CONSOLIDATED STATEMENTS OF CASH FLOWS
YEARS ENDED JUNE 30, 2004 AND 2003

	2004	2003
OPERATING ACTIVITIES:		
Payments from government, insurance and patients	$ 284,065,854	$ 269,030,488
Payments to employees	(197,019,766)	(186,178,895)
Payments to suppliers and others	(110,261,774)	(105,800,116)
Other receipts–net	5,493,078	1,488,783
Net cash used in operating activities	(17,722,608)	(21,459,740)
NONCAPITAL FINANCING ACTIVITIES:		
Appropriations from State of Hawaii	35,051,469	25,694,468
Advances from the State of Hawaii		14,000,000
Other nonoperating revenues–net	1,330,709	1,544,197
Net cash provided by noncapital financing activities	36,382,178	41,238,665
CAPITAL AND RELATED FINANCING ACTIVITIES:		
Repayments on capital lease obligations	(8,204,207)	(6,288,048)
Capital expenditures	(3,723,404)	(2,106,622)
Payments on long-term debt	(553,450)	(711,010)
Interest on capital lease obligations and long-term debt	(2,871,484)	(2,374,538)
Proceeds from sale of capital assets	1,772	2,615
Net cash used in capital and related financing activities	(15,350,773)	(11,477,603)
INVESTING ACTIVITIES—Distributions received from the Clinical Laboratories of Hawaii joint venture	48,960	
NET INCREASE IN CASH AND CASH EQUIVALENTS	3,357,757	8,301,322
CASH AND CASH EQUIVALENTS, BEGINNING OF YEAR	15,270,902	6,969,580
CASH AND CASH EQUIVALENTS, END OF YEAR	$ 18,628,659	$ 15,270,902

(Continued)

HAWAII HEALTH SYSTEMS CORPORATION

CONSOLIDATED STATEMENTS OF CASH FLOWS
YEARS ENDED JUNE 30, 2004 AND 2003

	2004	2003
RECONCILIATION OF LOSS FROM OPERATIONS TO NET CASH USED IN OPERATING ACTIVITIES:		
Loss from operations	$ (38,553,884)	$ (43,830,689)
Adjustments to reconcile loss from operations to net cash used in operating activities:		
Provision for doubtful accounts	22,397,079	16,728,285
Depreciation and amortization	16,243,898	15,493,133
Amounts released from restrictions	474,064	798,489
Change in operating assets and liabilities:		
Patient accounts receivable	(21,455,743)	(14,293,117)
Supplies and other assets	551,219	(1,907,314)
Accounts payable, accrued expenses, and other liabilities	(1,062,998)	3,232,036
Accrued workers' compensation liability	3,354,000	
Estimated third-party payor settlements	(172,366)	(412,563)
Accrued vacation	502,123	2,732,000
Net cash used in operating activities	$ (17,722,608)	$ (21,459,740)
SUPPLEMENTAL CASH FLOW INFORMATION:		
Interest paid, primarily on capital lease obligations	$ 3,123,893	$ 3,077,856
Non-cash financing and investing activities:		
• Capital assets acquired under capital leases	8,284,428	14,502,236
• Prior year capital assets in accounts payable funded through capital lease	1,364,870	
• Capital assets contributed by State of Hawaii	5,426,064	6,228,402
• Capital asset purchases included in accounts payable	1,452,737	1,838,295
• Capital asset purchases included in other liabilities	209,894	
• Contribution of capital assets	255,937	
• Capital assets acquired with restricted assets	138,461	
• Capital assets acquired through long-term debt financing		1,690,900
• Capital assets acquired through grants		423,238
• Rental income contributed to Clinical Laboratories of Hawaii joint venture	719,616	

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. 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, 2004. 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.

The 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.

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, 2004 and 2003 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 $10,663,000 at June 30, 2004.

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 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, 2004 and 2003.

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 2004 and 2003 financial statements.

The estimated third-party payor settlement accrual of approximately $1,394,000 and $1,566,000, as of June 30, 2004 and 2003, respectively, 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 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. HHSC's Medicare cost reports have been audited by the Medicare fiscal intermediary through fiscal year 2001.

