Hawaii Health Systems Corporation

Consolidated Financial Statements for the
Year Ended June 30, 2008, Supplemental Information
for the Year Ended June 30, 2008,
and Independent Auditors' Reports

HAWAII HEALTH SYSTEMS CORPORATION

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HAWAII HEALTH SYSTEMS CORPORATION

INTRODUCTION

Purpose of the Report

The purpose of this report is to present the consolidated financial statements of Hawaii Health Systems Corporation (HHSC) as of and for the year ended June 30, 2008, 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 year ended June 30, 2008, 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

To the Board of Directors of
Hawaii Health Systems Corporation:

We have audited the accompanying consolidated statement of net assets of Hawaii Health Systems Corporation (HHSC), a component unit of the State of Hawaii, as of June 30, 2008, and the related consolidated statements of revenues, expenses, and changes in net assets and of cash flows for the year then ended. These consolidated financial statements are the responsibility of HHSC's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes 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 audit provides a reasonable basis for our opinion.

In our opinion, such consolidated financial statements present fairly, in all material respects, the financial position of HHSC at June 30, 2008, and the results of its operations and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

The accompanying consolidated financial statements have been prepared assuming that HHSC will continue as a going concern. As discussed in Note 1 to the consolidated financial statements, HHSC's recurring losses from operations, recurring negative operating cash flows, and its difficulty in generating sufficient cash flow to meet its obligations and sustain its operations, raise substantial doubt about its ability to continue as a going concern. Management's plans concerning these matters are also discussed in Note 1 to the consolidated financial statements. The consolidated financial statements do not include any adjustments that might result from the outcome of this uncertainty.

As discussed in Note 2 of the consolidated financial statements, HHSC adopted the provisions of Governmental Accounting Standards Board Statement No. 45, *Accounting and Financial Reporting for Postemployment Benefits Other Than Pensions*, on July 1, 2007.

As discussed in Note 2 to the consolidated financial statements, HHSC changed its method of accounting for state appropriations effective July 1, 2007.

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, 2008, negotiations between the State and HHSC relating to the transfer of assets and liabilities (including amounts due to the State) still had not been finalized. Accordingly, the assets, liabilities and net assets reflected in the accompanying consolidated statement of net assets at June 30, 2008, may be significantly different from those eventually included in the final settlement.

In accordance with *Government Auditing Standards*, we have also issued our report dated May 15, 2009, 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.

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

Our audit was conducted for the purpose of forming an opinion on the basic consolidated 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 42 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 consolidated 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 consolidated financial statements and, in our opinion, is fairly stated in all material respects when considered in relation to the basic consolidated financial statements taken as a whole.

Deloitte + Touche LLP

May 15, 2009

HAWAII HEALTH SYSTEMS CORPORATION

MANAGEMENT'S DISCUSSION AND ANALYSIS
YEAR ENDED JUNE 30, 2008

Overview of the Financial Statements

This discussion and analysis are intended to serve as an introduction to Hawaii Health Systems Corporation's (HHSC) 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. 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 statement of net assets as of June 30, 2008, is as follows:

ASSETS	
Current assets	$ 144,830,380
Capital assets — net	284,142,914
Other assets	7,364,016
Total assets	$ 436,337,310
LIABILITIES	
Current liabilities	$ 137,018,943
Capital lease obligations — less current portion	31,996,813
Long-term debt — less current portion	28,451,038
Accrued vacation — less current portion	19,606,026
Other postemployment benefit liability	30,249,692
Due to the State of Hawaii	34,122,507
Other liabilities	662,099
Total liabilities	282,107,118
NET ASSETS	
Invested in capital assets — net of related debt	198,283,269
Restricted — primarily for capital acquisitions	2,116,477
Unrestricted	(46,169,554)
Total net assets	154,230,192
Total liabilities and net assets	$ 436,337,310

At June 30, 2008, HHSC's capital assets, net of accumulated depreciation, comprised approximately 65% 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 million is due to property additions of $51.4 million, offset by depreciation expense of $20.3 million and retirements of $.1 million. The primary reason for the increase is due to the acquisition of Roselani Place for $16 million (see Note 15), the acquisition of medical equipment, information systems, and architectural fees for a new surgery area and modifications to the existing surgery room at Kauai Veterans Memorial Hospital of $4 million funded through HHSC's municipal leasing lines of credit, State-funded capital improvement projects of $16 million, and federal funded capital improvement projects of the Yukio Okutsu Veterans Care Home of $2.2 million. The State-funded capital improvement projects consisted primarily of construction costs for the Phase I expansion of Maui Memorial Medical Center (MMMC) and the emergency room expansions at Hilo Medical Center (HMC) and MMMC.

A summary of HHSC's capital assets as of June 30, 2008, is as follows:

Land and land improvements	$ 7,139,880
Buildings and improvements	320,063,549
Equipment	149,573,318
Construction in progress	28,445,947
	505,222,694
Less accumulated depreciation and amortization	(221,079,780)
Capital assets — net	$ 284,142,914

At June 30, 2008, HHSC's current assets approximated 33% of total assets. Current assets increased $36.5 million from the fiscal year 2007 balance due to an increase in cash and cash equivalents, amounts due from the State of Hawaii, and estimated third party payor settlements offset by a decrease in federal grants receivable and patient accounts receivable. The increase in cash and cash equivalents of $7.5 million is primarily due to the receipt of an emergency appropriation of $14 million in May 2008, which significantly increased the cash balances of Hilo Medical Center, Kauai Veterans Memorial Hospital, Leahi Hospital, and Maluhia. The increase is also due to the receipt of $11 million in loan proceeds by Maui Memorial Medical Center in April 2008. The amounts due from the State of Hawaii of $25.9 million represents the outstanding balance of allotments, claims, and encumbrances relating to HHSC's State-funded construction in progress projects, and is reported in the consolidated statements of net assets as of June 30, 2008 because of a change in accounting principle mandated by the State of Hawaii. The increase in estimated third party payor settlements receivable of $10.1 million is primarily due to $5.3 million in receivables for fiscal year 2007 cost reports and $6 million in receivables for fiscal year 2008 cost report settlements from Medicaid for HHSC's critical access hospitals. The decrease in federal grants receivables of $2.2 million is due to contributions from the Department of Veteran Affairs that were received by HHSC in July 2007. The decrease in patient accounts receivable of $4.5 million is primarily due to an increase in management's estimate of the allowance for doubtful accounts. Cash collections for the year ended June 30, 2008 were $381 million, as compared to cash collections for the year ended June 30, 2007 of $354.7 million. Despite the increase in cash collections, the collections efforts at HHSC's acute care facilities (primarily Hilo Medical Center and Maui Memorial Medical Center) were not able to keep up with the increase in receivables, particularly from third-party payors. Management performed a study of the collectability of those accounts receivable outstanding from June 30, 2008, and determined that subsequent collections activity on those accounts were poor. As evidence of the reduced collections performance, two of HHSC's revenue cycle key performance indicators, third-party accounts receivable greater than 90 days outstanding and third-party accounts receivable greater than 180 days outstanding, indicate that Hilo Medical Center and Maui Memorial Medical Center experienced significant growth in aged third-party accounts receivable. During fiscal year 2008, Hilo Medical Center's third party accounts receivable greater than 90 days outstanding grew from 22% at the beginning of the year to 34% at the end of the year; while its third-party accounts receivable greater than 180 days outstanding grew from 15% at the beginning of the year to 23% at the end of the year. During fiscal year 2008, Maui Memorial Medical Center's third party accounts receivable greater than 90 days outstanding grew from 16% at the beginning of the year to 26% at the end of the year; while its third-party accounts receivable greater than 180 days outstanding grew from 10% at the beginning of the year to 13% at the end of the year.

At June 30, 2008, HHSC's current liabilities approximated 49% of total liabilities. The primary reason for the increase from fiscal year 2007 is due to increases in accounts payable and accrued expenses and an increase in the current portion of capital leases and long-term debt. Accounts payable and accrued expenses at June 30, 2008, increased by $20.7 million from June 30, 2007, primarily due to an increase of $16 million in accounts payable, resulting from the cash flow shortfalls experienced by HHSC during fiscal year 2008, and the

incurrence of $2.1 million in accounts payable and accrued expenses from the initial year of operations for Yukio Okutsu Veterans Care Home. Also, in April 2008, Maui Memorial Medical Center received an $11 million taxable revolving line of credit loan facility from JP Morgan Chase Bank, N.A. for working capital purposes. The loan requires quarterly interest payments at LIBOR plus 175 basis points, with any unpaid principal amounts due in April 2011. The loan contains several covenants, including a liquidity covenant of a minimum of 30 days of cash on hand, debt to capitalization ratio, and debt coverage ratio. At June 30, 2008, MMMC was in violation of the liquidity covenant requiring a minimum of 30 days cash on hand and the debt to capitalization ratio. Management is working on obtaining a waiver of the covenant, however as a waiver has not been received, the loan has been classified as a current liability in the consolidated statement of net assets.

