Hawaii Health Systems Corporation

Consolidated Financial Statements for the Years Ended June 30, 2007 and 2006, Supplemental Information for the Year Ended June 30, 2007, 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, 2007 and 2006 and the independent auditors' reports thereon.

SCOPE OF THE AUDIT

The audit was required to be performed in accordance with auditing standards generally accepted in the United States of America and *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that the auditors plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of HHSC's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of HHSC's internal control over financial reporting. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the consolidated financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall consolidated financial statement presentation.

ORGANIZATION OF THE REPORT

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

- The first section presents this introduction.
- The second section presents the consolidated financial statements of HHSC as of and for the years ended June 30, 2007 and 2006, 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, 2007 and 2006, and the related consolidated statements of revenues, expenses, and changes in net assets and cash flows for the years then ended. These financial statements are the responsibility of HHSC's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

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

In our opinion, such consolidated financial statements present fairly, in all material respects, the financial position of HHSC at June 30, 2007 and 2006, 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, 2007, 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, 2007 and 2006, may be significantly different from those eventually included in the final settlement.

The management's discussion and analysis information on pages 4 through 15 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 39 and 40 is presented for the purpose of additional analysis and is not a required part of the basic financial statements. The supplemental combining and consolidating information on pages 41 through 43 is 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 is not a required part of the basic financial statements. This supplemental schedule and the supplemental combining and consolidating information 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 April 7, 2008, on our consideration of HHSC's internal control over financial reporting and our tests of its compliance with certain provisions of laws, regulations, contracts, grant agreements, and other matters. The purpose of that report is to describe the scope of our testing of internal controls over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be read in conjunction with this report in considering the results of our audit.

Deloitte + Touche LLP

April 7, 2008

Overview of the Financial Statements

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

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

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

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

Financial Analysis

Consolidated Statements of Net Assets

Summarized financial information of HHSC's consolidated statements of net assets as of June 30, 2007 and 2006, is as follows:

	2007	2006
ASSETS		
Current assets	$ 108,303,038	$ 96,685,796
Capital assets — net	253,157,203	221,454,648
Other assets	7,865,821	3,903,016
Total assets	$ 369,326,062	$ 322,043,460
LIABILITIES		
Current liabilities	$ 108,772,545	$ 82,744,813
Capital lease obligations — less current portion	35,091,398	32,254,903
Long-term debt — less current portion	10,774,103	10,880,541
Accrued vacation — less current portion	20,578,812	18,577,707
Due to the State of Hawaii	34,122,507	34,122,507
Other liabilities	702,805	702,924
Total liabilities	210,042,170	179,283,395
NET ASSETS		
Invested in capital assets — net of related debt	197,794,179	169,665,927
Restricted — primarily for capital acquisitions	2,861,656	493,445
Unrestricted	(41,371,943)	(27,399,307)
Total net assets	159,283,892	142,760,065
Total liabilities and net assets	$ 369,326,062	$ 322,043,460

At June 30, 2007, HHSC's capital assets, net of accumulated depreciation, comprised approximately 69% of its total assets. These assets consist mainly of land, hospital buildings, and equipment that are used in HHSC's operations. The increase of approximately $31.7 million is due to property additions of $51.3 million, offset by depreciation expense of $18.8 million and retirements of $0.7 million. The primary reason for the increase is due to the acquisition of medical equipment and information systems of $10.2 million funded through HHSC's municipal leasing lines of credit, State-funded capital improvement projects of $19.6 million, and federal funded capital improvement projects of the Yukio Okutsu Veterans Care Home of $19.0 million. The State-funded capital improvement projects consisted primarily of construction costs for the expansion of Maui Memorial Medical Center (MMMC), the emergency room expansion at Hilo Medical Center (HMC), and part of the construction costs for the Yukio Okutsu Veterans Care Home.

At June 30, 2006, HHSC's capital assets, net of accumulated depreciation, comprised approximately 69% of its total assets. These assets consist mainly of land, hospital buildings and equipment that are used in HHSC's operations. The increase of approximately $25.7 million is due to property additions of $44.7 million, offset by depreciation expense of $18.5 million and retirements of $0.6 million. The primary reason for the increase is due to the acquisition of medical equipment, information systems, and energy-saving equipment of $13.3 million funded through HHSC's municipal leasing lines of credit and State-funded capital improvement projects of $26.1 million. The State-funded capital improvement projects consisted primarily of construction costs for the $38 million expansion of MMMC and for the construction of the Yukio Okutsu Veterans Care Home.

A summary of HHSC's capital assets as of June 30, 2007 and 2006, is as follows:

	2007	2006
Land and land improvements	$ 6,920,296	$ 5,180,572
Buildings and improvements	279,524,980	221,899,300
Equipment	130,016,266	121,057,483
Construction in progress	42,387,766	63,085,041
	458,849,308	411,222,396
Less accumulated depreciation and amortization	(205,692,105)	(189,767,748)
Capital assets — net	$ 253,157,203	$ 221,454,648

At June 30, 2007, HHSC's current assets approximated 29% of total assets. Current assets increased $11.6 million from the fiscal year 2006 balance due to an increase in patient accounts receivable, federal grants receivable and supplies and other current assets offset by a decrease in cash and cash equivalents. The increase in patient accounts receivable of $8.3 million is primarily due to Medicaid withholding $4.1 million in payments due to HHSC facilities as of June 2007, which were received in July 2007. The remainder of the increase in patient accounts receivable is due to an increase in outpatient and emergency department revenues by HHSC during fiscal year 2007, as well as a 10% rate increase that took effect at the beginning of fiscal year 2007. The increase in federal grants receivables of $2.2 million is due to contributions from the Department of Veteran Affairs that were accrued but not yet received by HHSC as of June 30, 2007. The increase in supplies and other current assets of $2.4 million is due primarily to the following: 1) Leahi Hospital placing $793,000 in a term certificate of deposit to fund planned building improvements, 2) increase in radiology inventory at MMMC of $761,000 as a result of expansion of angiography services, and 3) increase in surgical supplies inventory at Kauai Veterans Memorial Hospital (KVMH) of $303,000 due to the opening of a second operating room resulting in a 52% increase in operating room procedures.

At June 30, 2006, HHSC's current assets approximated 30% of total assets. Current assets increased $12.9 million from the fiscal year 2005 balance due to an increase in cash and cash equivalents and an increase in patient accounts receivable. The increase in cash and cash equivalents of $6.9 million is primarily due to the need to save sufficient funds to fund the July 20 payroll payment and an increase in the cash on deposit with the State of Hawaii of $1.4 million (used to fund the July 5 payroll payment). The other reason for the increase in cash and cash equivalents is the increase in cash collections for fiscal year 2006 as compared to the prior year. HHSC collected $351 million in fiscal year 2006 as compared to $317 million in fiscal year 2005 due to $12.7 million in extraordinary third-party payor settlements received as a result of the status of several HHSC facilities being designated as sole community hospitals, $8.8 million in supplemental direct payments to hospitals from the State Department of Human Services (DHS), and HHSC's success in negotiating increases in reimbursement rates with third-party payors. Further, HHSC reduced its gross days in accounts receivable from 72.1 days at June 30, 2005 to 70.7 days at June 30, 2006. The reduction in gross days in accounts receivable was due to management's concerted effort to improve HHSC's revenue-cycle processes, focusing on regular monitoring of HHSC's revenue-cycle performance against industry key performance indicators, with corrective action being taken where necessary. The increase in patient accounts receivable of $8.5 million is primarily due to the accrual of $5.1 million in relief payments from DHS to mitigate the detrimental impact on reimbursements that Act 294 had on HHSC's long-term care facilities. This money was paid to HHSC in July 2006.

At June 30, 2007, HHSC's current liabilities approximated 52% of total liabilities. The primary reason for the increase from fiscal year 2006 is due to increases in accounts payable and accrued expenses and an advance from the State of Hawaii. Accounts payable and accrued expenses at June 30, 2007, increased by $19.2 million from June 30, 2006, primarily due to an increase of $17.1 million in accounts payable, resulting from the cash flow shortfalls experienced by HHSC during fiscal year 2007. Further, during 2007, HHSC received a $10 million advance from the State of Hawaii which was repaid in July 2007.

The estimated third-party payor settlements liability decreased by $3.5 million to $1.1 million at June 30, 2007. The decrease is primarily due to an increase in the receivable from Medicaid for fiscal year 2006 and an increase in the cost basis for reimbursements for fiscal year 2007 for HHSC's seven critical access hospital facilities.

At June 30, 2006, HHSC's current liabilities approximated 42% of total liabilities. The primary reason for the increase from fiscal year 2005 is due to increases in accounts payable, accrued payroll, and estimated third-party payor settlements. Accounts payable at June 30, 2006, increased by $2.9 million from June 30, 2005, primarily due to an increase of $19.3 million in non-payroll expenses from fiscal year 2005 to fiscal year 2006. As a result, days in accounts payable increased from 35.6 days at June 30, 2005 to 38.8 days at June 30, 2006.

At June 30, 2007 and 2006, HHSC's total capital lease obligation balance increased approximately $1.9 million and $5.3 million from fiscal years 2006 and 2005, respectively. The primary reason for the increases is the acquisition of fixed equipment, medical equipment, and application systems (see explanation under capital assets above). HHSC has municipal leasing lines of credit with several municipal leasing companies, which allow HHSC to finance equipment purchases at interest rates below market rates.

At June 30, 2007, HHSC's long-term debt balances represented: 1) notes and term loans payable on the land, building, and medical equipment previously owned by Hilo Residency Training Program with a remaining balance of approximately $9.7 million, 2) a mortgage note payable relating to the acquisition of nursing cottages on the MMMC campus with a remaining balance of approximately $1.0 million, 3) notes payable to two individuals relating to the acquisition of clinic assets with a remaining balance of approximately $117,000, and 4) a term loan of $758,000 to pay for the planning and design of a new surgery area and modifications of the existing surgery room at the KVMH.

At June 30, 2007, the portion of HHSC's net assets that is reflected as its investment in capital assets, net of related debt, of approximately $197.8 million, and restricted net assets of $2.9 million are larger than the total net assets of approximately $159.3 million. This means that HHSC's net operations since inception have resulted in losses of approximately $41.4 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, 2007 and 2006, is as follows:

	2007	2006
Operating expenses:		
Salaries and benefits	$ 269,255,418	$ 234,888,851
Purchased services and professional fees	57,017,208	47,700,312
Supplies and drugs	58,171,015	56,760,887
Depreciation and amortization	18,919,920	18,483,895
Insurance	6,136,486	6,146,134
Other	29,246,222	27,168,552
Total operating expenses	438,746,269	391,148,631
Operating revenues	367,401,428	352,772,138
Loss from operations	(71,344,841)	(38,376,493)
Nonoperating revenues (expenses):		
General appropriations from State of Hawaii	34,154,041	32,280,041
Collective bargaining pay raise appropriation from State of Hawaii	14,585,780	5,474,356
Restricted contributions	369,194	260,421
Other nonoperating revenues (expenses) — net	44,372	(233,411)
Total nonoperating revenues (expenses)	49,153,387	37,781,407
Loss before capital grants and contributions	(22,191,454)	(595,086)
Capital grants and contributions	38,715,281	26,115,844
Increase in net assets	$ 16,523,827	$ 25,520,758

For the year ended June 30, 2007, HHSC's operating expenses exceeded its operating revenues by $71.3 million. The appropriations from the State of Hawaii for collective bargaining pay raises of $14.6 million, general fund appropriations from the State of Hawaii of $34.2 million, restricted contributions of $0.4 million, and capital grants and contributions from the State of Hawaii and the federal government of $38.7 million resulted in an increase in net assets of $16.5 million.

For the year ended June 30, 2006, HHSC's operating expenses exceeded its operating revenues by $38.4 million. The appropriations from the State of Hawaii for collective bargaining pay raises of $5.5 million, general fund appropriations from the State of Hawaii of $32.3 million, restricted contributions of $0.3 million, other non-operating expenses of $0.3 million, and capital assets contributed by the State of Hawaii of $26.1 million resulted in an increase in net assets of $25.5 million.

Management believes that three factors impede the comparability of the fiscal year 2007 results with those of prior fiscal years: 1) property contributed by the State of Hawaii and the federal government of $38.7 million, which represents payments made for HHSC's construction projects and 2) relief payments for fiscal years

2006 and 2007 to HHSC's facilities with long-term care beds for the negative impact of Act 294. Management believes that these factors are neither controllable nor recurring, and may not reflect HHSC's true operating performance. The following chart shows the impact of these three factors on HHSC's financial performance.