- ***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 years ended June 30, 2004 and 2003, the amount of bond interest allocated to HHSC was $2,608,000 and $2,443,000, 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, 2004 and 2003 was as follows:

	2004	2003
Medicare	12%	10%
Medicaid	17	17
HMSA	12	10
Other third-party payors	21	18
Patients and other	38	45
	100%	100%

Reclassifications—Effective in 2004, in accordance with GASB standards, the provision for doubtful accounts has been offset against patient service revenues and interest expense has been reclassified from an operating expense to a nonoperating expense. The 2003 financial statements have been reclassified to reflect these changes. The provision for doubtful accounts totaled $22,397,000 and $16,728,000 for the year ended June 30, 2004 and 2003, respectively. In addition, certain other amounts in the 2003 financial statements have been reclassified to conform to the 2004 presentation.

3. BOARD-DESIGNATED FUNDS

As of June 30, 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, 2004 and 2003, 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, 2004 and 2003 were as follows:

2004	Beginning of Year	Additions	Retirements	Transfers	End of Year
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

2003	Beginning of Year	Additions	Retirements	Transfers	End of Year
Assets Not Subject to Depreciation:					
Land and land improvements	$ 4,809,354	$ -	$ -	$ 274,000	$ 5,083,354
Construction in progress	14,986,281	16,541,247		(8,692,460)	22,835,068
Assets Subject to Depreciation:					
Buildings and improvements	193,742,748	4,156,964	(63,668)	7,591,826	205,427,870
Major moveable equipment	69,150,419	4,833,773	(1,030,996)	370,627	73,323,823
Fixed equipment	36,284,785	699,312	(243,706)	440,877	37,181,268
	318,973,587	26,231,296	(1,338,370)	(15,130)	343,851,383
Less accumulated depreciation and amortization	(142,804,953)	(15,493,133)	1,206,855	15,130	(157,076,101)
Capital assets–net	$ 176,168,634	$ 10,738,163	$ (131,515)	$ -	$ 186,775,282

In 2004 and 2003, the State Department of Accounting and General Services transferred capital assets, including construction in progress, aggregating $5,426,064 and $6,228,402, respectively, to HHSC as a contribution of capital.

During fiscal year 2004, $138,461 of capital assets were purchased with funds contributed by an affiliated foundation.

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. The advance is intended to be repaid in fiscal year 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, 2004 and 2003 were as follows:

2004	Beginning of Year	Additions	Reductions	End of Year	Current Portion	Noncurrent Portion
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
2003						
Accrued vacation	$ 18,993,138	$ 3,572,270	$ (840,270)	$ 21,725,138	$ 840,270	$ 20,884,868
Capital lease obligations	24,086,832	14,502,236	(6,288,048)	32,301,020	7,933,202	24,367,818

Future capital lease payments were as follows:

Year ended June 30:	
2005	$ 10,316,969
2006	9,006,377
2007	6,968,106
2008	4,334,132
2009	3,479,576
2010-2014	8,589,996
2015-2019	864,233
Total future minimum payments	43,559,389
Less amount representing interest	(9,813,278)
Total capital lease obligations	33,746,111
Current portion	(7,958,701)
Noncurrent portion	$ 25,787,410

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, 2004 and 2003, interest capitalized for Corporate and all facilities was approximately $826,000 and $779,000, respectively.

7. LONG-TERM DEBT

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

***Maui Memorial Medical Center Nurses' Cottages*—**During fiscal year 2003, HHSC acquired buildings for $1,670,000 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, 2004 and 2003 consisted of the following:

	2004	2003
Loan payable to Central Pacific Bank; $9,500,000; interest at 5.75% at June 30, 2004, thereafter, 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	$ 8,780,726	$ 9,103,432
Loan payable to Central Pacific Bank; $319,000; interest at 5.875% at June 30, 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	215,614	237,000
Loan payable to Academic Capital; $1,690,900; interest at 6.3%; monthly principal and interest payments of $19,028; due November 4, 2012	1,477,429	1,608,131
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	1,161,383	1,188,111
Note payable to USDA; $1,000,000; interest at 4.75%; monthly principal and interest payments of $8,170; due August 13, 2014	783,176	835,104
Total	12,418,328	12,971,778
Less current portion	(513,598)	(377,333)
Noncurrent portion	$11,904,730	$12,594,445