At June 30, 2008, HHSC's total capital lease obligation balance decreased approximately $2.3 million from fiscal year 2007 due to scheduled payments, excluding new leases.

At June 30, 2008, 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 $9.8 million, 2) a mortgage note payable relating to the acquisition of nursing cottages on the MMMC campus with a remaining balance of approximately $864,000, 3) a line of credit to operate the Veterans Home with a remaining balance of approximately $1.6 million, 4) a bridge loan of $4 million to pay for the planning and design of a new surgery area and modifications of the existing surgery room at the KVMH, 5) a taxable revolving line of credit facility of $11 million for working capital purposes, 6) a mortgage note payable relating to the acquisition of Roselani Place with a remaining balance of approximately $16.5 million, 7) a line of credit to KVMH with a remaining balance of $200,000, 8) a term loan with a remaining balance of approximately $442,000, and 9) a loan payable by the Veterans Home with a remaining balance of approximately $17,000.

At June 30, 2008, the portion of HHSC's net assets that is reflected as its investment in capital assets, net of related debt, of approximately $198.3 million, and restricted net assets of $2.1 million are larger than the total net assets of approximately $154.2 million. This means that HHSC's net operations since inception have resulted in losses of approximately $46.2 million.

Consolidated Statement 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 year ended June 30, 2008, is as follows:

Operating expenses:	
Salaries and benefits	$ 334,660,708
Purchased services and professional fees	57,413,345
Medical supplies and drugs	54,651,116
Depreciation and amortization	20,297,151
Insurance	4,923,601
Other	51,612,945
Total operating expenses	523,558,866
Operating revenues	392,901,641
Loss from operations	(130,657,225)
Nonoperating revenues:	
General appropriations from State of Hawaii	68,701,083
Collective bargaining pay raise appropriation from State of Hawaii	11,194,016
Restricted contributions	1,356,466
Other nonoperating revenues (expenses) — net	2,143,758
Total nonoperating revenues	83,395,323
Loss before capital grants and contributions	(47,261,902)
Capital grants and contributions	11,393,465
Decrease in net assets before change in accounting principle	(35,868,437)
Change in accounting for state appropriations	30,814,737
Decrease in net assets	$ (5,053,700)

For the year ended June 30, 2008, HHSC's operating expenses exceeded its operating revenues by $130.7 million. The appropriations from the State of Hawaii for collective bargaining pay raises of $11.2 million, general fund appropriations from the State of Hawaii of $68.7 million, restricted contributions of $1.4 million, other non-operating revenues-net of $2.1 million, capital grants and contributions from the State of Hawaii and the federal government of $11.4 million, and the change in accounting for state appropriations of $30.8 million resulted in a decrease in net assets of $5 million.

Operating expenses in fiscal year 2008 were approximately 19% higher than fiscal year 2007. The increase was mainly in the category of salaries and benefits, medical supplies and drugs and purchased services expenses. Salaries and benefits expense increased 24% from fiscal year 2007, due primarily to the following factors: 1) collective bargaining pay raises of 2.5% to 5% for HHSC's union employees totaling approximately $11.2 million, 2) implementation of GASB 45 relating to HHSC's share of the State of Hawaii's retiree health insurance liability of $30.2 million, 3) additional salaries and benefits expense from the start of operations for the Yukio Okutsu Veterans Care Home ($1.4 million), Kahuku Medical Center

($1.3 million), and Alii Health Center ($1.2 million), and 4) additional employees hired by HHSC's acute facilities to support clinical operations. Total filled FTE's for all of HHSC increased from 3,753 at June 30, 2007 to 3,896 at June 30, 2008, an increase of 143 FTE's or 3.8%. The largest increases in filled FTE's were at Hilo Medical Center (43 FTE's) and Maui Memorial Medical Center (55 FTE's), primarily to accommodate higher patient volumes. For Maui Memorial Medical Center, acute patient days increased 8% from fiscal year 2007 to fiscal year 2008, and emergency department visits increased 3% from fiscal year 2007 to fiscal year 2008. Also, additional FTE's were hired to staff the new Molokai East wing. For Hilo Medical Center, total admissions increased 5% from fiscal year 2007 to fiscal year 2008, and emergency department visits increased 6% from fiscal year 2007 to fiscal year 2008. Medical supplies and drug expenses increased by $5.5 million, or 11%, from fiscal year 2007 in proportion to the increase in HHSC average daily census. Purchased services increased by $5.5 million due to an increase in on-call payments for physicians, primarily at Maui Memorial Medical Center.

Fiscal year 2008 operating revenues increased by approximately 6.9% over fiscal year 2007 as a result of increases in patient volume and negotiated rate increases from third-party payors. Average daily census increased from 1,088 in fiscal year 2007 to 1,099 in fiscal year 2008, an increase of 11 patients per day, or approximately 1%. The facilities with the largest increases in revenue were Maui Memorial Medical Center (MMMC), Kona Community Hospital (Kona), and Kauai Veterans Memorial Hospital (KVMH). The increase in revenues at MMMC is primarily due to an increase in average daily census of 5.6 patients more per day in fiscal year 2008 than in fiscal year 2007 as a result of opening the Molokai East Med/Surg wing of 19 beds. Emergency room visits also increased by 3% in fiscal year 2008 as compared to fiscal year 2007. Kona operating revenues increased primarily due to an increase in average daily census of 5.41 patients more per day than in fiscal year 2007, or 7.8%. Kona's operating revenues were also lower in fiscal year 2007 due to the loss of revenue from the October 2006 earthquake. Emergency room visits also increased 5% from fiscal year 2007. KVMH operating revenues increased from fiscal year 2007 due to 3.8% increase in average daily census, an increase in emergency department revenue by $1 million as a result of having 1,000 more emergency department visits in fiscal year 2008 than fiscal year 2007, and an increase in radiology revenues of approximately $600,000. Also, the increase in operating revenues is also due to the start of operations of the Yukio Okutsu Veterans Care Home ($694,000 in operating revenue), Kahuku Medical Center ($2.2 million in operating revenue), and Alii Health Center ($2 million in operating revenue).

For the years ended June 30, 2008 and 2007, General Fund Appropriations from the State of Hawaii consisted of $68.7 million and $34.2 million, respectively, approved for HHSC's operating purposes by the 2007 and 2005 Legislatures, respectively.

HHSC's management believes that the significant excess of operating expenses over operating revenues in both 2008 and 2007, 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 2008, 59% 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 2007 "Financial Trends of Hawaii's Hospitals, Nursing Facilities, Home Care and Hospice Providers" presented by the Healthcare Association of Hawaii, Medicare and Medicaid/QUEST pays only 80% 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 2008, HHSC accrued estimated Act 294 relief payments for patient services rendered in fiscal years 2006 through 2008 of $3,786,146. 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, 2007" states that "Medicaid DSH funding financed more than a quarter of the unreimbursed care provided in 2007, while state and local payments financed 33 percent." 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 2007 and 2008 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 for both fiscal years 2008 and 2007. 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 2008 and 2007. 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.

A recent program announced by the Centers for Medicare & Medicaid Services (CMS) is expected to have a significant impact on all health care providers in the near future. CMS has awarded contracts to four Recovery Audit Contractors (RACs) to identify improper payments made on claims of health care services provided to Medicare beneficiaries (either overpayments or underpayments). RACs will be paid on a contingency fee

basis on both the overpayments and underpayments they find. The Tax Relief and Health Care Act of 2006 requires a permanent and national RAC program be in place by January 1, 2010. A demonstration RAC program conducted in California, Florida, New York, Massachusetts, South Carolina, and Arizona resulted in over $900 million in overpayments being returned to the Medicare Trust Fund between 2005 and 2008. It is anticipated that RACs will be investigating Hawaii health care providers sometime after August 1, 2009. Management cannot estimate the impact on the RAC program on HHSC, but believes that any negative impact on cash flows could be significant as the overpayments identified by the RAC are due immediately to the Medicare Trust Fund and any appeals will not be adjudicated until after the funds have been paid to Medicare.