Increase in net assets for the year ended June 30, 2007	$ 16,523,827
Adjustments to exclude noncontrollable or nonrecurring items:	
Contributed capital assets and transfers	(38,715,281)
Act 294 relief payments	(4,912,000)
Total adjustments	(43,627,281)
Adjusted decrease in net assets for the year ended June 30, 2007	$ (27,103,454)

Operating expenses in fiscal year 2007 were approximately 12% higher than fiscal year 2006. The increase was mainly in the category of salaries and benefits, purchased services, professional fees, and repairs and maintenance expense. Salaries and benefits expense increased 14.6% from fiscal year 2006, due primarily to the following factors: 1) collective bargaining pay raises of 3.5% to 5.0% for HHSC's union employees totaling approximately $9.1 million, 2) an increase in the fringe benefit rate assessed to HHSC by the State of Hawaii from 36.46% to 41.13% totaling approximately $8.7 million, and 3) additional employees hired by HHSC's acute facilities to support clinical operations. The additional employees hired at MMMC were to improve staffing ratios for patient care, to staff the new wing which opened in November 2006, to staff expansion of services such as angiography, and to add more staff nurses to reduce the need to contract for registry nurses. The additional employees hired at HMC were primarily nurses to reduce the need to contract for agency nurses, but the facility also hired two orthopedists and a general surgeon to provide basic medical services to the community, as well as support staff for those physicians and a physician practice manager to support the growing number of physicians being hired by the facility. The additional employees hired at Kona Community Hospital were support staff to create a medical staff office, as well as a general surgeon. The additional employees hired at KVMH were to support the growth in the physician practices at the facility and to fully staff the hospital and clinic business offices. Professional fees and purchased services expenses increased $9.3 million from fiscal year 2006 primarily due to the following: 1) an increase in registry nurse usage of approximately $1.2 million over fiscal year 2006, 2) an increase in payments for on-call and hospitalist services of $3.7 million over fiscal year 2006, and 3) an increase in clinical laboratory costs of approximately $1.7 million due to an inflationary price adjustment and an increase in laboratory test volumes of 7%. Repairs and maintenance expense increased $3.2 million from fiscal year 2006, due to expenses incurred to mitigate the damages caused by the October 15, 2006, earthquake to Kona Community Hospital, Hale Ho'ola Hamakua, and Kohala Hospital, as well as general maintenance work needed to keep HHSC's aging facilities up to standards required by surveyors.

Operating expenses in fiscal year 2006 were approximately 10.6% higher than fiscal year 2005. The increase was mainly in the category of salaries and benefits, supplies and drugs, professional fees, and purchased services expense. Salaries and benefits expense increased 7.2% from fiscal year 2005, due primarily to collective bargaining pay raises for HHSC's union employees and an increase in the fringe benefit rate assessed to HHSC by the State of Hawaii. During fiscal year 2006, HHSC's union employees in Hawaii Government Employees Association (HGEA) and UPW received pay raises from the unions' collective bargaining agreements with the State of Hawaii of varying percentages effective on various dates throughout the fiscal year. These pay raises represented an additional $5.5 million in salaries expense over fiscal year 2005. Further, the fringe benefit rate assessed to HHSC by the State of Hawaii increased from 34.66% for fiscal year 2005 to 39.39% for fiscal year 2006. The primary reason for the increase is the increase in the required contribution to fund the State Employee Retirement System. The impact of the increase in fringe benefit rate on HHSC was approximately $7.9 million for fiscal year 2006. The remaining increase is due to an increase in full-time equivalents as a result of additional contracting personnel needed to comply with the requirements of the State Procurement Code and additional physician employees to ensure that sufficient medical coverage is available for patients needing care in HHSC's acute care facilities. The increase in supplies and drugs expense was primarily due to a 7% increase in utilization of drugs sold to patients, as well as an increase in the use of chemotherapy drugs, which are much more expensive than other types of drugs. Chemotherapy procedures increased 41% from fiscal year 2005 to 2006. Professional fees and purchased services expenses increased $8.7 million from fiscal year 2005 primarily due to an increase of $4.8 million in registry nurse expense. The increase in registry nurse expense is primarily due to the need to maintain minimum nurse staffing ratios to keep up with patient volume. Increase is also due to the use of registry nurses to staff the emergency rooms that opened at Hale Ho'ola Hamakua, Kula Hospital, and Samuel Mahelona Memorial Hospital during fiscal year 2006. The remaining increase is primarily due to contracted payments to physicians to ensure the availability of specialty medical care and on-call coverage for neighbor island patients.

Fiscal year 2007 operating revenues increased by approximately 4% over fiscal year 2006 as a result of increases in net patient service revenues at HMC and KVMH. The increase in net patient service revenues at HMC was due to an increase in emergency department visits of 6.7% and an increase in acute admissions of 5.8%. The increase in net patient service revenues at KVMH was due to increases in surgery revenue and related revenues for anesthesia, laboratory, radiology, and pharmacy as a result of an 83% increase in inpatient surgery procedures from contracting with more physicians to provide basic general surgery and anesthesia services for the hospital.

Fiscal year 2006 operating revenues increased by approximately 9.9% over fiscal year 2005 as a result of extraordinary third-party payor settlements received for sole community hospital reimbursement (primarily at MMMC), payments received from DHS for supplemental direct payments to hospitals, payments received from DHS for Act 294 relief provisions for fiscal years 2004 and 2005, and increases in negotiated reimbursement rates from private third-party payors. In fiscal year 2006, HHSC received $9.2 million in third-party payor settlements from government-type payors relating to the sole community hospital reimbursement for MMMC, HMC, and Kona Community Hospital, with $8.2 million of the total going to MMMC. The settlements covered the fiscal years 2002 through 2004. Sole community hospitals are hospitals that, because of factors such as isolated location, weather conditions, travel conditions, or absence of other hospitals, are the sole source of inpatient services reasonably available in a geographic area, or are located more than 35 road miles from another hospital. Sole community hospitals receive either hospital-specific prospective rates based on base year costs updated to the present or the federal PPS rate, whichever is higher. In fiscal year 2006, HHSC received $8.8 million in supplemental direct payments to hospitals from DHS (see discussion on Medicaid reimbursement issues on page 12 for more information). In fiscal year 2006, HHSC also recorded $8.2 million in relief payments from DHS for the detrimental reimbursement impact on HHSC's long-term care reimbursements as a result of Act 294 (see discussion on Medicaid reimbursement issues below for more information). The increase in negotiated reimbursement rates from private third-party payors primarily represented inflationary increases of varying percentages.

For the years ended June 30, 2007 and 2006, General Fund Appropriations from the State of Hawaii consisted of $34.2 million and $32.3 million, respectively, approved for HHSC's operating purposes by the 2005 Legislature.

HHSC's management believes that the significant excess of operating expenses over operating revenues in both 2007 and 2006, 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 2007, 59% of HHSC's total gross revenues were from government-type payors (approximately 23% from Medicare and approximately 25%

from Medicaid and QUEST). For fiscal year 2006, 60% of HHSC's total gross revenues were from government-type payors (approximately 23% from Medicare and approximately 25% from Medicaid and QUEST). In fact, government-type payors account for 89% of HHSC's long-term care revenues. Reimbursements from government-type payors has not kept up with the increasing costs of health care providers since the Balanced Budget Act of 1997 was passed, which dramatically reduced the level of reimbursements from government-type payors. According to the November 2006 "Financial Trends of Hawaii's Hospitals, Nursing Facilities, Home Care and Hospice Providers" presented by the Healthcare Association of Hawaii, Medicare pays hospitals only 78% of cost and Medicaid/QUEST pays only 81% of cost for all Hawaii hospitals, the lowest as compared to all other third-party payors.

Further, management believes that there are two Medicaid reimbursement issues that have had 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 "Emergency Medical Treatment and Labor Act" (EMTALA) 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, DHS 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. Upon the implementation of Act 294, management estimates that the cost to HHSC will be approximately $13 million per year. Management believes that such large annual costs will simply serve to increase the amount of general fund appropriations that HHSC will be seeking from the State of Hawaii each year, as the amount of cost reductions/revenue enhancements that can be reasonably explored will not be enough to absorb such costs. In September 2003, the Center for Medicare and Medicaid Services approved Hawaii's Medicaid State Plan Amendment to provide relief payments to those nursing facilities negatively impacted by Act 294. In fiscal year 2007, DHS paid $5.1 million to HHSC in Act 294 relief payments for patient services rendered in fiscal year 2004. In fiscal year 2007, HHSC accrued estimated Act 294 relief payments for patient services rendered in fiscal year 2006 and 2007 of $3.6 million and $1.3million respectively. While this will provide short-term relief for HHSC's facilities that are negatively impacted by Act 294, management is continuing to work with DHS to explore long-term alternative reimbursement solutions that would ease the burden of Act 294 on HHSC's long-term care facilities.

When the State of Hawaii implemented the QUEST program in 1994, the federal funds provided to the State of Hawaii for Medicaid DSH payments to hospitals were used to partially fund the QUEST program in order to expand health insurance coverage to more residents of the State. 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, the amount of federal funds received by the State of Hawaii for the Medicaid program would be significantly more than what is currently being provided. To illustrate the importance of Medicaid DSH payments to public hospital systems, the National Association of Public Hospitals' report on

"America's Public Hospitals and Health Systems, 2004" states that "Medicaid DSH funding financed almost one-fifth of the unreimbursed care provided in 2004, while state and local subsidies financed 35 percent." In September 2005, the State Department of Human Services (DHS), in partnership with HHSC management, the Governor, the State of Hawaii Legislature, and the Healthcare Association of Hawaii (HAH), was able to use HHSC's fiscal years 2006 and 2007 projected losses from providing uncompensated care under the Medicaid fee-for-service program to draw down additional federal funding for all Hawaii hospitals. DHS has paid to HHSC $6.9 million and $8.8 million for fiscal years 2007 and 2006, respectively. Because of this innovative approach to drawing down additional federal funds, HHSC was able to reduce its request for State general fund appropriations by those amounts in fiscal years 2007 and 2006. Management will continue to work with DHS, the State of Hawaii Legislature, and HAH to explore long-term reimbursement enhancements that could reduce HHSC's reliance on general fund appropriations.

Second, HHSC's facilities on the neighbor islands suffer from an insufficient supply of long-term care beds. For fiscal year 2007, HHSC's long-term care occupancy percentage was 95.5%, and there are very few other freestanding long-term care facilities on the neighbor islands. As a result, HHSC's acute care facilities, especially HMC and MMMC, have numerous patients initially admitted as acute patients, but who continue to occupy acute-care beds while awaiting long-term care beds to become available. Such patients are called "wait-list" patients. HHSC receives little to no reimbursement from insurers for such patients, as insurers will not reimburse providers for patients whose required level of care does not coincide with the type of bed the patient is occupying. Combined, HMC and MMMC have an average census of approximately 20-40 wait list patients per day. Management expects the wait-list problem to worsen as Hawaii's population continues to age and the State of Hawaii lags behind on a credible plan to address the long-term care crisis.

Third, HHSC's salaries and benefits expenses represent approximately 60% 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 healthcare systems.

Also, since the majority of HHSC's facilities are in rural locations, management faces many recruitment and retention issues of key clinical personnel. Areas of acute shortage include RNs and LPNs, anesthetists, imaging technicians, physicians, surgery technicians, pharmacists and pharmacy technicians, and health information management specialists. These shortage areas are caused by several factors: 1) a nation-wide shortage of health care workers, 2) the inability of local colleges and universities to provide sufficient classes and teachers that can educate students in these areas, and 3) competition for these same types of positions with private hospitals, which can pay significantly higher wage rates than HHSC. In particular, the shortage of RNs and LPNs results in HHSC having to expend significant amounts for agency nurses, which are paid at significantly higher rates. Agency nurse expenses increased from $5,909,792 for fiscal year 2005 to $11,947,154 for fiscal year 2007. Another issue compounding HHSC's nursing situation is the fact that all of HHSC's nurses are full-time salaried employees, while the nurses at the other private hospitals are hourly employees. This allows the private hospitals to increase or decrease their nurse staffing based on census; by contrast, HHSC facilities cannot decrease their nurse staffing if census is lower than budgeted.

The shortage of physicians on the neighbor islands has been of particular concern to management. In past years, HHSC's facilities had very little contractual or employment relationships with physicians. The medical staff of HHSC's facilities consisted of those physicians with their own practices who had admitting privileges at the facilities. Within the past several years, many of the physicians who had practices on the neighbor islands have left their communities because of a confluence of factors including low physician reimbursements from third-party payors, high malpractice insurance costs, Hawaii's high cost of living, and the lack of tort reform that would limit the amounts that parties could sue medical care providers. As a result, residents of the neighbor islands were at times not able to receive specialty physician services in the event of an emergency, and had to be transported to Oahu to receive the necessary care. As an example, according to Hawaii Health Information Corporation data for fiscal year 2006, 57% of East Hawaii residents and 59% of West Hawaii residents were discharged for orthopedic surgeries from Oahu hospitals. In keeping with HHSC's mission of providing and enhancing accessible, comprehensive healthcare services that are quality-driven, customer-focused, and cost-effective, management began to contract or employ physicians to ensure that neighbor island residents would be able to receive quality healthcare in a timely manner in the community in which they reside. HHSC's costs of contracting with or employing physicians increased from $8.7 million in fiscal year 2006 to $9.6 million in fiscal year 2007, and it is expected to increase to $20 million in fiscal year 2008. These costs not only include the salary or contract payments to the physicians, but also the cost of establishing the clinics and physician offices for those physicians. Management believes that without significant medical tort reform and an increase in physician reimbursement rates, there will be continuing pressure put on HHSC's facilities to recruit and employ the physician specialists that are needed to ensure that neighbor island residents receive the quality healthcare that they deserve.