Transactions in long-term debt during the years ended June 30, 2004 and 2003 were as follows:

2004	Beginning of Year	Additions	Reductions	End of Year
Long-term debt	$12,971,778	$ -	$(553,450)	$12,418,328
2003				
Long-term debt	$11,991,888	$1,690,900	$(711,010)	$12,971,778

Maturities of long-term debt are as follows:

	Principal	Interest	Total
Year ending June 30:			
2005	$ 513,598	$ 644,234	$ 1,157,832
2006	497,357	660,475	1,157,832
2007	526,777	631,054	1,157,831
2008	477,525	602,024	1,079,549
2009	505,705	573,843	1,079,548
2010-2014	2,617,006	2,403,681	5,020,687
2015-2019	1,981,114	1,981,114	3,962,228
2020-2024	2,627,993	1,137,853	3,765,846
2025-2029	2,425,826	321,650	2,747,476
2030-2034	245,427	22,078	267,505
Total	$12,418,328	$ 8,978,006	$21,396,334

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 $11,113,000 and $10,857,000 (excluding Clinical Laboratories of Hawaii joint venture fees of $11,010,000 and $11,414,000 as disclosed in Note 11) during fiscal years 2004 and 2003, 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 $976,000 and $881,000 during fiscal years 2004 and 2003, 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 $848,000 and $946,000 during fiscal years 2004 and 2003, 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, 2004 and 2003 was $12,386,000 and $11,500,000, 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 $10,195,000 and $9,748,000 for the years ended June 30, 2004 and 2003, respectively.

Sick Leave

Accumulated sick leave as of June 30, 2004 and 2003 was approximately $41,147,000 and $38,991,000, respectively. 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.

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 $21,854,000 and $18,500,000 for unpaid claims as of June 30, 2004 and 2003, 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, 2004, 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 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 a State Veteran's Home on the site of the old hospital building. 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. Because an allocation of the asbestos remediation costs to HHSC, if any, presently cannot be determined, a liability for the cost of remediation has not been recorded in HHSC's financial statements.

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. At June 30, 2004, MMMC was in the process of negotiating contracts for the design and construction of the facilities. MMMC expects to break ground in 2005 and complete the project in 2007.

11. CLINICAL LABORATORIES OF HAWAII JOINT VENTURE

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 year 2004, HHSC received a partnership distribution of $49,000. Such partnership distribution is accounted for as a reduction of the investment balance.

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 2004 and 2003 amounted to $720,000 and $709,000, respectively, and the investment balance as of June 30, 2004 and 2003 was $1,439,000 and $768,000, 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 $1,158,000 and $1,723,000 during fiscal years 2004 and 2003, respectively. Amounts due from the Partnership for such charges aggregated $506,000 and $1,604,000 as of June 30, 2004 and 2003, respectively.

HHSC contracts with the Partnership to provide clinical laboratory and pathology services at its facilities. Amounts charged by the Partnership aggregated approximately $11,010,000 and $11,414,000 during fiscal years 2004 and 2003, respectively. Amounts due to the Partnership aggregated $5,866,000 and $7,244,000 as of June 30, 2004 and 2003, 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 $41,000 and $470,000 during fiscal years 2004 and 2003, respectively. Amounts due to the Partnership for such charges were $10,000 as of June 30, 2003. 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 $105,000 and $104,000 during fiscal years 2004 and 2003, respectively. Amounts due from the Partnership for such charges were $30,000 as of June 30, 2003. There were no amounts due from or due to the Partnership as of June 30, 2004.