Second, HHSC's facilities on the neighbor islands suffer from an insufficient supply of long-term care beds. For fiscal year 2008, HHSC's long-term care occupancy percentage was 97%, 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. The 2009 Healthcare Association of Hawaii Waitlist Task Force report shows that the net loss per day for waitlisted patients ranges from $724 to $1,087 per day. Combined, HMC and MMMC have an average census of approximately 44 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 64% 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 $9,589,838 for fiscal year 2008. 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 2008, 56% of East Hawaii residents and 63% 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 $9.6 million in fiscal year 2007 to $15.5 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 $5.3 million in fiscal year 2007 and $8.1 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 $986 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. 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.. Management believes that the assimilation of Kahuku Hospital and its subsequent operation as Kahuku Medical Center 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 five regions of the HHSC system, and restructured the HHSC board of directors from a 13-member board to a 15-member board. Further details on the establishment of the regional boards and the impact on the HHSC board of directors can be found in Note 1 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. However, management believes that a realistic transition work group is necessary to capitalize on the Act 290 transition

that has been put into effect. This transition work group would evaluate where HHSC facilities are now, what are the future needs of the communities that HHSC serves, and what is the best way to facilitate HHSC obtaining the authority and tools necessary to get its costs under control while evolving to meet the future needs of the communities. The HHSC Corporate Board and management are committed to working collaboratively with each of the five regions and representatives of the Legislature to establish a new operating model or models for all or portions of the State's community hospital system and to establish plans for a smooth transitioning process for any facility or region that will be restructured. Accordingly, management is supporting enabling legislation that would authorize a facility or regional health care system under HHSC to transition into a new legal entity, including a nonprofit or for-profit corporation, municipal facility, or public benefit corporation. Management believes that such enabling legislation would allow HHSC the flexibility to become more efficient and possibly attract new sources of capital that would alleviate the need for growing general fund subsidies from the State of Hawaii.

Finally, HHSC is a significant provider of health care for the State of Hawaii. For fiscal year 2008, HHSC's facilities accounted for 19.20% 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, 80.87% 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 67.48% 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 STATEMENT OF NET ASSETS
JUNE 30, 2008

ASSETS

CURRENT ASSETS:	
Cash and cash equivalents:	
On deposit with the State of Hawaii	$ 13,060,251
On deposit with banks and on hand (Note 3)	20,778,180
Patient accounts receivable — less allowances of $132,613,558 for contractual adjustments and doubtful accounts	57,479,173
Due from Medicaid for Act 294	3,786,146
Supplies and other current assets	14,857,878
Due from the State of Hawaii (Note 5)	25,876,767
Estimated third-party payor settlements (Note 6)	8,991,985
Total current assets	144,830,380
CAPITAL ASSETS — Net (Notes 4, 7, 8, and 13)	284,142,914
ASSETS LIMITED AS TO USE	2,490,398
OTHER ASSETS (Notes 8 and 11)	4,873,618
TOTAL	$436,337,310

(Continued)

HAWAII HEALTH SYSTEMS CORPORATION

CONSOLIDATED STATEMENT OF NET ASSETS
JUNE 30, 2008

LIABILITIES AND NET ASSETS

CURRENT LIABILITIES:	
Accounts payable and accrued expenses (Note 11)	$ 79,791,668
Accrued workers' compensation liability (Note 14)	18,299,000
Current portion of accrued vacation (Note 7)	14,409,184
Current portion of capital lease obligations (Note 7)	7,974,585
Current portion of long-term debt (Note 8)	15,981,243
Other current liabilities	563,263
Total current liabilities	137,018,943
CAPITAL LEASE OBLIGATIONS — Less current portion (Note 7)	31,996,813
LONG-TERM DEBT — Less current portion (Note 8)	28,451,038
ACCRUED VACATION — Less current portion (Note 7)	19,606,026
OTHER POSTEMPLOYMENT BENEFIT LIABILITY (Note 2)	30,249,692
DUE TO THE STATE OF HAWAII (Note 5)	34,122,507
PATIENTS' SAFEKEEPING DEPOSITS AND DEFERRED INCOME — Restricted contributions	373,921
OTHER LIABILITIES	288,178
Total liabilities	282,107,118
COMMITMENTS AND CONTINGENCIES (Note 14)	
NET ASSETS:	
Invested in capital assets — net of related debt	198,283,269
Restrictions — primarily for capital acquisitions (Note 12)	2,116,477
Unrestricted (Note 3)	(46,169,554)
Total net assets	154,230,192
TOTAL	$ 436,337,310

See notes to consolidated financial statements. (Concluded)

HAWAII HEALTH SYSTEMS CORPORATION

CONSOLIDATED STATEMENT OF REVENUES, EXPENSES, AND CHANGES IN NET ASSETS
YEAR ENDED JUNE 30, 2008

OPERATING REVENUES:	
Net patient service revenues (net of contractual adjustments and provision for doubtful accounts of $422,923,443) (Note 9)	$ 385,396,995
Other operating revenues	7,504,646
Total operating revenues	392,901,641
OPERATING EXPENSES:	
Salaries and benefits (Notes 2, 9, and 10)	334,660,708
Medical supplies and drugs	54,651,116
Purchased services (Notes 9 and 11)	49,788,837
Depreciation and amortization	20,297,151
Other supplies	15,572,964
Utilities	11,968,167
Repairs and maintenance	10,105,730
Professional fees	7,624,508
Rent and lease (Note 14)	5,824,253
Insurance	4,923,601
Other	8,141,831
Total operating expenses	523,558,866
LOSS FROM OPERATIONS	(130,657,225)
NONOPERATING REVENUES (EXPENSES):	
General appropriations from the State of Hawaii	68,701,083
Collective bargaining pay raise appropriation from the State of Hawaii	11,194,016
Noncapital restricted contributions (Note 12)	1,356,466
Interest and dividend income	1,030,747
Interest expense (net of capitalized interest) (Notes 7 and 8)	(4,448,164)
Act 290 appropriation from the State of Hawaii	750,000
Other nonoperating revenues — net (Notes 9 and 11)	4,811,175
Total nonoperating revenues — net	83,395,323
LOSS BEFORE CAPITAL GRANTS AND CONTRIBUTIONS	(47,261,902)
CAPITAL GRANTS AND CONTRIBUTIONS (Notes 4 and 13)	11,393,465
DECREASE IN NET ASSETS BEFORE CHANGE IN ACCOUNTING PRINCIPLE	(35,868,437)
CHANGE IN ACCOUNTING FOR STATE APPROPRIATIONS (Note 2)	30,814,737
DECREASE IN NET ASSETS	(5,053,700)
NET ASSETS — Beginning of year	159,283,892
NET ASSETS — End of year	$ 154,230,192

See notes to consolidated financial statements.

HAWAII HEALTH SYSTEMS CORPORATION

CONSOLIDATED STATEMENT OF CASH FLOWS
YEAR ENDED JUNE 30, 2008

OPERATING ACTIVITIES:	
Receipts from government, insurance, and patients	$ 380,959,224
Payments to employees	(300,135,426)
Payments to suppliers and others	(152,165,074)
Other receipts — net	7,504,646
Net cash used in operating activities	(63,836,630)
NONCAPITAL FINANCING ACTIVITIES:	
Appropriations from the State of Hawaii	80,645,099
Repayment of advance from the State of Hawaii	(10,000,000)
Other nonoperating revenues — net	6,261,282
Net cash provided by noncapital financing activities	76,906,381
CAPITAL AND RELATED FINANCING ACTIVITIES:	
Repayments on capital lease obligations	(7,833,505)
Capital expenditures	(24,312,118)
Payments on long-term debt	(10,338,933)
Interest on capital lease obligations and long-term debt	(4,448,164)
Additions to long-term debt	39,133,704
Proceeds from federal grants	2,243,898
Net cash used in capital and related financing activities	(5,555,118)
NET INCREASE IN CASH AND CASH EQUIVALENTS	7,514,633
CASH AND CASH EQUIVALENTS — Beginning of year	26,323,798
CASH AND CASH EQUIVALENTS — End of year	$ 33,838,431

(Continued)