Related to the physician shortage issue is the issue of on-call coverage. In the past, physicians provided on-call coverage for hospital emergency rooms as part of their duties as a medical staff member. However, due to the financial pressures listed in the paragraph above, physicians have started to demand payment for providing on-call coverage for hospital emergency rooms in order to make up for the financial shortfalls they experience from their private practices. Management has attempted to mitigate the need to pay physicians for on-call coverage by contracting with or employing hospitalists. Hospitalists are doctors whose primary professional focus is the practice of hospital medicine. They help manage patients throughout the continuum of hospital care, often seeing patients in the emergency room, and admitting them to inpatient wards. However, the lack of specialty physician availability on the neighbor islands described above has caused HHSC to pay certain of its physicians to provide on-call coverage for the emergency room. HHSC's cost for hospitalist/on-call coverage was $1.5 million in fiscal year 2006, $5.3 million in fiscal year 2007, and is expected to be $11.2 million in fiscal year 2008.

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. Management has identified over $831 million in capital improvement projects that need to be funded in the next ten years in order to have HHSC's facilities continue to deliver quality care to its 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 required 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 required that the State agency obtain no less than three price quotes, with the award of the contract made to the most advantageous quotation. Any exceptions to these regulations must be approved by the Chief Procurement Officer for that agency. Under Act 262, HHSC was granted the ability to develop its own internal policies and procedures for the procurement of goods and services, consistent with the goals of public accountability and public procurement practices, but not subject to HRS 103(d). In fact, prior to the formation of HHSC, the state hospitals under the Division of Community Hospitals were excluded from HRS 103(d) competitive procurement provisions, so that the hospitals could have the autonomy to procure goods and services in a setting where timeliness is crucial to the provision of quality health care to patients.

During the 2006 Legislative Session, the State of Hawaii Legislature passed S.B. 2898, S.D.2, H.D.2, C.D.1, designating the chief executive officer of HHSC as its chief procurement officer. This bill also amended HRS 103(d) by raising the small purchase threshold from $25,000 to $50,000. Even with the designation of chief procurement officer authority, HHSC has incurred significant costs in its attempt to comply with the provisions of HRS 103(d). The most troubling cost is in the area of delayed medical care due to the delay in obtaining needed medical equipment. This results in more pain for the patient and the likelihood of a detrimental outcome increases. Another cost is that the medical staffs at HHSC's hospitals are upset about the implementation of the code. These physicians are being forced to spend an inordinate amount of time justifying the purchase of a specific piece of essential medical equipment on a piece-by-piece basis, which is time that could better be spent providing care to their patients. Given the shortage of certain physician specialists on the neighbor islands, anything that would cause frustration to these physicians could result in a loss of certain specialty care in neighbor island communities should these physicians choose to leave. The medical staffs are also upset that preferences of a surgeon in using particular brands of medical equipment require extensive justification under HRS 103(d). Further, the State Procurement Office is having a difficult time providing answers to questions and training to HHSC personnel due to their limited staff and the difficulty in reconciling the provisions of HRS 323(f) (the statute that delineates the powers and governance of HHSC) and HRS 103(d). Finally, HHSC has incurred costs in increasing procurement/legal staff to handle the increased workload of complying with the requirements of HRS 103(d), as well as the cost of increased employee time to handle the increased paperwork and number of requests for proposal (RFPs) that are required under the code. An exemption was granted to the regions within HHSC as a result of Act 290, which is discussed more later on in this report.

In the 2007 Legislative Session, two acts were passed that will have a significant effect on how HHSC operates as a healthcare system in the future. Act 113, H.B. 843, which became effective May 31, 2007, amends Hawaii Revised Statutes 323F to allow for the assimilation of Kahuku Hospital into HHSC in a manner and to an extent that may be negotiated between Kahuku Hospital and HHSC. Kahuku Hospital is a 25-bed critical access hospital that provides acute, long-term care, and emergency room services to the North Shore residents on the island of Oahu. Further details on the assimilation can be found in Note 16 to the consolidated financial statements. Management believes that the assimilation of Kahuku Hospital is in line with HHSC's safety-net mission to provide important healthcare services in Hawaii's rural communities.

Act 290, S.B. 1792, which became effective July 1, 2007, requires the establishment of a 7 to 15-member regional system board of directors for each of the 5 regions of the HHSC system. Further details on the establishment of the regional boards and the impact on the HHSC board of directors can be found in Note 16 to the consolidated financial statements. Management believes that this Act significantly changes the structure and operations of HHSC since its inception in 1997, and that the new governance model will enhance the ability of HHSC's five regions to respond to the healthcare needs of their communities.

As this reorganization effort will require extensive coordination and support, management has selected The Governance Institute (TGI), a national leading governance development firm, to guide this unprecedented effort. TGI will educate board members on the fundamentals of board development as well as methods for creating strong working relationships between the regional boards, and facilitate extensive discussions on delineating the major roles and responsibilities of the regional and system boards. In addition, TGI will provide a two-year guidance program for the new boards, including extensive development support, materials and educational programs. Although there will continue to be operational challenges to resolve as the regional boards begin to assume governance over the HHSC regions, management is excited about this opportunity to transition to a stronger community-based governance model.

Finally, HHSC is a significant provider of health care for the State of Hawaii. For fiscal year 2006, HHSC's facilities accounted for 19.23% of all acute care discharges in the State of Hawaii. HHSC's facilities discharged more acute care patients during that time period than most of the acute care hospitals on Oahu. Also, HHSC is the sole source of health care for several isolated neighbor island communities (e.g. Ka'u, Kohala, Lanai, etc.). Further, MMMC is the primary acute care facility on the island of Maui, and HMC and Kona Community Hospital are the only acute care facilities with more than 50 acute beds on the island of Hawaii. In large part because of HHSC's facilities in Maui, 84.17% of Maui County residents received their care in Maui instead of having to fly to Oahu to receive care. The same can be said for residents of the county of Hawaii, as 66.58% of all residents in the county of Hawaii received medical services from HHSC's five facilities 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, 2007 AND 2006

	2007	2006
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents:		
On deposit with the State of Hawaii	$ 12,008,539	$ 11,171,229
On deposit with banks and on hand (Note 3)	14,315,259	16,317,741
Patient accounts receivable, less allowances of $97,310,824 and $75,777,177 for contractual adjustments and doubtful accounts	62,009,527	53,705,809
Due from Medicaid for Act 294	4,912,000	5,100,601
Federal grants receivable	2,243,901	
Supplies and other current assets	12,813,812	10,390,416
Total current assets	108,303,038	96,685,796
CAPITAL ASSETS — Net (Notes 4, 7, 8, and 13)	253,157,203	221,454,648
ASSETS LIMITED AS TO USE	4,308,834	872,233
OTHER ASSETS (Notes 8 and 11)	3,556,987	3,030,783
TOTAL	$369,326,062	$322,043,460

(Continued)

HAWAII HEALTH SYSTEMS CORPORATION

CONSOLIDATED STATEMENTS OF NET ASSETS
JUNE 30, 2007 AND 2006

LIABILITIES AND NET ASSETS	2007	2006
CURRENT LIABILITIES:		
Accounts payable and accrued expenses (Note 11)	$ 59,067,339	$ 39,825,747
Accrued workers' compensation liability (Note 14)	19,020,204	19,274,950
Current portion of capital lease obligations (Note 7)	7,179,538	8,105,845
Current portion of accrued vacation (Note 7)	10,684,661	9,645,674
Current portion of long-term debt (Note 8)	838,748	699,070
Other current liabilities	880,061	605,314
Estimated third-party payor settlements (Note 6)	1,101,994	4,588,213
Advance from the State of Hawaii (Note 5)	10,000,000	
Total current liabilities	108,772,545	82,744,813
CAPITAL LEASE OBLIGATIONS — Less current portion (Note 7)	35,091,398	32,254,903
LONG-TERM DEBT — Less current portion (Note 8)	10,774,103	10,880,541
ACCRUED VACATION — Less current portion (Note 7)	20,578,812	18,577,707
DUE TO AFFILIATES — Net		
DUE TO THE STATE OF HAWAII (Note 5)	34,122,507	34,122,507
PATIENTS' SAFEKEEPING DEPOSITS AND DEFERRED INCOME — Restricted contributions	395,211	378,788
OTHER LIABILITIES	307,594	324,136
Total liabilities	210,042,170	179,283,395
NET ASSETS:		
Invested in capital assets — net of related debt	197,794,179	169,665,927
Restrictions — primarily for capital acquisitions (Note 12)	2,861,656	493,445
Unrestricted (Note 3)	(41,371,943)	(27,399,307)
Total net assets	159,283,892	142,760,065
TOTAL	$369,326,062	$322,043,460

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, 2007 AND 2006

	2007	2006
OPERATING REVENUES:		
Net patient service revenues (net of contractual adjustments and provision for doubtful accounts of $403,470,168 and $320,954,755) (Note 9)	$ 361,761,910	$ 347,877,556
Other operating revenues	5,639,518	4,894,582
Total operating revenues	367,401,428	352,772,138
OPERATING EXPENSES:		
Salaries and benefits (Notes 9 and 10)	269,255,418	234,888,851
Purchased services (Notes 9 and 11)	50,789,110	43,644,893
Medical supplies and drugs	42,635,195	41,746,921
Depreciation and amortization	18,919,920	18,483,895
Other supplies	15,535,820	15,013,966
Repairs and maintenance	10,277,258	7,084,445
Utilities	9,607,844	8,733,781
Professional fees	6,228,098	4,055,419
Insurance	6,136,486	6,146,134
Rent and lease	5,458,805	4,520,138
Other (Note 14)	3,902,315	6,830,188
Total operating expenses	438,746,269	391,148,631
LOSS FROM OPERATIONS	(71,344,841)	(38,376,493)
NONOPERATING REVENUES (EXPENSES):		
General appropriations from State of Hawaii	34,154,041	32,280,041
Collective bargaining pay raise appropriation from State of Hawaii	14,585,780	5,474,356
Noncapital restricted contributions (Note 12)	369,194	260,421
Interest and dividend income	878,277	539,539
Interest expense (net of capitalized interest) (Notes 7 and 8)	(2,236,023)	(2,355,317)
Other nonoperating revenues — net (Notes 9 and 11)	1,402,118	1,582,367
Total nonoperating revenues (expenses)	49,153,387	37,781,407
LOSS BEFORE CAPITAL GRANTS AND CONTRIBUTIONS	(22,191,454)	(595,086)
CAPITAL GRANTS AND CONTRIBUTIONS (Notes 4 and 13)	38,715,281	26,115,844
INCREASE IN NET ASSETS	16,523,827	25,520,758
NET ASSETS — Beginning of year	142,760,065	117,239,307
NET ASSETS — End of year	$ 159,283,892	$ 142,760,065

See notes to consolidated financial statements.