12. TEMPORARILY RESTRICTED NET ASSETS

Changes in temporarily restricted net assets for the years ended June 30, 2004 and 2003 were as follows:

	2004	2003
Balance, beginning of year	$ 2,130,506	$ 481,471
Restricted contributions received	2,329,565	2,447,524
Expenditures for restricted purposes	(474,064)	(798,489)
Transfers of restricted net assets	(2,897,951)	
Capital assets purchased	(138,461)	
Balance, end of year	$ 949,595	$2,130,506

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. SUBSEQUENT EVENT

The Kona Hospital Foundation is an independent not-for-profit organization with a separate board of directors and management from HHSC. The Foundation receives donations from individuals in the community, and at December 31, 2003 had approximately $1.6 million in total assets. Subject to certain conditions relating to the building of a new radiation therapy unit, a pledge from the Foundation for $1.5 million is expected to be received in fiscal year 2005, and the related contribution revenue will be recorded as temporarily restricted until the funds are used for the construction of the radiation therapy unit at Kona Community Hospital.

* * * * * *

HAWAI HEALTH SYSTEMS CORPORATION

SUPPLEMENTAL SCHEDULE OF RECONCILIATION OF CASH ON DEPOSIT WITH THE STATE OF HAWAII
JUNE 30, 2004

	Appropriation Symbol	
CASH ON DEPOSIT WITH THE STATE OF HAWAII:		
SPECIAL FUNDS:		
	S-93-359-H	$ 2,818
	S-94-359-M	33,400
	S-94-396-H	8,673
	S-95-396-H	19,636
	S-96-359-H	2,007
	S-96-396-H	9,040
	S-97-359-H	3,556
	S-97-396-H	180
	S-98-396-H	1,687
	S-04-303-H	178
	S-04-312-H	202,641
	S-04-320-H	8,000,000
	S-04-350-H	345,362
	S-04-351-H	64,698
	S-04-352-H	22,207
	S-04-353-H	46,738
	S-04-354-H	152,740
	S-04-355-H	415,356
	S-04-358-H	14,276
	S-04-359-H	73,414
	S-04-365-H	161,259
	S-04-371-H	132,819
	S-04-373-H	82,909
TRUST FUNDS:		
	T-04-906-H	2,512
	T-03-909-H	680
	T-04-909-H	48,562
	T-03-918-H	1,273
	T-03-921-H	6,679
	T-04-907-H	200
	T-04-923-H	4,129
TOTAL PER STATE		9,859,629
RECONCILING ITEMS		4,670
TOTAL PER HHSC		$ 9,864,299

(Continued)

HAWAI HEALTH SYSTEMS CORPORATION

SUPPLEMENTAL SCHEDULE OF RECONCILIATION OF CASH ON DEPOSIT WITH THE STATE OF HAWAII
JUNE 30, 2004

	Appropriation Symbol	
ASSETS LIMITED AS TO USE:		
PATIENT TRUST FUNDS:		
	T-02-926-H	$ 18
	T-03-926-H	75
	T-04-911-H	22,912
	T-04-915-H	12,763
	T-04-919-H	1,044
	T-04-925-H	110,810
	T-04-926-H	11,296
TOTAL PER STATE		158,918
RECONCILING ITEMS:		
Patients' safekeeping deposits held by financial institutions		266,506
Restricted net assets held by financial institutions		888,312
Other		(1,643)
TOTAL PER HHSC		$ 1,312,093

(Concluded)