HAWAII HEALTH SYSTEMS CORPORATION

CONSOLIDATED STATEMENT OF CASH FLOWS
YEAR ENDED JUNE 30, 2008

RECONCILIATION OF LOSS FROM OPERATIONS TO NET CASH USED IN OPERATING ACTIVITIES:	
Loss from operations	$ (130,657,225)
Adjustments to reconcile loss from operations to net cash used in operating activities:	
Provision for doubtful accounts	36,150,026
Depreciation and amortization	20,297,151
Changes in operating assets and liabilities:	
Patient accounts receivable and amounts due from Medicaid for Act 294	(30,493,818)
Supplies and other assets	(2,376,361)
Assets limited as to use	1,818,436
Accounts payable, accrued expenses, and other liabilities	19,238,915
Accrued workers' compensation liability	(721,204)
Postretirement benefits	30,249,692
Estimated third-party payor settlements	(10,093,979)
Accrued vacation	2,751,737
NET CASH USED IN OPERATING ACTIVITIES	$ (63,836,630)
SUPPLEMENTAL CASH FLOW INFORMATION — Interest paid, primarily on capital lease obligations	$ 4,448,164
NONCASH FINANCING AND INVESTING ACTIVITIES:	
Capital assets acquired under capital leases and debt	9,558,626
Capital assets contributed by the State of Hawaii	16,331,444
Other assets contributed by the State of Hawaii	276,403
Capital asset purchases included in accounts payable	2,691,359
Rental income contributed to and equity in earnings of the Clinical Laboratories of Hawaii partnership	751,776

See notes to consolidated financial statements. (Concluded)

1. ORGANIZATION

Structure — 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 15-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 Hoʻola Hamakua
- Kaʻu 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
- Kahuku Medical Center

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, 2008. Accordingly, the assets, liabilities, and net assets of HHSC reflected in the accompanying consolidated statement of net assets may be significantly different from those eventually included in the final settlement.

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.

In June 2007, the State Legislature passed Act 290, S.B. 1792. This Act, which became effective July 1, 2007, required the establishment of a seven to 15-member regional system board of directors for each of the five regions of the HHSC system. Each regional board was given custodial control and responsibility for management of the facilities and other assets in their respective regions. This Act also restructured 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 exempted 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.

Kahuku Medical Center — In June 2007, the State Legislature passed Act 113, H.B. 843. This Act amended Hawaii Revised Statutes 323F to allow for the assimilation of Kahuku Hospital into HHSC in a manner and to an extent that was to be negotiated between Kahuku Hospital and HHSC. The Act also specified that none of the liabilities of Kahuku Hospital were to become the liabilities of HHSC, that HHSC could adjust the levels of services provided by Kahuku Hospital, and that the employees of Kahuku Hospital were not to be considered employees of the State. This Act appropriated $3,900,000, which was disbursed through the Department of Health of the State, to pay for the cost of acquiring the assets of Kahuku Hospital 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 for a purchase price of approximately $2,652,000 in cash, including transaction costs of $197,000 in cash, and the facility is now operating as Kahuku Medical Center. The purchase price was allocated to assets based on their respective estimated fair values at the acquisition date, with the excess purchase price allocated to goodwill. This allocation is subject to finalization of the valuation of certain assets. Approximately $2,178,000 was allocated to capital assets subject to depreciation, $61,000 to supplies, and $413,000 to goodwill, which is being amortized over an estimated useful life of five years. Amortization expense was approximately $10,000 in fiscal 2008.

The results of operations of Kahuku Medical Center are included in HHSC's consolidated financial statements commencing on March 14, 2008. HHSC has not presented unaudited pro forma results of operations because the acquisition of Kahuku Medical Center is not material to its consolidated results of operations, financial position or cash flows.

Going Concern — During the year ended June 30, 2008, HHSC incurred losses from operations of approximately $130.7 million and had negative cash flows from operations of $63.8 million. For fiscal year 2009, HHSC is anticipating continued operating losses, offset by State appropriations for general operations and collective bargaining of $78 million, and an additional $14 million of emergency appropriation, which was approved by the State of Hawaii House of Representatives and the State of Hawaii Senate, and is pending approval by the Governor of the State of Hawaii. Management believes that maintaining the current levels of service that HHSC provides would require increased funding by the State. HHSC projects continued operating losses for fiscal years 2010 and 2011 that will exceed anticipated State of Hawaii appropriation for general operations at $97 million and $84 million, respectively, and the additional $14.7 and $14.5 million for fiscal years 2010 and 2011, respectively, being requested as additional reimbursements from the Department of Human Services through the Medicaid program. At current levels of funding, HHSC is unable to keep current on payments to vendors, as HHSC's days in accounts payable have increased from 73.5 days at June 30, 2007, to 99.6

days at June 30, 2008. HHSC's primary acute care facilities often have critical medical supplies and services vendors placing them on credit hold or cash on delivery status. Further, one of their facilities was unable to comply with certain of its financial covenants on a bank loan. These matters create substantial doubt about HHSC's ability to continue as a going concern.

Management worked with the State of Hawaii legislators and the Governor of the State of Hawaii to seek an increase in general appropriations and/or emergency appropriations as noted above, which was passed in a bill on May 7, 2009 but is currently waiting for the Governor's approval, is meeting with HHSC's vendors to ensure a continual supply of necessary drugs and supplies, and is working with the bank to obtain a waiver for these covenant violations. In addition, as part of the State's 2010-2011 bienium budget, the State of Hawaii Legislature earmarked $500,000 out of the budgeted appropriations for general operations for HHSC to contract a consultant to perform a study on the operational performance of each of HHSC facilities, recommend optimal legal and governance structure, recommend the optimal provision of corporate office services, and establish performance benchmarks. The accompanying consolidated financial statements do not include any adjustments that might result should HHSC be unable to continue as a going concern.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

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

HHSC's consolidated 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 (GAAP) 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, 2008, 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 $20,106,819 at June 30, 2008. 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:

Buildings 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 nonoperating revenues. Normal repairs and maintenance expenses are charged to operations as incurred.

Certain of HHSC's capital improvement projects are managed by the State Department of Accounting and General Services. The related costs for these projects are transferred to HHSC's capital assets accounts and are reflected as revenue below the nonoperating revenues category in 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, 2008, assets limited as to use consisted of restricted cash of $2,490,398.

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.

Postemployment Benefits — HHSC adopted GASB Statement No. 45, *Accounting and Financial Reporting by Employers for Postretirement Benefits Other Than Pensions*, on July 1, 2007. This statement requires accrual-based measurement, recognition, and disclosure of other postemployment benefits (OPEB) expense, such as retiree medical and dental costs, over the employees' years of service, along with the related liability. Previously, HHSC recorded OPEB expenses when they were paid and did not recognize the liability in its consolidated financial statements. The implementation of GASB Statement No. 45 resulted in HHSC recording OPEB expense and a related liability of $30,249,692 as of June 30, 2008.

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 year ended June 30, 2008, was $3.9 million.

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 2008 consolidated financial statements.

The estimated third-party payor settlement receivable of $8,991,985 as of June 30, 2008, is based on estimates, because complete information is not currently available to determine the final settlement amounts for certain cost report years. Management has used its best 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 2007.

- *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 classification system calculated from the Minimum Data Set 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.

- *Critical Access Hospitals* — HHSC has eight facilities (Hale Ho'ola Hamakua, Kauai Veterans Memorial Hospital, Kahuku Medical Center, 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 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.

State Appropriations — Effective July 1, 2007, HHSC changed its accounting policy to comply with the State of Hawaii's directive to recognize general operating and capital appropriations at the time allotments are made available to HHSC for expenditure. Prior to that date, general operating appropriations were recognized on a monthly basis over the year that the appropriations pertained to, and capital appropriations were recognized at the time the State reimbursed HHSC for the expenditures incurred. The effect of the change was to increase net assets at July 1, 2007, by $30,814,737.

General appropriations are reflected as nonoperating revenues and capital appropriations are included in capital grants and contributions after the nonoperating revenues (expenses) subtotal in the consolidated Statement of Revenues, Expenses, and Changes in Net Assets. If restrictions are placed on such appropriations, the restrictions are given separate and discrete accounting recognition.

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 nonoperating expense the interest paid by the State for general obligation bonds whose proceeds were used for hospital construction. A corresponding contribution from the State is also reported as nonoperating 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 year ended June 30, 2008, the amount of bond interest allocated to HHSC was approximately $5,651,000.