HAWAII HEALTH SYSTEMS CORPORATION

CONSOLIDATED STATEMENTS OF CASH FLOWS
YEARS ENDED JUNE 30, 2007 AND 2006

	2007	2006
OPERATING ACTIVITIES:		
Receipts from government, insurance, and patients	$ 350,160,574	$ 347,976,991
Payments to employees	(264,122,172)	(235,762,109)
Payments to suppliers and others	(136,656,187)	(133,378,977)
Other receipts — net	5,639,518	4,894,582
Net cash used in operating activities	(44,978,267)	(16,269,513)
NONCAPITAL FINANCING ACTIVITIES:		
Appropriations from State of Hawaii	48,739,821	37,754,397
Advances from the State of Hawaii	10,000,000	
Other nonoperating revenues — net	2,213,648	1,664,197
Net cash provided by noncapital financing activities	60,953,469	39,418,594
CAPITAL AND RELATED FINANCING ACTIVITIES:		
Repayments on capital lease obligations	(8,260,533)	(8,068,835)
Capital expenditures	(20,061,682)	(5,322,474)
Payments on long-term debt	(724,760)	(650,995)
Interest on capital lease obligations and long-term debt	(2,236,023)	(2,355,317)
Proceeds from sale of capital assets		150
Additions to long-term debt	758,000	
Proceeds from federal grants	15,347,990	
Net cash used in capital and related financing activities	(15,177,008)	(16,397,471)
INVESTING ACTIVITIES:		
Distributions received from the Clinical Laboratories of Hawaii partnership	146,884	183,600
Purchase of investments and amounts held in escrow	(2,110,250)	
Net cash provided by (used in) investing activities	(1,963,366)	183,600
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	(1,165,172)	6,935,210
CASH AND CASH EQUIVALENTS — Beginning of year	27,488,970	20,553,760
CASH AND CASH EQUIVALENTS — End of year	$ 26,323,798	$ 27,488,970

(Continued)

HAWAII HEALTH SYSTEMS CORPORATION

CONSOLIDATED STATEMENTS OF CASH FLOWS
YEARS ENDED JUNE 30, 2007 AND 2006

	2007	2006
RECONCILIATION OF LOSS FROM OPERATIONS TO NET CASH USED IN OPERATING ACTIVITIES:		
Loss from operations	$ (71,344,841)	$ (38,376,493)
Adjustments to reconcile loss from operations to net cash used in operating activities:		
Provision for doubtful accounts	31,247,900	21,173,044
Depreciation and amortization	18,919,920	18,483,895
Amounts released from restrictions	397,763	860,292
Change in operating assets and liabilities:		
Patient accounts receivable and amounts due from Medicaid for Act 294	(39,363,017)	(29,636,517)
Supplies and other assets	(2,390,541)	(1,481,657)
Assets limited as to use		
Accounts payable, accrued expenses, and other liabilities	18,255,422	7,238,372
Accrued workers' compensation liability	(254,746)	(6,008,013)
Estimated third-party payor settlements	(3,486,219)	8,562,908
Accrued vacation	3,040,092	2,914,656
NET CASH USED IN OPERATING ACTIVITIES	$ (44,978,267)	$ (16,269,513)
SUPPLEMENTAL CASH FLOW INFORMATION —		
Interest paid, primarily on capital lease obligations	$ 2,263,023	$ 2,355,317
NONCASH FINANCING AND INVESTING ACTIVITIES:		
• Capital assets acquired under capital leases	10,170,721	13,339,332
• Capital assets contributed by State of Hawaii	19,628,153	26,115,844
• Restricted cash and accrued federal government contributions	3,739,138	
• Capital asset purchases included in accounts payable	1,545,921	301,544
• Contribution of capital assets	54,091	24,736
• Capital assets acquired with restricted assets (Note 12)	156,739	209,221
• Rental income contributed to and equity in earnings of the Clinical Laboratories of Hawaii partnership	751,776	984,727
• Capital assets transferred from other noncurrent assets		25,000

See notes to consolidated financial statements.

(Concluded)

1. ORGANIZATION

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

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

East Hawaii Region:
- Hilo Medical Center
- Hale Ho'ola Hamakua
- Ka'u Hospital
- Yukio Okutsu Veterans Care Home

West Hawaii Region:
- Kona Community Hospital
- Kohala Hospital

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

Oahu Region:
- Leahi Hospital
- Maluhia

Kauai Region:
- 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, and is a component unit of the State. 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, 2007. 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.

During 2007 and 2006, HHSC had losses from operations of approximately $71 million and $38 million, respectively. Management believes that maintaining the current levels of service that HHSC provides would require continued funding by the State.

The consolidated financial statements are being presented for HHSC, Hawaii Health Systems Foundation (HHSF), and Alii Community Care, Inc. ("Alii"). HHSF and Alii are nonprofit organizations of which HHSC is the sole member. The purpose of HHSF is to raise funds and to 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.

See Note 16 for a description of (1) Act 290, which restructures the HHSC governing board system and (2) Act 113, which assimilates the operations of Kahuku Hospital into HHSC.

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 and Accounting Guide, *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 monies paid into the State Treasury ("cash pool"). HHSC's portion of this cash pool at June 30, 2007 and 2006, 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 approximately $19,433,473 and $18,224,319 at June 30, 2007 and 2006, respectively. Accordingly, these deposits were exposed to custodial credit risk. Custodial credit risk is the risk that in the event of a financial institution failure, HHSC's deposits may not be returned to it.

Supplies — Supplies consist principally of medical and other supplies and are recorded 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 are recorded at the present value of future payments. Buildings, equipment, and improvements are depreciated by the straight-line method using these asset lives:

Building and improvements	5–40 years
Major moveable equipment	10–20 years
Fixed equipment	3–15 years

Gains or losses on the sale of capital assets are reflected in other non-operating 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 non-operating revenues category on the consolidated statement of revenues, expenses, and changes in net assets.

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

At June 30, 2007, assets limited as to use consisted of restricted cash of $3,698,584 and an escrow fund receivable from a municipal leasing company of $610,250. At June 30, 2006, the entire balance of assets limited as to use consisted of restricted cash.

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

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

Net Patient Service Revenues — Net patient service revenues are recorded on an accrual basis in the period in which the related services are provided at established rates, less contractual adjustments, and provision for doubtful accounts. HHSC, as a safety net provider, provides charity care to certain patients; the specific cost of such care for the years ended June 30, 2007 and 2006, was $2,211,583 and $2,575,220, respectively.

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 2007 and 2006 financial statements.

The estimated third-party payor settlement payable of $1,101,994 and $4,588,213 as of June 30, 2007 and 2006, respectively, are based on estimates, because complete information is not currently available to determine the final settlement amounts for certain cost report years. Management has used its best effort, judgment, and certain methodologies to estimate the anticipated final outcome.

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

- *Medicare* — Inpatient acute services rendered to Medicare program beneficiaries are paid at prospectively determined rates per discharge referred to as the inpatient prospective payment system (IPPS). Under the IPPS, each case is categorized into a diagnosis-related group (DRG). Each DRG has a payment weight assigned to it, based on the average resources used to treat Medicare patients in that DRG.

  Outpatient services rendered to Medicare beneficiaries are paid under a prospective payment system called Ambulatory Payment Classifications (APC). Services in each APC are similar clinically and in terms of the resources they require. A payment rate is established for each APC and, depending on the services provided, hospitals may be paid for more than one APC for an encounter.

  Skilled Nursing Services provided to Medicare beneficiaries are paid on a per diem prospective payment system covering all costs (routine, ancillary, and capital) related to the services furnished. The per diem payments for each admission are case-mix adjusted using a resident classification system (Resource Utilization Groups) based on data from resident assessments and relative weights developed from staff time data.

  All Medicare-certified hospitals and Skilled Nursing Facilities are required to file annual Medicare cost reports, which are due to the Medicare fiscal intermediaries five months after the fiscal year-end. Medicare cost reports for the majority of the HHSC facilities have been audited by the Medicare fiscal intermediary through fiscal year 2006.

- *Medicaid* — Inpatient acute services rendered to Medicaid program beneficiaries are reimbursed under a prospectively determined rate per day and per discharge with a cost settlement for capital costs. Medicaid long-term care services are reimbursed based on a price-based case mix reimbursement system. The case mix reimbursement system uses the Resource Utilization Groups (RUG) classification system calculated from the Minimum Data Set (MDS) assessment. The case mix reimbursement payment method takes into account a patient's clinical condition and the resources needed to provide care for the patient. Medicaid outpatient services are reimbursed based on a fee schedule using current procedure terminology (CPT) codes established for the State.

  Net patient revenue for 2007 and 2006 include approximately $4,900,000 and $5,100,000, respectively, of adjustments to Medicaid payments made by the State to mitigate the impact of Act 294 on HHSC's long-term care facilities.

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

- *Sole Community Hospitals* — HHSC has three facilities (Hilo Medical Center, Kona Community Hospital, and Maui Memorial Medical Center) that are designated as sole community hospitals (SCH) by the CMS. Inpatient case rates for services rendered to Medicare beneficiaries are finally determined upon the filing of the annual Medicare cost reports.

- *Hawaii Medical Service Association (HMSA)* — Inpatient services rendered to HMSA subscribers are reimbursed at prospectively determined case rates. The prospectively determined case rates are not subject to retroactive adjustment. In addition, outpatient surgical procedures and emergency room visits are reimbursed at a negotiated case rate. All other outpatient services are reimbursed based on a fee schedule using standard CPT codes.

- *Other Commercial* — 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 consolidated financial statements since it is not susceptible to objective measurement or valuation.

Bond Interest — HHSC reports as non-operating 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 also reported as non-operating revenues, resulting in no significant effect in the financial statements. 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, 2007 and 2006, the amount of bond interest allocated to HHSC was approximately $5,329,000 and $4,414,000, respectively.

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 14.

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, 2007 and 2006, was as follows:

	2007	2006
Medicare	15 %	15 %
Medicaid	21	20
HMSA	12	14
Other third-party payors	22	25
Patients and other	30	26
	100 %	100 %

Reclassifications — Certain amounts in the 2006 financial statements have been reclassified to conform to the 2007 presentation. In addition, losses on disposal of capital assets have been reclassified from capital financing activities to noncapital financing activities in the statement of cash flows for the year ended June 30, 2006, consistent with the presentation for the year ended June 30, 2007. The effect of this reclassification was to increase net cash used in capital and related financing activities, and decrease net cash used in noncapital financing activities by $551,756.

New Accounting Pronouncements — The following accounting pronouncements will become effective after June 30, 2007:

GASB Statement No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions* — This statement establishes standards for the measurement, recognition, and display of other postemployment expense and related liabilities, note disclosures, and if applicable, required supplementary information in the financial reports of state and local government employers. The statement will become effective for periods beginning after December 15, 2006. Management is studying the effects that the statement may have on HHSC's financial statements.

GASB Statement No. 48, *Sales and Pledges of Receivables and Future Revenues and Intra-Entity Transfers of Assets and Future Revenues* — This statement establishes criteria that governments will use to ascertain whether proceeds received from the exchange of their interest in expected cash flows from collecting specific receivables or specific future revenues for immediate cash payments should be reported as revenue or a liability. The statement also includes guidance to be used for recognizing other assets and liabilities arising from a sale of specific receivables or future revenues, including residual interests and recourse provisions. The statement will become effective for periods beginning after December 15, 2006. Management is studying the effects that the statement may have on HHSC's financial statements.

GASB Statement No. 49, *Accounting and Financial Reporting for Pollution Remediation Obligations* — This statement addresses accounting and financial reporting standards for pollution remediation obligations, which are obligations to address the current or potential detrimental effects of existing pollution by participating in pollution remediation activities such as site assessments and cleanups. Pollution remediation outlays should be capitalized only if the outlays incurred meet four specific criteria; otherwise they should be expensed. The statement will become effective for periods beginning after December 15, 2007. Management is studying the effects that the statement may have on HHSC's financial statements.

GASB Statement No. 50, *Pension Disclosures* — This statement more closely aligns the financial reporting requirements for pensions with those for other postemployment benefits. The reporting changes required by this statement amend applicable note disclosures and required supplementary information requirements of GASB Statements No. 25, *Financial Reporting for Defined Benefit Pension Plans and Note Disclosures for Defined Contribution Plans*, and No. 27, *Accounting for Pensions by State and Local Governmental Employers*, to conform with requirements of GASB Statements No. 43, *Financial Reporting for Postemployement Benefit Plans Other Than Pension Plans*, and No. 45, *Accounting and Financial Reporting by Employers for Postemployement Benefits Other Than Pensions*. The statement will become effective for periods beginning after June 15, 2007. Management is studying the effects that the statement may have on HHSC's financial statements.

GASB Statement No. 51, *Accounting and Financial Reporting for Intangible Assets* — This statement establishes accounting and financial reporting requirements for intangible assets. The statement requires that all intangible assets not specifically excluded by the statement be classified as capital assets. The statement will become effective for periods beginning after June 15, 2009. Management is studying the effects that the statement may have on HHSC's financial statements.

GASB Statement No. 52, *Land and Other Real Estate Held as Investments by Endowments* — This statement establishes standards for the reporting of land and other real estate held as investments by essentially similar entities. It requires endowments to report their land and other real estate investments at fair value. Governments also are required to report the changes in fair value as investment income and to disclose the methods and significant assumptions employed to determine fair value. The statement will become effective for periods beginning after June 15, 2008. Management is studying the effects that the statement may have on HHSC's financial statements.

3. BOARD-DESIGNATED FUNDS

As of June 30, 2007 and 2006, 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, 2007 and 2006, 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.

4. CAPITAL ASSETS

Transactions in the capital assets accounts for the years ended June 30, 2007 and 2006, were as follows:

2007	Beginning of Year	Additions	Retirements	Transfers	End of Year
Assets not subject to depreciation:					
Land and land improvements	$ 5,180,572	$ 361,627	$ -	$ 1,378,097	$ 6,920,296
Construction in progress	63,085,041	41,722,741	(198,184)	(62,221,832)	42,387,766
Assets subject to depreciation:					
Buildings and improvements	221,899,300	719,151	(487,289)	57,393,818	279,524,980
Major moveable equipment	84,255,477	8,333,836	(2,337,713)	3,171,491	93,423,091
Fixed equipment	36,802,006	147,259	(634,516)	278,426	36,593,175
	411,222,396	51,284,614	(3,657,702)	-	458,849,308
Less accumulated depreciation and amortization	(189,767,748)	(18,842,938)	2,918,581		(205,692,105)
Capital assets — net	$ 221,454,648	$ 32,441,676	$ (739,121)	$ -	$ 253,157,203

2006	Beginning of Year	Additions	Retirements	Transfers	End of Year
Assets not subject to depreciation:					
Land and land improvements	$ 5,180,572	$ -	$ -	$ -	$ 5,180,572
Construction in progress	30,385,291	37,868,620		(5,168,870)	63,085,041
Assets subject to depreciation:					
Buildings and improvements	216,954,326	838,620	(383,809)	4,490,163	221,899,300
Major moveable equipment	79,429,038	5,755,287	(2,152,755)	1,223,907	84,255,477
Fixed equipment	43,239,553	216,533	(6,108,880)	(545,200)	36,802,006
	375,188,780	44,679,060	(8,645,444)	-	411,222,396
Less accumulated depreciation and amortization	(179,395,725)	(18,465,561)	8,093,538		(189,767,748)
Capital assets — net	$ 195,793,055	$ 26,213,499	$ (551,906)	$ -	$ 221,454,648

In 2007 and 2006, the State Department of Accounting and General Services transferred capital assets, including construction in progress, aggregating $19,628,153 and $26,115,844, respectively, to HHSC as a contribution of capital.