HAWAII HEALTH SYSTEMS CORPORATION

SUPPLEMENTAL COMBINING AND CONSOLIDATING STATEMENT OF NET ASSETS INFORMATION
JUNE 30, 2004

	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	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	$ 352,877	$ 152,740	$ 415,356	$ 28,886	$ 132,819	$ 87,605	$ 78,727	$ 68,482	$ 46,738	$ 285,140	$ 161,259	$ 14,276	$ 1,824,905	$ 8,039,394	$ -	$ 9,864,299	$ -	$ -	$ -	$ 9,864,299
On deposit with banks and on hand	111,086		108,659	9,720	12,411	116,679	60,654	500	17,803	445,077	68,218	40,332	991,139	7,547,130		8,538,269	123,741	102,350		8,764,360
Patient accounts receivable–less allowances for contractual adjustments and doubtful accounts	10,418,304	5,807,672	22,229,055	587,565	1,426,285	1,751,447	1,195,569	463,913	564,155	2,494,291	2,363,375	236,295	49,537,926			49,537,926				49,537,926
Supplies and other current assets	2,171,737	1,522,782	2,496,692	44,911	198,790	339,044	78,206	93,805	39,102	508,442	108,616	76,353	7,678,480	166,542		7,845,022		230,621		8,075,643
Total current assets	13,054,004	7,483,194	25,249,762	671,082	1,770,305	2,294,775	1,413,156	626,700	667,798	3,732,950	2,701,468	367,256	60,032,450	15,753,066		75,785,516	123,741	332,971		76,242,228
DUE FROM AFFILIATES—Net			3,169,424										3,169,424	150,870,503	(149,840,522)	4,199,405			(4,199,405)	-
CAPITAL ASSETS—Net	41,856,593	28,768,925	56,479,756	1,344,311	4,841,948	12,644,020	3,715,789	13,807,010	2,249,041	6,463,321	3,571,414	983,032	176,725,160	12,182,721		188,907,881	651	379,953		189,288,485
ASSETS LIMITED AS TO USE	30,796	144,814	300,000	4,335	50,376	41,306	47,872	20,315	8,894	161,599	81,713	3,664	895,684	5,000		900,684	411,409			1,312,093
OTHER ASSETS	745,470	260,958	378,545	12,745	10,629			15,249	14,632				1,438,228	97,822		1,536,050			(97,822)	1,438,228
TOTAL	$ 55,686,863	$ 36,657,891	$ 85,577,487	$ 2,032,473	$ 6,673,258	$ 14,980,101	$ 5,176,817	$ 14,469,274	$ 2,940,365	$ 10,357,870	$ 6,354,595	$ 1,353,952	$ 242,260,946	$ 178,909,112	$(149,840,522)	$ 271,329,536	$ 535,801	$ 712,924	$ (4,297,227)	$ 268,281,034

(Continued)