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, 2008, was as follows:

Medicare	21 %
Medicaid	17
HMSA	20
Other third-party payors	25
Patients and other	17
	100 %

New Accounting Pronouncements — The following accounting pronouncements will become effective after June 30, 2008:

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 consolidated 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 consolidated financial statements.

GASB Statement No. 53, *Accounting and Financial Reporting for Derivative Instruments* — This Statement addresses the recognition, measurement, and disclosure of information regarding derivative instruments entered into by state and local governments. Derivative instruments are complex financial arrangements used by governments to manage specific risks or to make investments. The Statement will require governments to measure derivative instruments at fair value in their economic resources measurement focus financial statements. The Statement will become effective for financial statements for periods beginning after June 15, 2009. Management is studying the effects that this Statement will have on HHSC's consolidated financial statements.

Government Accounting Standards Board Statement No. 54, *Fund Balance Reporting and Governmental Fund Type Definitions* — This Statement establishes fund balance classifications that comprise a hierarchy based primarily on the extent to which a government is bound to observe constraints imposed upon the use of the resources in governmental funds. The Statement provides for classification of fund balances as nonspendable, restricted, committed, assigned, and unassigned, based

on the relative strength of the constraints that control how specific amounts can be spent. This Statement will become effective for financial statements for periods beginning after June 15, 2010. Management is studying the effects that this Statement will have on HHSC's consolidated financial statements.

GASB Statement No. 55, *The Hierarchy of Generally Accepted Accounting Principles for State and Local Governments* — This Statement incorporates the hierarchy of GAAP for state and local governments into the GASB's authoritative literature. The "GAAP hierarchy" consists of the sources of accounting principles used in the preparation of financial statements of state and local governmental entities that are presented in conformity with GAAP, and the framework for selecting those principles. The Statement became effective upon its issuance in March 2009. Management believes that this Statement will make it easier to identify and apply all relevant guidance when preparing future financial statements.

Government Accounting Standards Board Statement No. 56, *Codification of Accounting and Financial Reporting Guidance Contained in the AICPA Statements on Auditing Standards* — This Statement incorporates into the GASB's authoritative literature certain accounting and financial reporting guidance presented in the American Institute of Certified Public Accountants' Statement on Auditing Standards. The three issues not included in the authoritative literature that establishes accounting principles are: related party transactions, going concern considerations, and subsequent events. The GASB believes that presentation of principles used in the preparation of financial statements is more appropriately included in accounting and financial reporting standards rather than in the auditing literature. This Statement became effective upon its issuance in March 2009. Management believes that the Statement will improve financial reporting by bringing the authoritative accounting and financial reporting literature together in one place.

3. BOARD-DESIGNATED FUNDS

At June 30, 2008, HHSC's Board of Directors had designated cash reserves as follows:

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

During the year ended June 30, 2008, 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 year ended June 30, 2008, were as follows:

	Beginning of Year	Additions	Retirements	Transfers	End of Year
Assets not subject to depreciation:					
Land and land improvements	$ 6,920,296	$ 219,584	$ -	$ -	$ 7,139,880
Construction in progress	42,387,766	26,203,223	(32,777)	(40,112,265)	28,445,947
Assets subject to depreciation:					
Buildings and improvements	279,524,980	18,174,749	(8,815)	22,372,635	320,063,549
Major moveable equipment	93,423,091	4,328,846	(4,838,322)	8,667,250	101,580,865
Fixed equipment	36,593,175	2,475,864	(148,966)	9,072,380	47,992,453
	458,849,308	51,402,266	(5,028,880)	-	505,222,694
Less accumulated depreciation and amortization	(205,692,105)	(20,263,684)	4,876,009		(221,079,780)
Capital assets — net	$ 253,157,203	$ 31,138,582	$ (152,871)	$ -	$ 284,142,914

In 2008, the State Department of Accounting and General Services transferred capital assets, including construction in progress, aggregating $16.3 million, to HHSC as a contribution of capital.

During fiscal year 2008 $2.2 million of capital assets was purchased with funds contributed by the federal government.

5. STATE OF HAWAII ADVANCES AND RECEIVABLES

In fiscal year 2003, HHSC received a $14,000,000 advance from the State to relieve its cash flow shortfall. At June 30, 2008, 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 2009. Accordingly, the advance is classified as a noncurrent liability at June 30, 2008. The amount due to the State of $34,122,507 at June 30, 2008, 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. At June 30, 2008, $25,876,767 was due to HHSC from the State for allotments made to HHSC before June 30, 2008.

6. ESTIMATED THIRD-PARTY PAYOR SETTLEMENTS

The estimated amounts due from government reimbursement programs at June 30, 2008, consisted of the following:

Cost reports:	
Medicare	$ 2,084,671
Medicaid	8,197,481
HMSA 65 C Plus	88,147
Medicaid dual eligible claims	(1,378,314)
Total	$ 8,991,985

7. LONG-TERM LIABILITIES

Among HHSC's long-term liabilities include accrued vacation and capital lease obligations. Transactions for these accounts during the year ended June 30, 2008, was as follows:

	Beginning of Year	Additions	Reductions	End of Year	Current Portion	Noncurrent Portion
Accrued vacation	$ 31,263,473	$ 24,352,798	$ (21,601,061)	$ 34,015,210	$ 14,409,184	$ 19,606,026
Capital lease obligations	42,270,936	5,533,967	(7,833,505)	39,971,398	7,974,585	31,996,813

Future capital lease payments as of June 30, 2008 were as follows:

Years Ending June 30	
2009	$10,369,158
2010	9,049,708
2011	8,136,537
2012	6,073,995
2013	4,198,995
2014–2018	8,956,654
2019–2023	1,537,138
2024–2028	1,113,792
Total future minimum payments	49,435,977
Less amount representing interest	(9,464,579)
Total capital lease obligations	39,971,398
Current portion	7,974,585
Noncurrent portion	$31,996,813

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 year ended June 30, 2008, interest capitalized was approximately $446,000.

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.

MMMCWorking Capital Financing — In April 2008, MMMC obtained an $11,000,000 taxable revolving line of credit loan facility from JP Morgan Chase Bank, N.A. for working capital purposes. The loan requires quarterly interest payments at London InterBank Offered Rate (LIBOR) plus 175 basis points, with any unpaid principal amounts due in April 2011. The loan is collateralized by a first priority security interest and lien on all assets of MMMC, including, without limitation, all revenues and all real property and improvements. The loan contains several covenants, including a liquidity covenant of a minimum of 30 days of cash on hand, debt to capitalization ratio, and debt coverage ratio. At June 30, 2008, MMMC was in violation of the liquidity covenant requiring a minimum of 30 days cash on hand and the debt to capitalization ratio. Management is working on obtaining a waiver of the covenant, however, as a waiver has not been received, the loan has been classified as a current liability in the consolidated statement of net assets.

Kauai Veterans Memorial Hospital Kalaheo 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 noncompete 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, 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 in August 2007 but was extended in August 2007 to August 2009. The new terms require $31,583 in monthly principal payments, plus interest.

Bridge Loan — In April 2008, HHSC Corporate entered into a bridge loan for $10,000,000 to pay for the architectural, design, and engineering costs of a new surgery area and modifications of the existing surgery room at KVMH. The original bridge loan required monthly payments of interest of $68,750 out of the lease escrow funds, and the principal balance was initially due on November 1, 2008, but was extended in October 2008 to March 2, 2009. The new terms require $77,083 in monthly payments of interest out of the lease escrow funds. In February 2009, KVMH paid down $7 million of its $10 million principal balance and amended the terms of the bridge loan again to require monthly payments of interest only at $23,125 with the remaining principal balance of $3,000,000 due and payable on June 1, 2009. Management expects to refinance this bridge loan with another loan that would finance revised plans to expand the facilities at KVMH on a reduced scale from the original plans.

KVMH Port Allen Clinic — In April 2008, HHSC Corporate entered into a promissory note for $1,700,000 with Pacific Rim Bank to pay for the leasehold improvements for KVMH's planned clinic in Port Allen. The note calls for monthly interest-only payments for the first six months of the note at 8.5%, with monthly principal and interest payments of $21,078 for the remaining 9.5 years. The note is secured by a security interest in the leasehold improvements of the Port Allen clinic. At June 30, 2008, $200,000 had been drawn under this promissory note. Subsequent to June 30, 2008, an additional $1.1 million was drawn under this promissory note.