During fiscal years 2007 and 2006, $19,243,867 and $209,221, respectively, of capital assets were purchased with funds contributed by the federal government and outside organizations.

5. ADVANCE FROM THE STATE OF HAWAII

In fiscal year 2003, HHSC received a $14,000,000 advance from the State to relieve its cash flow shortfall. At June 30, 2007, HHSC did not have the ability, and thus does not intend to repay the advance. Furthermore, management does not expect the State to demand payment of the advance in fiscal year 2008. Accordingly, the advance is classified as a noncurrent liability at June 30, 2007, consistent with fiscal year 2006. The amount due to the State of $34,122,507 at June 30, 2007 and 2006, consists of the $14,000,000 previously described, plus $20,122,507 of cash advances to the Department of Health – Division of Community Hospitals, which was assumed by HHSC at the date of its formation.

In 2007, HHSC received a $10,000,000 advance from the State which was repaid in July 2007.

6. ESTIMATED THIRD-PARTY PAYOR SETTLEMENTS

The estimated amounts due to government reimbursement programs at June 30, 2007 and 2006, consisted of the following:

	2007	2006
Cost Reports:		
Medicare	$ 1,358,736	$1,129,946
Medicaid	(2,620,625)	(294,400)
HMSA 65 C Plus	(221,484)	522,625
Medicaid dual eligible claims	2,585,367	3,230,042
Total	$ 1,101,994	$4,588,213

7. LONG-TERM LIABILITIES

Among HHSC's long-term liabilities include accrued vacation and capital lease obligations. Transactions for these accounts during the years ended June 30, 2007 and 2006, were as follows:

	Beginning of Year	Additions	Reductions	End of Year	Current Portion	Noncurrent Portion
2007						
Accrued vacation	$28,223,381	$19,214,881	$ (16,174,789)	$31,263,473	$10,684,661	$20,578,812
Capital lease obligations	40,360,748	10,170,721	(8,260,533)	42,270,936	7,179,538	35,091,398
2006						
Accrued vacation	$25,308,725	$ 4,586,009	$ (1,671,353)	$28,223,381	$ 9,645,674	$18,577,707
Capital lease obligations	35,090,251	13,339,332	(8,068,835)	40,360,748	8,105,845	32,254,903

Future capital lease payments were as follows:

Years Ended June 30	
2008	$ 9,853,558
2009	8,880,946
2010	7,754,053
2011	7,101,719
2012	4,570,594
2013-2017	12,576,468
2018-2021	2,528,360
Total future minimum payments	53,265,698
Less amount representing interest	(10,994,762)
Total capital lease obligations	42,270,936
Current portion	(7,179,538)
Noncurrent portion	$ 35,091,398

HHSC entered into capital leases on behalf of the facilities. The capital lease obligation is recorded in HHSC-Corporate's ("Corporate") accounting records. While the assets are being constructed, the amounts are recorded as construction in progress in the accounting records 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 years ended June 30, 2007 and 2006, interest capitalized was approximately $1,239,000 and $1,279,000, respectively.

8. 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 from Central Pacific Bank and the United States Department of Agriculture (USDA). 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. In October 2007, the loans and notes payable to Central Pacific Bank and the USDA were refinanced into a single note payable to Academic Capital.

Maui Memorial Medical Center Nurses' Cottages — During fiscal year 2003, HHSC acquired buildings for $1,690,900 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.

Kauai Veterans Memorial Hospital Clinic — During fiscal year 2005, Kauai Veterans Memorial Hospital (KVMH), purchased certain assets of a clinic operated by certain physicians for $360,000. The assets purchased included office equipment, supplies, a trademark/service mark, and non-compete agreements for two physicians. No existing liabilities of the clinic were assumed. Since the purchase price exceeded the estimated fair value of the purchased assets, goodwill of $243,000 was recorded, and is being amortized over 40 years. The non-compete agreements were valued at $55,000 and are being amortized over the three-year period of the agreements. The goodwill and non-compete agreements are included in other assets. In connection with the purchase, HHSC paid cash of $108,000 and signed two promissory notes to the former clinic owners totaling $252,000.

Term Loan — In August 2006, HHSC Corporate entered into a term loan for $758,000 to pay for the planning and design of a new surgery area and modifications of the existing surgery room at KVMH. The original term loan required monthly payments of interest at LIBOR plus 3%, and the principal balance was initially due on August 2007, but was extended in August 2007 to August 2009. The new terms require $31,583 in monthly principal payments, plus interest.

Long-term debt as of June 30, 2007 and 2006, consisted of the following:

	2007	2006
Loan payable to Central Pacific Bank; $9,500,000; interest at 5.75% (interest at weekly average of 5-year U.S. Treasury Securities rate plus 250 basis points); monthly principal and interest payments of $57,015; due December 1, 2027	$ 8,199,062	$ 8,423,972
Loan payable to Central Pacific Bank; $319,000; interest at 5.88% (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		161,951
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	976,686	1,003,357
Note payable to USDA; $1,000,000; interest at 4.75%; monthly principal and interest payments of $8,170; due August 13, 2014	530,371	648,765
Loan payable to Academic Capital; $1,690,900; interest at 6.3%; monthly principal and interest payments of $19,028; due November 4, 2012	1,032,048	1,189,928
Notes payable to two individuals; $252,000; interest at 5% monthly principal and interest payments of $22,745; due January 1, 2008	116,684	151,638
Term loan to AIG Commercial Equip. Finance, Inc.; $758,000; interest at 8.43% (LIBOR plus 3%); monthly principal payments of $31,583; due August 1, 2009	758,000	
Total	11,612,851	11,579,611
Less current portion	(838,748)	(699,070)
Noncurrent portion	$10,774,103	$10,880,541

Transactions in long-term debt during the years ended June 30, 2007 and 2006, were as follows:

	Beginning of Year	Additions	Reductions	End of Year
2007				
Long-term debt	$ 11,579,611	$ 758,000	$ (724,760)	$ 11,612,851
2006				
Long-term debt	$ 12,230,606	$ -	$ (650,995)	$ 11,579,611

Maturities of long-term debt are as follows:

Years Ending June 30	Principal	Interest	Total
2008	$ 838,748	$ 600,700	$ 1,439,448
2009	874,817	570,626	1,445,443
2010	602,239	539,548	1,141,787
2011	556,364	508,395	1,064,759
2012	589,381	475,379	1,064,760
2013-2017	1,994,273	1,996,934	3,991,207
2018-2022	2,322,596	1,414,475	3,737,071
2023-2027	3,083,657	653,414	3,737,071
2028-2032	595,399	67,237	662,636
2033-2034	155,377	6,143	161,520
Total	$11,612,851	$6,832,851	$18,445,702

9. 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 $18,095,000 and $16,795,000 (excluding Clinical Laboratories of Hawaii partnership fees of approximately $14,511,000 and $12,724,000 as disclosed in Note 11) during fiscal years 2007 and 2006, 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 non-operating revenues and aggregated approximately $1,156,000 and $1,070,000 during fiscal years 2007 and 2006, respectively. In addition, HHSC charges the contractors for the use of clinical personnel employed in the facilities. These amounts are netted against salaries and benefits expense and totaled approximately $ 854,000 and $848,000 during fiscal years 2007 and 2006, respectively.

10. 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.

On July 1, 2006, a new hybrid contributory plan became effective pursuant to Act 179, Session Laws of Hawaii of 2004. Participants prior to July 1, 2006, could choose to participate in this hybrid plan or remain in the existing plans. New employees hired from July 1, 2006, are required to join the hybrid plan. Participants will contribute 6% of their salary to this plan. Further, members in the hybrid plan are eligible for retirement at age 62 with five years of credited service or at age 55 and 30 years of credited service. Members will receive a multiplier of 2% for each year of credited service in the hybrid plan. The benefit payment options are similar to the current contributory plan.

HHSC's contribution to the ERS for the years ended June 30, 2007, 2006 and 2005, was approximately $26,103,000, $22,973,000, and $14,126,000 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 provides certain health care (medical, prescription drug, vision, and dental) and life insurance benefits to all qualified employees and their dependents. Pursuant to HRS Chapter 87A, on July 1, 2003, the Hawaii Employer-Union Health Benefits Trust Fund was established as the State agency to provide such benefits.

For employees hired before July 1, 1996, the State pays the entire monthly health care premium for employees retiring with 10 or more years of credited service, and 50% of the monthly premium for employees retiring with fewer than 10 years of credited service.

For employees hired after June 30, 1996, and who retire with fewer than 10 years of service, the State makes no contributions. For those retiring with at least 10 years but fewer than 15 years of services, the State pays 50% of the retired employees' monthly Medicare or non-Medicare premium. For employees hired after June 30, 1996, and who retire with at least 15 years but fewer than 25 years of service, the State pays 75% of the retired employees' monthly Medicare or non-Medicare premium; for those retiring with over 25 years of service, the State pays the entire health care premium.

Free life insurance coverage for retirees and free dental coverage for dependents under age 19 are also available. Retirees covered by the medical portion of Medicare are eligible to receive reimbursement of the basic medical coverage premium.

Contributions are financed on a pay-as-you-go basis. HHSC's post-retirement benefits expense approximated $13,483,000 and $11,179,000 for the years ended June 30, 2007 and 2006, respectively.

Sick Leave — Accumulated sick leave as of June 30, 2007 and 2006, was approximately $ 54,858,330 and $50,105,000, respectively. Sick leave accumulates at the rate of 14 hours for each month of service, as defined, without limit. Sick pay can be taken only in the event of illness and is not convertible to pay upon termination of employment. Accordingly, no liability for sick pay is recorded in the accompanying consolidated financial statements.

11. CLINICAL LABORATORIES OF HAWAII PARTNERSHIP

On May 1, 2002, HHSC entered into a Partnership Agreement with Clinical Laboratories of Hawaii, Inc., St. Francis Healthcare Enterprises, Inc., and Kapiolani Service Corporation to form Clinical Laboratories of Hawaii, LLP ("Partnership"). The primary purpose of the Partnership is to provide clinical laboratory services within the State of Hawaii. On June 1, 2002, HHSC contributed the use of the laboratory space and related ancillary services in seven of its facilities (Hilo Medical Center, Kona Community Hospital, MMMC, Hale Ho'ola Hamakua, Ka'u Hospital, Kohala Hospital, and Kula Hospital) in exchange for a less than controlling interest in the Partnership. Ordinary distributions from the Partnership are to be made at least annually from the Partnership's "Available Cash" (as defined in the Partnership Agreement). In fiscal years 2007 and 2006, HHSC received partnership distributions of $146,884 and $183,600, respectively.

HHSC's investment in the Partnership and related contribution of laboratory space and ancillary services are being recorded over the life of the Partnership Agreement. The contributed space and services recognized in fiscal year 2007 and 2006 amounted to $751,776 and $984,727, respectively, and the investment balance as of June 30, 2007 and 2006, was $ 3,365,175 and $2,760,283, respectively. The contributed space and services are included in other non-operating revenues in the consolidated statements of revenues, expenses and changes in net assets, and the investment balance is included in other assets in the consolidated statements of net assets.

In addition, HHSC charges the Partnership for the use of clinical personnel employed in the facilities, and certain routine tests referred to a facility's laboratory by the Partnership. Amounts billed to the Partnership totaled approximately $1,815,000 and $1,706,000 during fiscal years 2007 and 2006, respectively. Amounts due from the Partnership for such charges aggregated approximately $571,000 and $522,000 as of June 30, 2007 and 2006, respectively.

HHSC contracts with the Partnership to provide clinical laboratory and pathology services at its facilities. Amounts charged by the Partnership aggregated approximately $14,511,000 and $12,724,000 during fiscal years 2007 and 2006, respectively. Amounts due to the Partnership aggregated approximately $8,865,000, and $3,388,000 as of June 30, 2007 and 2006, respectively.

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 $150,000 and $93,000 during fiscal years 2007 and 2006, respectively. In addition, the Partnership contracts with KVMH to perform certain routine tests referred to the KVMH laboratory by the Partnership. Amounts billed to the Partnership were approximately $81,000 and $79,000 during fiscal years 2007 and 2006, respectively. There were no amounts due from or due to the Partnership as of June 30, 2007 and 2006.