HAWAII HEALTH SYSTEMS CORPORATION

SUPPLEMENTAL COMBINING AND CONSOLIDATING STATEMENT OF NET ASSETS INFORMATION
JUNE 30, 2004

	Facilities																			
LIABILITIES AND NET ASSETS	Hilo Medical Center	Kona Community Hospital	Maui Memorial Medical Center	Ka'u Hospital	Kula Hospital	Kauai Veterans Memorial Hospital	Samuel Mahelona Memorial Hospital	Hale Ho'ola Hamakua	Kohala Hospital	Leahi Hospital	Maluhia	Lanai Community Hospital	Total Facilities	Corporate	Reclassifi-cations and Elimi-nations	HHSC Combined	Hawaii Health Systems Founda-tion	Alii Com-munity Care	Reclassifi-cations and Elimi-nations	HHSC Consolidated
CURRENT LIABILITIES:																				
Accounts payable and accrued expenses	$ 9,545,370	$ 5,515,832	$ 17,632,795	$ 310,946	$ 1,331,810	$ 1,079,821	$ 618,173	$ 503,246	$ 407,181	$ 1,567,194	$ 1,142,996	$ 258,512	$ 39,913,876	$ 2,623,626	$ -	$ 42,537,502	$ 29,968	$ 256,490	$ -	42,823,960
Accrued workers' compensation liability	7,077,474	2,411,024	4,319,298	165,490	1,977,407	888,785	960,572	719,175	293,388	1,620,373	1,134,220	135,450	21,702,656	151,344		21,854,000				21,854,000
Advance from the State of Hawaii													-	14,000,000		14,000,000				14,000,000
Current portion of capital lease obligations	305,632						1,604						307,236	7,651,465		7,958,701				7,958,701
Estimated third-party payor settlements	117,230	16,623	390,066	79,048	9,940	752,094	30,805	52,359	44,972	56,695	9,308	(165,520)	1,393,620			1,393,620				1,393,620
Current portion of accrued vacation	191,999	84,412	240,379	35,203	329,866	34,854	67,562	26,771	88,812	75,590	74,743	90,542	1,340,733	24,528		1,365,261				1,365,261
Current portion of long-term debt	374,363												374,363	139,235		513,598				513,598
Other current liabilities	315,020	3,983				205,509		3,016					527,528			527,528	103,496	127,526		758,550
Total current liabilities	17,927,088	8,031,874	22,582,538	590,687	3,649,023	2,961,063	1,678,716	1,304,567	834,353	3,319,852	2,361,267	318,984	65,560,012	24,590,198		90,150,210	133,464	384,016		90,667,690
CAPITAL LEASE OBLIGATIONS—Less current portion	89,269												89,269	25,698,141		25,787,410				25,787,410
LONG-TERM DEBT—Less current portion	10,566,536												10,566,536	1,338,194		11,904,730				11,904,730
ACCRUED VACATION—Less current portion	5,096,931	2,680,608	5,531,723	153,952	732,442	1,122,733	958,273	468,934	195,580	1,735,462	1,355,534	111,259	20,143,431	718,569		20,862,000				20,862,000
DUE TO AFFILIATES—Net	29,907,233	19,980,107		6,854,471	9,800,619	33,662,236	10,658,190	104,600	6,491,623	6,999,409	17,087,387	8,294,647	149,840,522		(149,840,522)	-	357,674	3,841,731	(4,199,405)	-
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	30,796	7,570		4,335	50,376	7,065	22,244	11,073	6,598	161,599	57,178	3,664	362,498			362,498				362,498
OTHER LIABILITIES	10,862		4,369	10,932		3,808	10,620	13,478	9,942	45,005	13,296		122,312	217,380		339,692				339,692
Total liabilities	63,628,715	38,305,364	28,118,630	7,614,377	15,346,724	38,800,250	15,745,193	2,408,805	8,066,245	18,678,118	21,366,112	8,728,554	266,807,087	52,562,482	(149,840,522)	169,529,047	491,138	4,225,747	(4,199,405)	170,046,527
NET ASSETS:																				
Invested in capital assets–net of related debt	30,520,793	28,768,925	56,479,756	1,344,311	4,841,948	12,644,020	3,714,185	13,807,010	2,249,041	6,463,321	3,571,414	983,032	165,387,756	(22,644,314)		142,743,442	651	379,953		143,124,046
Temporarily restricted		137,244	300,000			34,241	25,628	9,242	2,296		24,535		533,186	5,000		538,186	411,409			949,595
Unrestricted	(38,462,645)	(30,553,642)	679,101	(6,926,215)	(13,515,414)	(36,498,410)	(14,308,189)	(1,755,783)	(7,377,217)	(14,783,569)	(18,607,466)	(8,357,634)	(190,467,083)	148,985,944		(41,481,139)	(367,397)	(3,892,776)	(97,822)	(45,839,134)
Total net assets	(7,941,852)	(1,647,473)	57,458,857	(5,581,904)	(8,673,466)	(23,820,149)	(10,568,376)	12,060,469	(5,125,880)	(8,320,248)	(15,011,517)	(7,374,602)	(24,546,141)	126,346,630		101,800,489	44,663	(3,512,823)	(97,822)	98,234,507
TOTAL	$ 55,686,863	$ 36,657,891	$ 85,577,487	$ 2,032,473	$ 6,673,258	$ 14,980,101	$ 5,176,817	$ 14,469,274	$ 2,940,365	$ 10,357,870	$ 6,354,595	$ 1,353,952	$ 242,260,946	$ 178,909,112	$(149,840,522)	$ 271,329,536	$ 535,801	$ 712,924	$ (4,297,227)	$ 268,281,034

(Concluded)

HAWAII HEALTH SYSTEMS CORPORATION

SUPPLEMENTAL COMBINING AND CONSOLIDATING STATEMENT OF REVENUES, EXPENSES, AND CHANGES IN NET ASSETS INFORMATION
YEAR ENDED JUNE 30, 2004