Roselani Place — In September 2007, 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.

Yukio Okutsu Veterans Home — In May 2008, the Veterans' Home entered into a line of credit for $1.8 million, which calls for monthly interest-only payments at a variable rate and matures in December 2008.

Long-term debt as of June 30, 2008, consisted of the following:

Loan payable to Academic Capital; $10,000,000; interest at 5.9%; monthly principal and interest payments of $64,068.99; due September 1, 2032	$ 9,823,517
Loan payable to Academic Capital; $1,690,900; interest at 6.3%; monthly principal and interest payments of $19,028; due November 4, 2012	863,929
Loan payable to JP Morgan Chase Bank; $11,000,000; interest at 4.44625% (interest at LIBOR, plus 175 basis points); quarterly interest payments; due April 10, 2011	11,000,000
Line of credit payable to Pacific Rim Bank; variable rate based on lender's base rate; interest only until maturity on December 5, 2008	1,574,826
Loan payable to AIG Commercial Equip. Finance, Inc.; $16,500,000; interest at 5.9%; interest-only payments of $81,125 through October 19, 2008; due October 19, 2027	16,500,000
Loan payable to Academic Capital; $4,092,771; interest at 8.25%; balance due June 2009	4,010,271
Line of credit payable to Pacific Rim Bank; $200,000; interest at 8.5%; monthly interest-only payments for the first six months with principal and interest payments thereafter; due October 23, 2018	200,000
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	442,167
Loan payable to Zions Bank; $26,283; interest at 8.6%; monthly payments of $833; due May 31, 2010	17,571
Total	44,432,281
Less current portion	(15,981,243)
Noncurrent portion	$ 28,451,038

Transactions in long-term debt during the year ended June 30, 2008, were as follows:

	Beginning of Year	Additions	Reductions	End of Year
Long-term debt	$ 11,612,851	$ 43,158,363	$ (10,338,933)	$ 44,432,281

Maturities of long-term debt as of June 30, 2009 are as follows:

Years Ending June 30	Principal	Interest	Total
2009	$15,981,243	$ 1,290,922	$17,272,165
2010	2,486,293	1,557,327	4,043,620
2011	773,884	1,512,334	2,286,218
2012	821,657	1,464,561	2,286,218
2013	872,150	1,414,028	2,286,178
2014–2018	5,221,138	6,209,585	11,430,723
2019–2023	7,007,581	4,423,141	11,430,722
2024–2028	8,387,141	2,032,037	10,419,178
2029–2033	2,881,194	383,699	3,264,893
Total	$44,432,281	$20,287,634	$64,719,915

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 $21,696,000 (excluding Clinical Laboratories of Hawaii partnership fees of approximately $8,541,000 as disclosed in Note 11) during fiscal year 2008.

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

HHSC charges the contractors for use of the premises, supplies, and laundry. These amounts are included in other nonoperating revenues and aggregated approximately $1,463,800 during fiscal year 2008. 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 $783,000 during fiscal year 2008.

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 year ended June 30, 2008, 2007 and 2006, was approximately $34.7 million, 26.1 million and 23 million, 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.

Postretirement 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. A retiree can elect family plan to cover dependents.

For employees hired after June 30, 1996 but before July 1, 2001, and who retire with less than 10 years of service, the State makes no contributions. For those retiring with at least 10 years but fewer than 15 years of service, the State pays 50% of the base monthly contribution. For those retiring with at least 15 years but fewer than 25 years of service, the State pays 75% of the base monthly contribution. For those employees retiring with at least 25 years of service, the State pays 100% of the base monthly contribution. Retirees in this category can elect a family plan to cover dependents.

For employees hired on or after July 1, 2001, and who retire with less than 10 years of service, the State makes no contributions. For those retiring with at least 10 years but fewer than 15 years of service, the State pays 50% of the base monthly contribution. For those retiring with at least 15 years but fewer than 25 years of service, the State pays 75% of the base monthly contribution. For those employees retiring with at least 25 years of service, the State pays 100% of the base monthly contribution. Only single plan coverage is provided for retirees in this category. Retirees can elect family coverage but must pay the difference in plan costs.

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.

HHSC's contributions for post-retirement benefits approximated $17,896,000 for the year ended June 30, 2008.

Sick Leave — Accumulated sick leave as of June 30, 2008, was approximately $58,321,000. 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 was 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 were to be made at least annually from the Partnership's "Available Cash" (as defined in the Partnership Agreement). There were no partnership distributions during fiscal year 2008.

HHSC's investment in the Partnership and related contribution of laboratory space and ancillary services were being recorded over the life of the Partnership Agreement. The contributed space and services recognized in fiscal year 2008 amounted to $924,477, and the investment balance as of June 30, 2008, was $4,289,999. The contributed space and services are included in other nonoperating revenues in the consolidated statement of revenues, expenses and changes in net assets, and the investment balance is included in other assets in the consolidated statement of net assets.

In addition, HHSC charged 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 $869,000 during fiscal year 2008. Amounts due from the Partnership for such charges aggregated approximately $1,280,000 as of June 30, 2008.

HHSC contracted with the Partnership to provide clinical laboratory and pathology services at its facilities. Amounts charged by the Partnership aggregated approximately $8,541,000 during fiscal year 2008. Amounts due to the Partnership aggregated approximately $12.1 million as of June 30, 2008.

KVMH and Samuel Mahelona Memorial Hospital contracted 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 during fiscal year 2008. In addition, the Partnership contracted with KVMH to perform certain routine tests referred to the KVMH laboratory by the Partnership. Amounts billed to the Partnership were approximately $81,000 during fiscal year 2008. There were no amounts due from or due to the Partnership as of June 30, 2008. See Note 16 for the sale of the Partnership in September 2008.

12. TEMPORARILY RESTRICTED NET ASSETS

Changes in temporarily restricted net assets for the year ended June 30, 2008, were as follows:

Balance — beginning of year	$ 2,861,656
Restricted contributions received	1,356,466
Capital assets purchased and expenditures for restricted purposes	(2,101,645)
Balance — end of year	$ 2,116,477

13. VETERANS HOME

Through the end of fiscal year 2007, $26,151,230 had been expended for planning, design, and construction costs of the veterans' home. In November 2007, construction on the veterans' home was completed and operation of the 95-bed facility commenced. At the end of November 2007, the total planning, design, and construction costs of $28,022,522 for the veterans home long-term care facility was completed and reclassified to buildings and improvements in the consolidated statement of net assets.

14. COMMITMENTS AND CONTINGENCIES

Professional Liability — HHSC maintains professional and general liability insurance with a private insurance carrier with a $25 million limit per claim and $29 million in aggregate. 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 coverage 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 $18,299,000 for unpaid claims as of June 30, 2008.

Corporate Integrity Agreement — In July 2007, Hilo Medical Center (HMC) and the Office of the Inspector General 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 HMC'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.

Operating Lease Agreement — HMC — Effective July 1, 2007, HMC entered into a lease and related sublease agreement for a medical building. Future minimum lease payments and sublease receipts at June 30, 2008, were as follows:

Years Ending June 30	Lease Payments	Sublease Receipts
2009	$ 733,200	$ 181,981
2010	733,200	181,981
2011	755,040	187,174
2012	776,880	192,580
2013	776,880	
2014–2017	3,107,520	
Total	$ 6,882,720	$ 743,716

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, 2008, there were no payments made to the OHA.

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 consolidated 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.

Purchase of Assisted Living Facility — In September 2007, 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.

16. SUBSEQUENT EVENTS

Sale of Clinical Laboratories of Hawaii Partnership — In September 2008, the partners sold their interest in the partnership to Sonic Healthcare USA. According to the terms of the sale, the majority of the sales proceeds were distributed to each of the partners in the Partnership according to their ownership percentage in the Partnership, with a certain portion being held in escrow to cover unanticipated compliance claims, to be distributed to the partners at certain dates in the future. HHSC's share of the sales proceeds was $8,484,290, which was used to pay down HHSC's accounts payable to the Partnership as stated in the sale agreement.

Advance from the State of Hawaii — In April 2009, MMMC received a $2 million advance from the State of Hawaii for working capital. In addition, the facility is also working with the State of Hawaii to obtain an additional $8 million advance prior to June 30, 2009.