12. TEMPORARILY RESTRICTED NET ASSETS

Changes in temporarily restricted net assets for the years ended June 30, 2007 and 2006, were as follows:

	2007	2006
Balance — beginning of year	$ 493,445	$ 1,302,537
Restricted contributions received	19,456,322	260,421
Restricted cash ·		
Expenditures for restricted purposes	(397,763)	(860,292)
Capital assets purchased	(16,690,348)	(209,221)
Balance — end of year	$ 2,861,656	$ 493,445

13. VETERANS HOME

In fiscal years 2007 and 2006, HHSC received $4,337,353 and $3,392,928, respectively, from the State for construction of the new veterans' long-term care facility. At June 30, 2007, $26,151,230 had been expended for planning, design, and construction costs and is included in construction in progress in the consolidated statements of net assets.

In fiscal year 2007, HHSC recorded $19,087,128 in contributions from the Department of Veterans Affairs for construction of the facility.

14. 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. Settled claims have not exceeded the overage provided by the insurance carrier in any of the past three fiscal years.

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 $19,020,204 and $19,274,950 for unpaid claims as of June 30, 2007 and 2006, respectively.

Corporate Integrity Agreement — In July 2007, Hilo Medical Center (HMC) and the Office of the Inspector General (OIG) of the U.S. Department of Health and Human Services entered into a settlement agreement and a corporate integrity agreement to resolve allegations of non-compliance with certain federal laws governing Hilo's financial arrangements with a physician. The corporate integrity agreement requires HMC to, among other things, maintain its existing compliance program and code of conduct; provide a variety of compliance trainings to its employees, contractors, and physicians; formalize procedures to ensure that each existing and new or renewed arrangements with physicians and other health care providers are in compliance with the federal laws; and retain an Independent Review Organization to conduct periodic reviews of its compliance with the requirements of the agreement. The amount of the settlement of $774,542 was paid in June 2007 (reflected as other operating expenses in the statement of revenues, expenses, and changes in net assets).

Ceded Lands — The Office of Hawaiian Affairs (OHA) and the State are presently in litigation involving the State's alleged failure to properly account for and pay to OHA monies due to OHA under the provisions of the Hawaii State Constitution and Chapter 10 of the Hawaii Revised Statutes for use by the State of certain ceded lands.

During the 2006 Legislative Session, the State of Hawaii Legislature enacted Act 178, which provided interim measures to ensure that a certain amount of proceeds were made available to OHA from the pro rata portion of the public land trust, for the betterment of the conditions of native Hawaiians. The Act provided that the State agencies that collect receipts from the use of lands within the public land trust transfer a total of $3,775,000 to OHA within 30 days of the close of each fiscal quarter (or $15,100,000 per fiscal year), beginning with the 2006 fiscal year. In addition, the Act appropriated $17,500,000 out of the State's general revenues to pay OHA for underpayments of the State's use of lands in the public land trust for the period from July 1, 2001 to June 30, 2005.

On September 20, 2006, the Governor of the State of Hawaii issued Executive Order No. 06-06, which established procedures for the State agencies to follow in order to carry out the requirements of Act 178. Each State agency that collects receipts from the use of ceded or public land trust land is to determine OHA's share of such receipts by calculating the ceded/non-ceded fraction of the parcel that generated the receipt, multiplying the receipt by the ceded/non-ceded fraction, and multiplying that result by 20%. The resulting amounts are to be deposited into a trust holding account established for such purpose, and within 10 days of the close of each fiscal quarter, the amounts are to be transferred to OHA. Within a specified period after the close of each quarter, the Director of Finance is to reconcile the actual amounts transferred to OHA with the required amount of $3,775,000, and adjust each specific agency's payments accordingly.

For the year ended June 30, 2007, HHSC's share of public land trust payments to OHA approximated $57,000.

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.

15. SIGNIFICANT EVENTS

October 15, 2006 Earthquake — On October 15, 2006, an earthquake with a magnitude of 6.7 occurred approximately 10 miles north-northwest of Kailua-Kona on the island of Hawaii. The earthquake and its subsequent aftershocks caused significant damage to the structure and fixtures at Kona Community Hospital and Hale Ho'ola Hamakua, with minor damage reported at Kohala Hospital, Kula Hospital, and MMMC. Total damages incurred and substantially expensed by HHSC as a result of the earthquake were approximately $1,825,000. Management expects that the majority of the costs of repairing the hospitals' facilities will be reimbursed to HHSC from a combination of proceeds from the State's property insurance policy and disaster relief assistance from the Federal Emergency Management Agency (FEMA). In September 2007, HHSC received $82,772 from FEMA through the State Department of Civil Defense for reimbursement of repairs made to HHSC's facilities.

16. SUBSEQUENT EVENTS

Act 290 – Regional System Board of Directors — In June 2007, the State Legislature passed Act 290, S.B. 1792. The Act, which became effective July 1, 2007, requires the establishment of a 7 to 15-member regional system board of directors for each of the five regions of the HHSC system. Each regional board is given custodial control and responsibility for management of the facilities and other assets in their respective regions. The Act requires that these regional boards be formed no later than January 1, 2008. The Act also restructures the 13 member HHSC board of directors to 15 members, comprised of 10 members appointed by the governor from nominees submitted by legislative leadership, two at-large members at the governor's discretion, two physician members selected by the HHSC board, and the State Director of Health.

Act 290 also exempts the regions from the requirements of the State procurement code and other exemptions from State agency laws, such as tax clearance certificate requirements, the concession law, and the sunshine law.

The Act appropriates $750,000 to pay for implementation of the new structure.

Purchase of Assisted Living Facility — In September 2007, Alii Community Care, Inc. ("Alii") exercised its option to purchase its 113-unit assisted living and Alzheimer facility and personal property from the developer/landlord for $16 million. In connection with the purchase, Alii also assumed the land lease on which the facility is situated, and a parking license covering real property adjacent to the facility.

In connection with the purchase agreement, Alii also reached an agreement with the developer/landlord concerning an arbitration award that was rendered in favor of the developer/landlord in January 2006 for $1.9 million. The arbitration decision was on appeal to the Intermediate Court of Appeals of the State of Hawaii. Alii and the developer/landlord agreed to settle the $1.9 million judgment for $500,000. This settlement payment is in addition to the $16 million purchase price. Because of the settlement of the arbitration award, Alii adjusted the arbitration liability recorded at June 30, 2007, to $500,000.

Operating Lease Agreement – Hilo Medical Center — Effective July 1, 2007, Hilo Medical Center entered into a lease and related sublease agreement for a medical building. Future minimum lease payments and sublease receipts at July 1, 2007, were as follows:

Years Ending June 30	Lease Payments	Sublease Receipts
2008	$ 613,230	$ 181,981
2009	733,200	181,981
2010	733,200	181,981
2011	755,040	187,174
2012	776,880	192,580
2013-2017	3,884,400	
Total	$ 7,495,950	$ 925,697

Act 113 – Kahuku Hospital — In June 2007, the State Legislature passed Act 113, H.B. 843. The Act amends Hawaii Revised Statutes 323F to allow for the assimilation of Kahuku Hospital into HHSC in a manner and to an extent that may be negotiated between Kahuku Hospital and HHSC. The Act also specifies that none of the liabilities of Kahuku Hospital shall become the liabilities of HHSC, that HHSC may adjust the levels of services provided by Kahuku Hospital, and that the employees of Kahuku Hospital shall not be considered employees of the State. The Act appropriated $3,900,000 to pay for the costs of assimilating Kahuku Hospital into HHSC and to operate the facility.

From July 1, 2007 through March 13, 2008, HHSC operated Kahuku Hospital under a management agreement between the two parties. HHSC formed a nonprofit corporation, Kahuku Medical Center, to acquire the assets of Kahuku Hospital and to operate the facility. On March 14, 2008, the asset purchase was completed and the facility is now operating as Kahuku Medical Center.

Financing – Maui Memorial Medical Center — On January 7, 2008, Maui Memorial Medical Center received a non-binding commitment from a lender to obtain $11 million in financing for working capital needs, subject to certain conditions. In addition, the facility is also working with the lender to obtain additional financing for a heart, brain and vascular tower, and for other programs.

* * * * * *

HAWAII HEALTH SYSTEMS CORPORATION

SUPPLEMENTAL SCHEDULE OF RECONCILIATION OF CASH ON DEPOSIT WITH THE STATE OF HAWAII
JUNE 30, 2007

	Appropriation Symbol	
CASH ON DEPOSIT WITH THE STATE OF HAWAII:		
SPECIAL FUNDS:		
	S-07-373-H	$ 380,877
	S-07-312-H	736,292
	S-07-355-H	3,656,731
	S-07-365-H	557,862
	S-07-358-H	102,593
	S-07-371-H	625,354
	S-07-353-H	169,223
	S-93-359-H	2,818
	S-96-359-H	2,007
	S-97-359-H	3,556
	S-07-359-H	669,191
	S-07-350-H	2,821,666
	S-07-352-H	170,713
	S-07-351-H	254,364
	S-07-354-H	1,459,352
	S-94-396-H	8,673
	S-95-396-H	19,636
	S-96-396-H	9,039
	S-97-396-H	182
	S-98-396-H	1,687
	S-07-303-H	314,481
TRUST FUNDS:		
	T-04-923-H	4,129
	T-04-921-H	6,679
	T-04-918-H	1,273
TOTAL PER STATE		11,978,378
RECONCILING ITEMS		30,161
TOTAL PER HHSC		$ 12,008,539

(Continued)

HAWAII HEALTH SYSTEMS CORPORATION

SUPPLEMENTAL SCHEDULE OF RECONCILIATION OF CASH ON DEPOSIT WITH THE STATE OF HAWAII
JUNE 30, 2007

	Appropriation Symbol	
ASSETS LIMITED AS TO USE:		
PATIENT TRUST FUNDS:		
	T-07-365-H	$ 22,912
	T-06-915-H	12,763
	T-04-919-H	1,044
	T-07-925-H	102,650
	T-07-926-H	12,197
TOTAL PER STATE		151,566
RECONCILING ITEMS:		
Patients' safekeeping deposits held by financial institutions		256,188
Restricted assets held by financial institutions		3,292,473
Escrow fund receivable		610,250
Other		(1,643)
TOTAL PER HHSC		$4,308,834

(Concluded)

HAWAII HEALTH SYSTEMS CORPORATION

SUPPLEMENTAL COMBINING AND CONSOLIDATING STATEMENT OF NET ASSETS INFORMATION
JUNE 30, 2007

Facilities

ASSETS	Hilo Medical Center	Hale Ho'ola Hamakua	Ka'u Hospital	Yukio Okutsu Veterans Care Home — Hilo	Kona Community Hospital	Kohala Hospital	Maui Memorial Medical Center	Kula Hospital
CURRENT ASSETS:								
Cash and cash equivalents:								
On deposit with the State of Hawaii	$ 2,821,666	$ 255,637	$ 177,392	$ -	$ 1,459,352	$ 169,223	$ 3,656,731	$ 625,354
On deposit with banks on hand	305,685	11,616	45,152		168,334	37,650	87,493	10,374
Patient accounts receivable — less allowances for contractual adjustments and doubtful accounts	14,016,134	513,986	585,431		7,131,128	674,828	26,462,574	2,471,627
Due from Medicaid for Act 294	642,000	381,000			847,000			530,000
Federal grant receivable				2,243,901				
Supplies and other current assets	2,509,953	112,539	35,448		2,264,146	41,679	4,604,773	294,690
Total current assets	20,295,438	1,274,778	843,423	2,243,901	11,869,960	923,380	34,811,571	3,932,045
DUE FROM AFFILIATES — Net								
CAPITAL ASSETS — Net	39,439,166	13,342,781	1,127,658	26,178,892	26,782,408	1,855,968	101,436,071	4,144,537
ASSETS LIMITED AS TO USE	37,179	17,031	5,378	1,495,237	67,259	5,137	123,913	99,654
RESTRICTED CASH								
OTHER ASSETS	1,744,445	35,674	29,868		610,647	34,245	885,806	24,885
TOTAL	$ 61,516,228	$ 14,670,264	$ 2,006,327	$ 29,918,030	$ 39,330,274	$ 2,818,730	$ 137,257,361	$ 8,201,121

ASSETS	Lanai Community Hospital	Leahi Hospital	Maluhia	Kauai Veterans Memorial Hospital	Samuel Mahelona Memorial Hospital	Total Facilities
CURRENT ASSETS:						
Cash and cash equivalents:						
On deposit with the State of Hawaii	$ 102,593	$ 768,803	$ 557,862	$ 681,701	$ 380,877	$ 11,657,191
On deposit with banks on hand	3,186	100,771	79,252	659,215	66,304	1,575,032
Patient accounts receivable — less allowances for contractual adjustments and doubtful accounts	308,786	2,457,392	1,841,382	3,700,336	1,845,923	62,009,527
Due from Medicaid for Act 294		1,231,000	1,076,000		205,000	4,912,000
Federal grant receivable						2,243,901
Supplies and other current assets	98,568	954,858	616,451	1,077,385	147,256	12,757,746
Total current assets	513,133	5,512,824	4,170,947	6,118,637	2,645,360	95,155,397
DUE FROM AFFILIATES — Net						
CAPITAL ASSETS — Net	863,824	4,826,946	4,943,366	14,278,276	5,451,792	244,671,685
ASSETS LIMITED AS TO USE		131,678	78,338	42,935	63,683	2,167,422
RESTRICTED CASH						
OTHER ASSETS				191,417		3,556,987
TOTAL	$ 1,376,957	$ 10,471,448	$ 9,192,651	$ 20,631,265	$ 8,160,835	$ 345,551,491