	Facilities																			
	Hilo Medical Center	Kona Community Hospital	Maui Memorial Medical Center	Ka'u Hospital	Kula Hospital	Kauai Veterans Memorial Hospital	Samuel Mahelona Memorial Hospital	Hale Ho'ola Hamakua	Kohala Hospital	Leahi Hospital	Maluhia	Lanai Community Hospital	Total Facilities	Corporate	Reclassifi-cations and Elimi-nations	HHSC Combined	Hawaii Health Systems Founda-tion	Alii Com-munity Care	Reclassifi-cations and Elimi-nations	HHSC Consolidated
OPERATING REVENUES:																				
Net patient service revenues	$ 72,749,297	$35,073,721	$104,578,262	$2,580,616	$10,353,361	$12,130,026	$ 7,322,893	$ 5,027,342	$ 2,681,306	$17,049,083	$12,374,589	$ 1,376,388	$283,296,884	$ -	$ -	$283,296,884	$ -	$ -	$ -	$283,296,884
Other operating revenues	1,103,004	295,334	954,304	5,878	71,837	641,532	157,289	18,854	25,626	399,694	29,637	8,550	3,711,539		(244,379)	3,467,160		1,474,699		4,941,859
Total operating revenues	73,852,301	35,369,055	105,532,566	2,586,494	10,425,198	12,771,558	7,480,182	5,046,196	2,706,932	17,448,777	12,404,226	1,384,938	287,008,423		(244,379)	286,764,044		1,474,699		288,238,743
OPERATING EXPENSES:																				
Salaries and benefits	51,250,584	24,238,568	57,523,282	2,501,892	10,709,631	9,404,752	6,924,078	4,527,010	2,764,647	14,420,028	11,106,703	1,547,864	196,919,039	4,748,123		201,667,162	244,794	1,152,802		203,064,758
Medical supplies and drugs	11,064,383	5,266,258	16,675,134	91,219	809,977	858,059	344,546	141,156	65,776	792,156	684,224	134,364	36,927,252			36,927,252				36,927,252
Purchased services	7,551,472	4,893,932	16,215,140	99,848	633,309	2,304,820	482,704	166,904	442,672	781,378	882,471	344,052	34,798,702	187,259	(490,291)	34,495,670		12,452		34,508,122
Depreciation and amortization	3,266,901	2,524,031	4,304,747	99,961	330,130	593,533	326,175	533,385	219,920	913,216	327,046	92,886	13,531,931	2,709,847		16,241,778	2,120			16,243,898
Other supplies	2,508,588	850,813	3,822,358	80,421	655,731	380,872	281,857	223,758	136,801	853,240	544,159	82,269	10,420,867	76,159		10,497,026	57,833	178,109		10,732,968
Utilities	1,642,082	735,309	1,930,032	88,064	172,823	601,815	256,533	361,873	83,899	590,604	368,244	72,845	6,904,123	77,729		6,981,852	1,348	178,130		7,161,330
Repairs and maintenance	1,798,642	1,007,368	1,517,488	14,358	60,999	322,736	144,059	82,340	20,109	134,411	137,745	23,243	5,263,498	44,575		5,308,073	130	26,906		5,335,109
Rent and lease	578,487	298,603	1,007,809	11,185	18,123	143,070	7,333	17,645	21,389	17,944	4,231	3,391	2,129,210	48,447		2,177,657	9,398	1,653,827		3,840,882
Professional fees	800,108	601,686	250,918	85,044	78,568	165,681	156,961	100,304	94,468	41,404	25,762	154,822	2,555,726	166,687		2,722,413	10,236	247,798		2,980,447
Insurance	584,054	253,337	837,293	39,394	52,453	165,354	43,711	21,527	17,661	103,629	80,638	17,718	2,216,769	21,275		2,238,044	68	95,489		2,333,601
Other	864,478	474,989	984,289	45,202	80,453	256,626	68,329	34,584	47,142	86,825	126,478	40,851	3,110,246	205,284		3,315,530	215,751	132,979		3,664,260
Total operating expenses	81,909,779	41,144,894	105,068,490	3,156,588	13,602,197	15,197,318	9,036,286	6,210,486	3,914,484	18,734,835	14,287,701	2,514,305	314,777,363	8,285,385	(490,291)	322,572,457	541,678	3,678,492		326,792,627