Abandonment of Construction Project — In February 2009, the Kauai Regional Board directed management to cease work on the design and building of a new hospital building and renovation of the existing hospital and medical office buildings located at KVMH, based on the results of an independent third-party financial feasibility study. The total architectural and design fees incurred for this project was approximately $3.9 million at June 30, 2008, and the total fees incurred as of the date of this report is approximately $7.2 million. Management is evaluating the architectural and design work performed to date to determine if there are any portions of that work that can be used in future projects on the KVMH campus.

* * * * * *

HAWAII HEALTH SYSTEMS CORPORATION

SUPPLEMENTAL SCHEDULE OF RECONCILIATION OF CASH ON DEPOSIT WITH THE STATE OF HAWAII
JUNE 30, 2008

	Appropriation Symbol	
CASH ON DEPOSIT WITH THE STATE OF HAWAII:		
SPECIAL FUNDS:		
	S-07-355-H	$ 4,230,868
	S-07-365-H	563,494
	S-07-358-H	113,687
	S-07-371-H	608,328
	S-07-353-H	6,563
	S-93-359-H	2,818
	S-96-359-H	2,007
	S-97-359-H	3,556
	S-07-359-H	706,953
	S-08-350-H	2,987,216
	S-08-352-H	172,169
	S-08-351-H	241,831
	S-07-354-H	1,589,322
	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	314,872
	S-08-919-H	472,650
	S-08-353-H	191,203
	T-08-312-H	789,290
TRUST FUNDS:		
	T-04-918-H	1,273
	T-04-923-H	4,129
	T-04-921-H	6,207
	T-08-909-H	19,404
TOTAL PER STATE		13,067,057
RECONCILING ITEMS		(6,806)
TOTAL PER HHSC		$ 13,060,251

(Continued)

HAWAII HEALTH SYSTEMS CORPORATION

SUPPLEMENTAL SCHEDULE OF RECONCILIATION OF CASH ON DEPOSIT WITH THE STATE OF HAWAII
JUNE 30, 2008

	Appropriation Symbol	
ASSETS LIMITED AS TO USE:		
PATIENT TRUST FUNDS:		
	T-07-365-H	$ 22,912
	T-06-915-H	11,120
	T-04-919-H	1,045
	T-07-925-H	104,546
	T-07-926-H	
TOTAL PER STATE		139,623
RECONCILING ITEMS:		
Patients' safekeeping deposits held by financial institutions		295,345
Restricted assets held by financial institutions		2,091,012
Other		(35,582)
TOTAL PER HHSC		$ 2,490,398

(Concluded)

HAWAII HEALTH SYSTEMS CORPORATION

SUPPLEMENTAL COMBINING AND CONSOLIDATING STATEMENT OF NET ASSETS INFORMATION
JUNE 30, 2008

	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**	**Lanai Community Hospital**	**Leahi Hospital**	**Maluhia**	**Kahuku**	**Kauai Veterans Memorial Hospital**	**Samuel Mahelona Memorial Hospital**	**Total Facilities**	**Corporate**	**Reclassifi-cations and Eliminations**	**HHSC Combined**	**Hawaii Health Systems Foundation**	**Alii - Maui Community Care**	**Alii - Kona Community Care**	**Reclassifi-cations and Eliminations**	**HHSC Consolidated**
CURRENT ASSETS:																							
Cash and cash equivalents:																							
On deposit with the State of Hawaii	$ 2,987,216	$ 243,104	$ 170,646	$ -	$ 1,589,322	$ 197,766	$ 4,230,868	$ 608,328	$ 113,687	$ 808,823	$ 563,494	$ -	$ 719,463	$ 473,695	$ 12,706,412	$ 353,839	$ -	$ 13,060,251	$ -	$ -	$ -	$ -	$ 13,060,251
On deposit with banks and on hand	7,000,918	25,349	59,819	200	245,973	218,735	4,302,633	7,137	35,410	571,272	32,236	44,831	270,925	24,806	12,840,244	7,635,471	-	20,475,715	83,113	113,583	105,769	-	20,778,180
Patient accounts receivable - less allowances for contractual adjustments and doubtful accounts	14,009,792	441,222	251,119	460,511	7,720,110	412,730	21,583,343	1,810,263	284,390	1,267,011	1,029,865	1,298,819	4,852,509	1,592,816	57,014,500	-	-	57,014,500	-	-	464,673	-	57,479,173
Due from Medicaid for Act 294	895,441	155,325			263,613		7,469	204,633		2,115,706				143,959	3,786,146			3,786,146					3,786,146
Supplies and other current assets	2,663,486	80,288	71,324	10,923	2,179,481	46,508	5,901,983	331,956	85,329	736,952	1,341,045	167,431	842,663	177,808	14,637,177	95,127	-	14,732,304	-	46,926	78,648	-	14,857,878
Due from State of Hawaii	809,774	7,761,645	364,720	1,807	176,679	500,000	8,950,466	1,729,824	326,974	775,072	914,418		1,594,292	1,221,096	25,126,767	750,000		25,876,767					25,876,767
Estimated third-party payor settlements	477,306	1,575,483	930,756	-	396,008	1,176,528	(1,400,847)	1,075,258	525,585	(8,384)	-	510,454	1,120,577	2,613,261	8,991,985	-	-	8,991,985	-	-	-	-	8,991,985
Total current assets	28,843,933	10,282,416	1,848,384	473,441	12,571,186	2,552,267	43,575,915	5,767,399	1,371,375	6,266,452	3,881,058	2,021,535	9,400,429	6,247,441	135,103,231	8,834,437	-	143,937,668	83,113	160,509	649,090	-	144,830,380
DUE FROM AFFILIATES - Net																339,955,354	(328,805,539)	11,149,815	-	-	-	(11,149,815)	-
CAPITAL ASSETS - Net	41,808,574	13,444,965	1,044,211	28,882,363	26,187,259	1,665,475	108,586,588	3,897,061	799,509	4,594,172	4,799,122	2,181,672	18,005,981	5,255,723	261,152,675	7,361,021	-	268,513,696	-	15,473,455	155,763	-	284,142,914
ASSETS LIMITED AS TO USE	38,098	21,826	6,207	78,794	18,881	2,297	405,638	92,158	-	123,606	69,001	372	25,329	70,301	952,508	1,500,000	-	2,452,508	37,890	-	-	-	2,490,398
OTHER ASSETS	2,223,627	45,473	38,014	-	778,386	43,652	1,129,129	31,720	-	-	-	402,927	157,950	-	4,850,878	97,822	-	4,948,700	-	-	22,740	(97,822)	4,873,618
TOTAL	$ 72,914,232	$ 23,794,680	$ 2,936,816	$ 29,434,598	$ 39,555,712	$ 4,263,691	$ 153,697,270	$ 9,788,338	$ 2,170,884	$ 10,984,230	$ 8,749,181	$ 4,606,506	$ 27,589,689	$ 11,573,465	$ 402,059,292	$ 357,748,634	$ (328,805,539)	$ 431,002,387	$ 121,003	$ 15,633,964	$ 827,593	$ (11,247,637)	$ 436,337,310
LIABILITIES AND NET ASSETS (DEFICIT)																							
CURRENT LIABILITIES:																							
Accounts payable and accrued expenses	$ (22,048,128)	$ (850,281)	$ (439,727)	$ (2,093,041)	$ (10,373,269)	$ (317,192)	$ (26,818,482)	$ (2,030,790)	$ (410,699)	$ (1,941,127)	$ (1,187,980)	$ (439,317)	$ (3,727,615)	$ (1,126,710)	(73,804,358)	$ (4,731,694)	$ -	$ (78,536,052)	$ (348)	$ (865,243)	$ (345,268)	$ (44,757)	$ (79,791,668)
Accrued workers' compensation liability	(4,596,000)	(414,000)	(188,000)	-	(2,410,000)	(182,000)	(4,992,000)	(1,588,000)	(100,000)	(1,087,000)	(691,000)	-	(1,144,000)	(585,000)	(17,977,000)	(322,000)	-	(18,299,000)	-	-	-	-	(18,299,000)
Current portion of accrued vacation	(2,494,359)	(292,255)	(119,817)	-	(2,876,152)	(202,482)	(3,582,237)	(484,101)	(92,004)	(1,095,368)	(718,856)	-	(913,432)	(588,777)	(13,459,840)	(922,269)	-	(14,382,109)	-	-	(27,075)	-	(14,409,184)
Current portion of capital lease obligations	-	-	-	-	-	-	(7,126)	-	-	-	-	-	-	-	(7,126)	(7,967,459)	-	(7,974,585)	-	-	-	-	(7,974,585)
Current portion of long-term debt	(190,192)	-	-	(8,806)	-	-	(11,000,000)	-	-	-	-	-	-	-	(11,198,998)	(4,568,221)	-	(15,767,219)	-	(214,024)	-	-	(15,981,243)
Other current liabilities	(162,534)	-	-	-	(8,056)	-	-	-	-	-	-	-	(67,324)	-	(237,914)	-	-	(237,914)	-	(325,320)	(29)	-	(563,263)
Total current liabilities	(29,491,213)	(1,556,536)	(747,544)	(2,101,847)	(15,667,477)	(701,674)	(46,399,845)	(4,102,891)	(602,703)	(4,123,495)	(2,597,836)	(439,317)	(5,852,371)	(2,300,487)	(116,685,236)	(18,511,643)	-	(135,196,879)	(348)	(1,404,587)	(372,372)	(44,757)	(137,018,943)
CAPITAL LEASE OBLIGATIONS - Less current portion	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	(31,996,813)	-	(31,996,813)	-	-	-	-	(31,996,813)
LONG-TERM DEBT - Less current portion	(9,633,325)	-	-	(1,583,591)	-	-	-	-	-	-	-	-	(200,000)	-	(11,416,916)	(748,146)	-	(12,165,062)	-	(16,285,976)	-	-	(28,451,038)
ACCRUED VACATION - Less current portion	(5,520,384)	(419,970)	(175,655)	-	(1,400,781)	(190,118)	(5,940,003)	(1,318,551)	(163,374)	(1,242,100)	(1,180,150)	-	(985,192)	(775,996)	(19,312,274)	(293,752)	-	(19,606,026)	-	-	-	-	(19,606,026)
OTHER POSTEMPLOYMENT BENEFIT LIABILITY	(7,442,288)	(615,667)	(406,985)	-	(3,639,366)	(352,296)	(9,423,456)	(1,461,785)	(213,535)	(1,836,033)	(1,401,124)	-	(1,643,959)	(1,036,903)	(29,473,397)	(776,295)	-	(30,249,692)	-	-	-	-	(30,249,692)
DUE TO AFFILIATES - Net	(77,797,229)	(4,349,213)	(10,488,944)	(508,155)	(52,038,712)	(9,329,956)	(16,578,561)	(20,441,736)	(12,933,912)	(16,999,577)	(26,559,849)	(921,898)	(58,592,413)	(21,265,384)	(328,805,539)	-	328,805,539	-	-	(10,744,858)	(897,220)	11,642,078	-
DUE TO THE STATE OF HAWAII	-	(506,153)	-	-	(7,605,205)	(528,149)	-	(1,114,264)	-	(6,416,791)	(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	(38,098)	(21,826)	(6,207)		(7,761)	(2,297)	-	(92,158)	-	(123,606)	(44,466)	(372)	(4,821)	(32,309)	(373,921)	-	-	(373,921)	-	-	-	-	(373,921)
OTHER LIABILITIES	(19,663)	-	-	-	(197,540)	-	-	-	-	-	(13,296)	-	(50,080)	(7,149)	(287,728)	(450)	-	(288,178)	-	-	-	-	(288,178)
Total liabilities	(129,942,200)	(7,469,365)	(11,825,335)	(4,193,593)	(80,556,842)	(11,104,490)	(78,341,865)	(28,531,385)	(13,913,524)	(30,741,602)	(32,288,171)	(1,361,587)	(68,372,181)	(27,835,378)	(526,477,518)	(66,327,099)	328,805,539	(263,999,078)	(348)	(28,435,421)	(1,269,592)	11,597,321	(282,107,118)
COMMITMENTS AND CONTINGENCIES																							
NET ASSETS:																							
Invested in capital assets - net of related debt	(31,985,057)	(13,444,965)	(1,044,211)	(27,289,966)	(26,187,259)	(1,665,475)	(97,579,462)	(3,897,061)	(799,509)	(4,457,791)	(4,745,208)	(2,181,672)	(17,805,981)	(5,255,723)	(238,339,340)	37,919,618	-	(200,419,722)	-	2,292,216	(155,763)	-	(198,283,269)
Unrestricted	89,013,025	(2,880,350)	9,932,730	2,127,755	67,199,509	8,506,274	22,629,695	22,640,108	12,542,149	24,215,163	28,308,733	(1,063,247)	58,608,981	21,555,628	363,336,153	(327,841,153)	-	35,495,000	(82,765)	10,509,241	597,762	(349,684)	46,169,554
Restrictions - primarily for capital acquisitions	-	-	-	(78,794)	(11,120)	-	(405,638)	-	-	-	(24,535)	-	(20,508)	(37,992)	(578,587)	(1,500,000)	-	(2,078,587)	(37,890)	-	-	-	(2,116,477)
Total net assets	57,027,968	(16,325,315)	8,888,519	(25,241,005)	41,001,130	6,840,799	(75,355,405)	18,743,047	11,742,640	19,757,372	23,538,990	(3,244,919)	40,782,492	16,261,913	124,418,226	(291,421,535)	-	(167,003,309)	(120,655)	12,801,457	441,999	(349,684)	(154,230,192)
TOTAL	$ (72,914,232)	$ (23,794,680)	$ (2,936,816)	$ (29,434,598)	$ (39,555,712)	$ (4,263,691)	$ (153,697,270)	$ (9,788,338)	$ (2,170,884)	$ (10,984,230)	$ (8,749,181)	$ (4,606,506)	$ (27,589,689)	$ (11,573,465)	$ (402,059,292)	$ (357,748,634)	$ 328,805,539	$ (431,002,387)	$ (121,003)	$ (15,633,964)	$ (827,593)	$ 11,247,637	$ (436,337,310)