ASSETS	Corporate	Reclassifi- cations and Eliminations	HHSC Combined	Hawaii Health Systems Foundation	Alii Community Care	Reclassifi- cations and Eliminations	HHSC Consolidated
CURRENT ASSETS:							
Cash and cash equivalents:							
On deposit with the State of Hawaii	$ 351,348	$ -	$ 12,008,539	$ -	$ -	$ -	$ 12,008,539
On deposit with banks on hand	11,740,784		13,315,816	709,056	290,387		14,315,259
Patient accounts receivable — less allowances for contractual adjustments and doubtful accounts			62,009,527				62,009,527
Due from Medicaid for Act 294			4,912,000				4,912,000
Federal grant receivable			2,243,901				2,243,901
Supplies and other current assets	10,631		12,768,377		45,435		12,813,812
Total current assets	12,102,763		107,258,160	709,056	335,822		108,303,038
DUE FROM AFFILIATES — Net	273,407,548	(262,686,172)	10,721,376			(10,721,376)	
CAPITAL ASSETS — Net	8,288,982		252,960,667		196,536		253,157,203
ASSETS LIMITED AS TO USE			2,167,422	29,396	1,766		2,198,584
RESTRICTED CASH	2,110,250		2,110,250				2,110,250
OTHER ASSETS	97,822		3,654,809			(97,822)	3,556,987
TOTAL	$ 296,007,365	$ (262,686,172)	$ 378,872,684	$ 738,452	$ 534,124	$ (10,819,198)	$ 369,326,062

HAWAII HEALTH SYSTEMS CORPORATION

SUPPLEMENTAL COMBINING AND CONSOLIDATING STATEMENT OF NET ASSETS INFORMATION
JUNE 30, 2007

ASSETS LIABILITIES AND NET ASSETS (DEFICIT)	Facilities: Hilo Medical Center	Hale Ho'ola Hamakua	Ka'u Hospital	Yukio Okutsu Veterans Care Home — Hilo	Kona Community Hospital	Kohala Hospital	Maui Memorial Medical Center	Kula Hospital	Lanai Community Hospital	Leahi Hospital
CURRENT LIABILITIES										
Accounts payable and accrued expenses	$ 14,721,201	$ 505,865	$ 546,381	$ 1,185,618	$ 7,908,976	$ 460,149	$ 21,607,746	$ 1,203,123	$ 669,078	$ 1,463,158
Accrued workers' compensation liability	4,799,254	696,000	162,000		2,307,000	253,000	4,692,000	1,785,000	129,000	1,253,373
Current portion of capital lease obligations										
Current portion of accrued vacation	2,085,154	237,412	109,980		1,360,588	172,907	2,842,797	518,336	89,135	1,055,284
Current portion of long-term debt	288,112									
Other current liabilities	208,236		354		5,072					
Estimated third-party payor settlements	1,850,726	(912,679)	(413,675)		401,852	(781,351)	2,852,706	(149,536)	(463,222)	53,389
Advance from the State of Hawaii										
Total current liabilities	23,952,683	526,598	405,040	1,185,618	11,983,488	104,705	31,995,249	3,356,923	423,991	3,825,204
CAPITAL LEASE OBLIGATIONS — Less current portion										
LONG-TERM DEBT — Less current portion	9,468,007									
ACCRUED VACATION — Less current portion	5,239,712	466,514	198,165		2,661,561	190,743	5,733,072	1,189,716	161,965	1,189,477
DUE TO AFFILIATES — Net	57,524,291	3,892,996	9,551,871	276,909	41,744,651	8,919,476	5,010,195	19,008,231	11,219,742	13,586,093
DUE TO THE STATE OF HAWAII		506,153			7,605,205	528,149		1,114,264		6,416,791
PATIENTS' SAFEKEEPING DEPOSITS AND DEFERRED INCOME — Restricted contributions	37,179	17,031	5,378		6,505	5,137		99,654		131,678
OTHER LIABILITIES	7,802						9,770			
Total liabilities	96,229,674	5,409,292	10,160,454	1,462,527	64,001,410	9,748,210	42,748,286	24,768,788	11,805,698	25,149,243
NET ASSETS:										
Invested in capital assets — net of related debt	29,683,047	13,342,781	1,093,735	24,993,274	26,769,227	1,855,968	101,373,233	4,144,537	829,374	4,803,934
Unrestricted	(64,396,493)	(4,081,809)	(9,247,862)	908,709	(51,501,117)	(8,785,448)	(6,988,071)	(20,712,204)	(11,258,115)	(19,481,729)
Temporarily restricted				2,553,520	60,754		123,913			
Total net assets	(34,713,446)	9,260,972	(8,154,127)	28,455,503	(24,671,136)	(6,929,480)	94,509,075	(16,567,667)	(10,428,741)	(14,677,795)
TOTAL	$ 61,516,228	$ 14,670,264	$ 2,006,327	$ 29,918,030	$ 39,330,274	$ 2,818,730	$ 137,257,361	$ 8,201,121	$ 1,376,957	$ 10,471,448

ASSETS LIABILITIES AND NET ASSETS (DEFICIT)	Facilities: Maluhia	Kauai Veterans Memorial Hospital	Samuel Mahelona Memorial Hospital	Total Facilities	Corporate	Reclassifi- cations and Eliminations	HHSC Combined	Hawaii Health Systems Foundation	Alii Community Care	Reclassifi- cations and Eliminations	HHSC Consolidated
CURRENT LIABILITIES											
Accounts payable and accrued expenses	$ 1,178,941	$ 2,486,271	$ 877,351	$ 54,813,858	$ 3,524,431	$ -	$ 58,338,289	$ -	$ 728,258	$ 792	$ 59,067,339
Accrued workers' compensation liability	981,220	1,001,785	540,572	18,600,204	420,000		19,020,204				19,020,204
Current portion of capital lease obligations					7,179,538		7,179,538				7,179,538
Current portion of accrued vacation	711,912	1,081,372	148,497	10,413,374	271,287		10,684,661				10,684,661
Current portion of long-term debt		66,684		354,796	483,952		838,748				838,748
Other current liabilities		71,998		285,660			285,660	283,306	311,095		880,061
Estimated third-party payor settlements		19,932	(1,356,148)	1,101,994			1,101,994				1,101,994
Advance from the State of Hawaii					10,000,000		10,000,000				10,000,000
Total current liabilities	2,872,073	4,728,042	210,272	85,569,886	21,879,208		107,449,094	283,306	1,039,353	792	108,772,545
CAPITAL LEASE OBLIGATIONS — Less current portion					35,091,398		35,091,398				35,091,398
LONG-TERM DEBT — Less current portion				9,468,007	1,306,096		10,774,103				10,774,103
ACCRUED VACATION — Less current portion	1,061,966	509,731	1,196,506	19,799,128	779,684		20,578,812				20,578,812
DUE TO AFFILIATES — Net	23,995,501	49,124,458	18,831,758	262,686,172		(262,686,172)		357,674	10,364,494	(10,722,168)	
DUE TO THE STATE OF HAWAII	491,450	1,043,345	2,417,150	20,122,507	14,000,000		34,122,507				34,122,507
PATIENTS' SAFEKEEPING DEPOSITS AND DEFERRED INCOME — Restricted contributions	53,803	11,281	25,799	393,445			393,445		1,766		395,211
OTHER LIABILITIES	13,296	48,726	10,620	90,214	217,380		307,594				307,594
Total liabilities	28,488,089	55,465,583	22,692,105	398,129,359	73,273,766	(262,686,172)	208,716,953	640,980	11,405,613	(10,721,376)	210,042,170
NET ASSETS:											
Invested in capital assets — net of related debt	4,836,677	14,192,066	5,451,792	233,369,645	(35,772,002)		197,597,643		196,536		197,794,179
Unrestricted	(24,156,650)	(49,058,038)	(20,020,946)	(288,779,773)	258,505,601		(30,274,172)	68,076	(11,068,025)	(97,822)	(41,371,943)
Temporarily restricted	24,535	31,654	37,884	2,832,260			2,832,260	29,396			2,861,656
Total net assets	(19,295,438)	(34,834,318)	(14,531,270)	(52,577,868)	222,733,599		170,155,731	97,472	(10,871,489)	(97,822)	159,283,892
TOTAL	$ 9,192,651	$ 20,631,265	$ 8,160,835	$ 345,551,491	$ 296,007,365	$ (262,686,172)	$ 378,872,684	$ 738,452	$ 534,124	$ (10,819,198)	$ 369,326,062