INCOME (LOSS) FROM OPERATIONS	(8,057,478)	(5,775,839)	464,076	(570,094)	(3,176,999)	(2,425,760)	(1,556,104)	(1,164,290)	(1,207,552)	(1,286,058)	(1,883,475)	(1,129,367)	(27,768,940)	(8,285,385)	245,912	(35,808,413)	(541,678)	(2,203,793)		(38,553,884)
NONOPERATING REVENUES (EXPENSES):																				
General appropriations from State of Hawaii													-	31,220,000		31,220,000				31,220,000
Collective bargaining pay raise appropriation from State of Hawaii	988,561	484,102	1,222,035	33,825	195,596	124,661	115,742	96,220	48,044	263,462	219,204	40,017	3,831,469			3,831,469				3,831,469
Restricted contributions		253,819	100,000			14,000	22,584	9,242	9,242				408,887			408,887	1,920,678			2,329,565
Interest and dividend income	3,104	2,419	39,702	607		2,179	225	1,345	303	5,309	28	14	55,235	65,886		121,121	8,564	51	(11,513)	118,223
Interest expense (net of capitalized interest)	(672,210)	(39,496)	(25,499)		(7,031)		(674)	(348)	(1,418)	(1,987)	(364)		(749,027)	(2,122,457)		(2,871,484)	(11,513)		11,513	(2,871,484)
Corporate allocation expense	(2,887,926)	(1,408,686)	(3,659,735)	(109,907)	(485,075)	(542,026)	(297,309)	(198,946)	(127,424)	(649,390)	(503,238)	(90,169)	(10,959,831)	10,959,831		-				-
Other nonoperating revenues (expenses)–net	723,703	407,354	346,928	(15,713)	85,904	99,001	178,554	133,365	(12,914)	86,538	1,888	37,884	2,072,492	(198,218)	(245,912)	1,628,362	(2,596,901)			(968,539)
Nonoperating revenues (expenses)–net	(1,844,768)	(300,488)	(1,976,569)	(91,188)	(210,606)	(302,185)	19,122	40,878	(84,167)	(296,068)	(282,482)	(12,254)	(5,340,775)	39,925,042	(245,912)	34,338,355	(679,172)	51		33,659,234
INCOME (LOSS) BEFORE CAPITAL CONTRIBUTIONS	(9,902,246)	(6,076,327)	(1,512,493)	(661,282)	(3,387,605)	(2,727,945)	(1,536,982)	(1,123,412)	(1,291,719)	(1,582,126)	(2,165,957)	(1,141,621)	(33,109,715)	31,639,657	-	(1,470,058)	(1,220,850)	(2,203,742)	-	(4,894,650)
CAPITAL ASSETS CONTRIBUTED BY STATE OF HAWAII	928,421		2,926,492		345,081	619,053	229,271	82,253	282,181			13,312	5,426,064			5,426,064				5,426,064
INCREASE (DECREASE) IN NET ASSETS	$ (8,973,825)	$ (6,076,327)	$ 1,413,999	$ (661,282)	$ (3,042,524)	$ (2,108,892)	$ (1,307,711)	$ (1,041,159)	$ (1,009,538)	$ (1,582,126)	$ (2,165,957)	$ (1,128,309)	$ (27,683,651)	$ 31,639,657	$ -	$ 3,956,006	$ (1,220,850)	$ (2,203,742)	$ -	$ 531,414

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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, 2004 and 2003, and have issued our report thereon dated December 13, 2004. 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.

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. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control over financial reporting that might be material weaknesses. A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements in amounts that would be material in relation to the consolidated financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We noted no matters involving the internal control over financial reporting and its operation that we consider to be material weaknesses.

Compliance and Other Matters

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

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

Deloitte & Touche LLP

December 13, 2004