HAWAII HEALTH SYSTEMS CORPORATION

SUPPLEMENTAL COMBINING AND CONSOLIDATING STATEMENT OF REVENUES, EXPENSES, AND CHANGES IN NET ASSETS INFORMATION

YEAR ENDED JUNE 30, 2007

	Facilities																				
	Hilo Medical Center	Hale Ho'ola Hamakua	Ka'u Hospital	Yukio Okutsu Veterans Care Home — Hilo	Kona Community Hospital	Kohala Hospital	Maui Memorial Medical Center	Kula Hospital	Lanai Community Hospital	Leahi Hospital	Maluhia	Kauai Veterans Memorial Hospital	Samuel Mahelona Memorial Hospital	Total Facilities	Corporate	Reclassifi-cations and Eliminations	HHSC Combined	Hawaii Health Systems Foundation	Alii Community Care	Reclassifi-cations and Eliminations	HHSC Consolidated
OPERATING REVENUES																					
Net patient service revenue	$ 95,010,265	$ 7,662,074	$ 4,249,286	$ -	$ 42,998,842	$ 4,150,974	$ 126,273,047	$ 14,309,508	$ 2,154,069	$ 18,292,637	$ 14,894,334	$ 21,219,249	$ 10,547,625	$ 361,761,910	$ -	$ -	$ 361,761,910	$ -	$ -	$ -	$ 361,761,910
Other revenues	664,314	22,049	13,659		426,411	17,631	1,135,754	103,048	18,153	345,735	54,344	283,988	44,456	3,129,542		(13,020)	3,116,522		2,522,996		5,639,518
Total operating revenues	95,674,579	7,684,123	4,262,945	-	43,425,253	4,168,605	127,408,801	14,412,556	2,172,222	18,638,372	14,948,678	21,503,237	10,592,081	364,891,452	-	(13,020)	364,878,432	-	2,522,996	-	367,401,428
OPERATING EXPENSES																					
Salaries and benefits	65,559,182	5,804,229	3,682,540		33,474,727	3,458,347	81,774,778	13,485,258	2,019,152	16,909,583	12,975,482	14,229,381	9,200,681	262,573,340	6,665,856		269,239,196	16,222			269,255,418
Purchased services	14,197,158	943,639	840,517		5,911,405	723,895	17,615,626	1,562,220	915,011	684,498	753,451	5,494,995	1,316,282	50,958,697	164,392	(350,154)	50,772,935	1,199	14,976		50,789,110
Medical supplies and drugs	13,598,695	188,202	159,739		5,805,982	119,556	19,344,469	422,377	309,623	484,767	320,735	1,574,773	306,277	42,635,195			42,635,195				42,635,195
Depreciation and amortization	3,558,944	496,703	95,046		3,061,786	231,305	6,439,795	338,465	72,683	726,328	314,186	1,430,389	400,729	17,166,359	1,656,946		18,823,305		96,615		18,919,920
Other supplies	3,811,816	331,140	156,953		1,248,923	136,113	5,289,934	999,244	93,613	973,570	745,062	836,851	527,731	15,150,950	145,491		15,296,441	1,836	237,543		15,535,820
Repairs and maintenance	2,915,222	485,341	30,495		2,741,540	88,219	2,043,649	173,465	33,009	363,537	547,111	477,002	76,206	9,974,796	272,027		10,246,823		30,435		10,277,258
Utilities	1,475,688	593,866	104,482		1,181,730	121,942	3,129,492	265,698	85,721	665,230	426,893	838,420	368,907	9,258,069	87,770		9,345,839		262,005		9,607,844
Professional fees	627,310	32,675	13,227	3,800	575,179	110,791	1,317,691	56,959	71,169	47,373	35,912	483,033	373,010	3,748,129	746,635		4,494,764		1,733,334		6,228,098
Insurance	1,760,690	128,060	157,204		551,091	57,754	1,651,832	365,685	30,312	445,518	389,295	399,436	97,773	6,034,650	16,843		6,051,493		84,993		6,136,486
Rent and lease	726,430	22,597	30,223		383,464	21,712	1,997,750	21,038	7,218	17,110	25,921	477,723	32,976	3,764,162	63,150	(32,723)	3,794,589	555	1,663,661		5,458,805
Other	1,101,793	46,073	119,385		668,103	31,072	1,470,304	95,384	41,049	107,705	440,560	445,789	404,387	4,971,604	229,672		5,201,276	7,009	(1,305,970)		3,902,315
Total operating expenses	109,332,928	9,072,525	5,389,811	3,800	55,603,930	5,100,706	142,075,320	17,785,793	3,678,560	21,425,219	16,974,608	26,687,792	13,104,959	426,235,951	10,048,782	(382,877)	435,901,856	26,821	2,817,592	-	438,746,269
INCOME (LOSS) FROM OPERATIONS	(13,658,349)	(1,388,402)	(1,126,866)	(3,800)	(12,178,677)	(932,101)	(14,666,519)	(3,373,237)	(1,506,338)	(2,786,847)	(2,025,930)	(5,184,555)	(2,512,878)	(61,344,499)	(10,048,782)	369,857	(71,023,424)	(26,821)	(294,596)	-	(71,344,841)
NONOPERATING REVENUES AND EXPENSES:																					
General operating appropriations from State of Hawaii															34,154,041		34,154,041				34,154,041
Collective bargaining pay raise appropriation from State of Hawaii	3,701,113	313,584	154,280		1,905,510	184,657	4,515,620	710,134	131,693	932,023	743,831	717,575	426,620	14,436,640	149,140		14,585,780				14,585,780
Restricted contributions		10,681	16,477		319,592		(339)					12,436	347	359,194			359,194	10,000			369,194
Interest and dividend income	5,533		83		5,188		7,057			34,625	16,104	208	3,137	71,935	782,191		854,126	22,610	1,541		878,277
Interest expense (net of capitalized interest)	(545,494)	(342)			(92,434)	(3,524)	(75,116)	(157)		(73)		(6,031)	8	(723,163)	(1,512,860)		(2,236,023)				(2,236,023)
Corporate allocation expense	(3,012,296)	(248,957)	(148,236)		(1,511,321)	(134,934)	(3,897,906)	(497,757)	(104,180)	(589,925)	(494,046)	(728,507)	(360,309)	(11,728,374)	11,728,374						
Other nonoperating revenues (expenses) — net	898,979	183,372	11,818		239,790	50,653	30,298	92,600	45,779	(32,706)	(71,145)	239,826	258,067	1,947,331	(43,255)	(369,857)	1,534,219	(132,101)			1,402,118
Nonoperating revenues (expenses) — net	1,047,835	258,338	34,422	-	866,325	96,852	579,614	304,820	73,292	343,944	194,744	235,507	327,870	4,363,563	45,257,631	(369,857)	49,251,337	(99,491)	1,541	-	49,153,387
INCOME (LOSS) BEFORE CAPITAL CONTRIBUTIONS, TRANSFERS, AND SPECIAL ITEM	(12,610,514)	(1,130,064)	(1,092,444)	(3,800)	(11,312,352)	(835,249)	(14,086,905)	(3,068,417)	(1,433,046)	(2,442,903)	(1,831,186)	(4,949,048)	(2,185,008)	(56,980,936)	35,208,849		(21,772,087)	(126,312)	(293,055)		(22,191,454)
CAPITAL GRANTS AND CONTRIBUTIONS	1,790,573	684,000		23,424,481	297,000	74,258	10,897,454	58,000		114,461	331,464	328,766	714,824	38,715,281			38,715,281				38,715,281
INCREASE (DECREASE) IN NET ASSETS	$ (10,819,941)	$ (446,064)	$ (1,092,444)	$ 23,420,681	$ (11,015,352)	$ (760,991)	$ (3,189,451)	$ (3,010,417)	$ (1,433,046)	$ (2,328,442)	$ (1,499,722)	$ (4,620,282)	$ (1,470,184)	$ (18,265,655)	$ 35,208,849	$ -	$ 16,943,194	$ (126,312)	$ (293,055)	$ -	$ 16,523,827

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INDEPENDENT AUDITORS' REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING AND ON COMPLIANCE AND OTHER MATTERS BASED ON AN AUDIT OF FINANCIAL STATEMENTS PERFORMED IN ACCORDANCE WITH *GOVERNMENT AUDITING STANDARDS*

Board of Directors of
Hawaii Health Systems Corporation:

We have audited the consolidated financial statements of Hawaii Health Systems Corporation (HHSC) as of and for the year ended June 30, 2007, and have issued our report thereon dated April 7, 2008. 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 as a basis for designing our auditing procedures for the purpose of expressing our opinion on the consolidated financial statements, but not for the purpose of expressing an opinion on the effectiveness of HHSC's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of HHSC's internal control over financial reporting.

Our consideration of the internal control over financial reporting was for the limited purpose described in the preceding paragraph and would not necessarily identify all deficiencies in internal control over financial reporting that might be significant deficiencies or material weaknesses. However, as discussed below, we identified certain deficiencies in internal control over financial reporting that we would consider to be significant deficiencies.

A *control deficiency* exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis. A *significant deficiency* is a control deficiency, or combination of control deficiencies, that adversely affects the entity's ability to initiate, authorize, record, process, or report financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the entity's financial statements that is more than inconsequential will not be prevented or detected by the entity's internal control. We consider the deficiencies described in the accompanying schedule of findings and responses to be significant deficiencies in internal control over financial reporting.

A *material weakness* is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected by the entity's internal control.

Our consideration of the internal control over financial reporting was for the limited purpose described in the first paragraph of this section and would not necessarily identify all deficiencies in the internal control that might be significant deficiencies and, accordingly, would not necessarily disclose all significant deficiencies that are also considered to be material weaknesses. However, we believe that none of the significant deficiencies described is a material weakness.

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 grant agreements, 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 or other matters that are required to be reported under *Government Auditing Standards*.

We noted certain matters that we reported to management of HHSC in a separate letter dated April 7, 2008.

HHSC is still studying the findings identified in our audit, and accordingly, has not yet provided its response.

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

April 7, 2008

KA'U HOSPITAL

Ka'u 2007-1 Account Reconciliations

Criteria — The accounting for inventory, capital assets, accounts payable, accrued payroll and accrued vacation was not recorded properly, and reconciliations were not reviewed timely.

Condition — The facility did not update its accounting records as of June 30, 2007 for inventory, accrued payroll and accrued vacation. In addition, a duplicate payment was made for a capital asset purchase and accounts payable were not properly accrued at year-end.

Cause — During fiscal 2007, the facility lost its accountant, and was not able to find a replacement before year-end. An accountant at the Hilo Medical Center temporarily assisted in the closing of the facility's records at June 30, 2007.

Effect — Adjustments of the following amounts were made to the facility's June 30, 2007 records:

Inventory – $36,000 reduction

Capital Assets – $4,000 reclass to receivable

Accounts Payable – $7,000 unrecorded accounts payable

Accrued Payroll – $54,000 unrecorded accrued payroll

Accrued Vacation – $17,000 unrecorded accrued vacation

Recommendation — Hire an accountant as soon as possible, and ensure that reviews of account reconciliations are performed timely.

MAUI MEMORIAL MEDICAL CENTER

MMMC 2007-1 Capital Assets

Criteria — The capital asset detail should be updated, reconciled to the general ledger and reviewed by management on a timely basis.

Condition — The facility had designed internal controls over the recording of capital assets and depreciation; however, the internal controls were not implemented properly during the year. Capital assets that were completed during the year were not reclassified from construction-in-progress timely, and the capital asset detail was not updated timely.

Cause — The individual responsible for the reconciliation of the capital asset account balances did not perform their assigned tasks on a timely basis. As such, this caused a delay in the updating of the capital asset detail, the reconciling of the detail to the general ledger, the reclassifying of construction-in-progress, and the recording of depreciation on completed items.

Effect — An audit adjustment of approximately $710,000 was recorded to reclassify certain capital assets to the appropriate capital asset category, and an audit adjustment of $687,000 was recorded to reflect depreciation expense and accumulated depreciation on the completed items.

Recommendation — Ensure that capital asset details are updated and reconciled to the general ledger control accounts on a timely basis. Management reviews of assets remaining in construction-in-progress should also be performed periodically throughout the year.

KAUAI VETERANS MEMORIAL HOSPITAL

KVMH 2007-1 Administrative and Bad Debt Allowances

Criteria — The administrative and bad debt allowances for patient receivables should be calculated and reviewed by management on a timely basis.

Condition — The facility had designed internal controls over the recording of administrative and bad debt allowances for patient receivables; however, the internal controls were not implemented properly at year-end. The facility's management had requested the assistance of HHSC's Corporate Office personnel to prepare the initial calculations of the required allowances at year-end. However, after receiving the calculations, management did not adequately review the assumptions used in the calculations, nor did management perform an analysis to test the reasonableness of the allowances as compared to the receivable balances, based on trends, past data, or budgets.

Cause — It appears that the Corporate Office personnel prepared the estimate of the allowances based on the assumptions used in the prior year. However, during the current year, the collections of the hospital, clinic and professional fee receivables decreased substantially, with the resulting aging of receivables increasing accordingly. As a result, the calculated allowances were significantly understated. And, the facility's management did not consider it necessary to test the Corporate Office's calculations.

Effect — An audit adjustment of approximately $1,589,000 was recorded to increase the administrative and bad debt allowances at year-end.

Recommendation — Consider having the Corporate Office personnel instruct the facility's management as to methodology to be used in (1) calculating the administrative and bad debt allowances, and (2) testing the reasonableness of the resulting range of amounts.

SAMUEL MAHELONA MEMORIAL HOSPITAL

SMMH 2007-1 Administrative and Bad Debt Allowances

Criteria — The administrative and bad debt allowances for patient receivables should be calculated and reviewed by management on a timely basis.

Condition — The facility had designed internal controls over the recording of administrative and bad debt allowances for patient receivables; however, the internal controls were not implemented properly at year-end. The facility's management had requested the assistance of HHSC's Corporate Office personnel to prepare the initial calculations of the required allowances at year-end. However, after receiving the calculations, management did not adequately review the assumptions used in the calculations, nor did management perform an analysis to test the reasonableness of the allowances as compared to the receivable balances, based on trends, past data, or budgets.

Cause — It appears that the Corporate Office personnel prepared the estimate of the allowances based on the assumptions used in the prior year. However, during the current year, the collections of the hospital, clinic and professional fee receivables decreased substantially, with the resulting aging of receivables increasing accordingly. As a result, the calculated allowances were significantly understated and the Facility's management did not consider it necessary to test the Corporate Office's calculations.

Effect — An audit adjustment of approximately $378,000 was recorded to increase the administrative and bad debt allowances at year-end.

Recommendation — Consider having the Corporate Office personnel instruct the facility's management as to methodology to be used in (1) calculating the administrative and bad debt allowances, and (2) testing the reasonableness of the resulting range of amounts.

SMMH 2007-2 General Ledger Account Reconciliations

Criteria — All subsidiary records should be reconciled to their general ledger control accounts, and all reconciling differences should be resolved, on a timely basis.

Condition — Substantially all of the significant general ledger accounts had not been reconciled throughout fiscal year 2007.

Cause — Due to the staffing situation at the facility, and based on the priorities placed upon the use of the fiscal personnel's time, the general ledger account reconciliations were not performed throughout the fiscal year.

Effect — Proper internal controls require that the general ledger control accounts be reconciled on a timely basis. Failure to reconcile the accounts increases the possibility of not being able to prevent or detect a material misstatement of the financial statements or misappropriation of assets.

The untimely reconciliation by the facility resulted in post-closing entries affecting over 90 general ledger accounts. And, an audit adjustment of $65,500 was required to properly state cash and payroll expense.

Recommendation — Change the priorities over the use of the fiscal personnel's time to ensure that all subsidiary records are reconciled to their general ledger control accounts on a timely basis, and that all reconciling differences are resolved by the end of the fiscal year.

CORPORATE

Corporate 2007-1 Capital Leases

Criteria — The recording of capital leases should be performed timely.

Condition — The HHSC Corporate Office had designed internal controls over the recording of capital leases; however, the internal controls were not implemented properly during the year. The HHSC Corporate Office negotiates all capital lease arrangements, records the capital lease obligations for all facilities in its accounting records, and informs the facilities of all new leases. The facilities record the related capital assets and accumulated depreciation. However, during 2007, the Corporate Office did not record a capital lease obligation of approximately $1.1 million for equipment used by Hilo Medical Center, although payments were made during the year for this lease. Correspondingly, Hilo Medical Center did not record the related capital asset.

Cause — There has been turnover of the accounting staff at the Corporate Office, and the new accountant was not familiar with the lease schedules, and did not record this new lease.

Effect — An audit adjustment of approximately $1 million was made at the Corporate Office to record the lease obligation, and the same amount was recorded at Hilo Medical Center to record the equipment.

Recommendation — Ensure that new hires are properly trained, and that management reviews of the lease schedules are performed timely.