HAWAII HEALTH SYSTEMS CORPORATION

SUPPLEMENTAL COMBINING AND CONSOLIDATING STATEMENT OF REVENUES, EXPENSES, AND CHANGES IN NET ASSETS INFORMATION
YEAR ENDED JUNE 30, 2008

	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	Kahuku	Kauai Veterans Memorial Hospital	Samuel Mahelona Memorial Hospital	Total Facilities	Corporate	Reclassifi-cations and Eliminations	HHSC Combined	Hawaii Health Systems Foundation	Alii Community Care - Maui	Alii Community Care - Kona	Reclassifi-cations and Eliminations	HHSC Consolidated
OPERATING REVENUES																							
Net patient service revenue	$ 96,114,382	$ 8,376,110	$ 4,855,971	$ 693,925	$ 47,656,307	$ 5,436,762	$ 131,846,401	$ 16,229,735	$ 2,466,743	$ 17,510,181	$ 13,102,767	$ 1,985,930	$ 24,617,855	$ 13,107,334	$ 384,000,403	$ -	$ -	$ 384,000,403	$ -	$ -	$ 1,396,592	$ -	$ 385,396,995
Other operating revenues	1,108,503	15,705	16,269	-	536,339	6,674	1,088,212	104,619	10,374	280,220	42,857	180,731	288,499	92,586	3,771,588	-	(212,078)	3,559,510	-	3,353,685	591,451	-	7,504,646
Total operating revenues	97,222,885	8,391,815	4,872,240	693,925	48,192,646	5,443,436	132,934,613	16,334,354	2,477,117	17,790,401	13,145,624	2,166,661	24,906,354	13,199,920	387,771,991	-	(212,078)	387,559,913	-	3,353,685	1,988,043	-	392,901,641
OPERATING EXPENSES																							
Salaries and benefits	79,876,934	6,707,764	4,465,327	1,393,438	41,657,526	4,019,088	102,308,281	16,121,414	2,629,948	19,998,638	15,159,777	1,272,722	17,687,832	12,083,699	325,382,388	8,086,255	-	333,468,643	4,220	-	1,187,845	-	334,660,708
Medical supplies and drugs	13,922,617	218,933	133,290	14,345	6,647,873	140,581	29,035,067	421,782	308,737	448,326	297,069	140,733	2,501,023	308,330	54,538,706	-	-	54,538,706	-	-	112,410	-	54,651,116
Purchased services	14,194,330	955,349	792,617	29,916	6,723,047	914,705	13,474,044	1,992,390	748,733	585,412	754,838	229,578	6,626,942	1,951,665	49,973,566	113,451	(374,761)	49,712,256	-	17,576	59,005	-	49,788,837
Depreciation and amortization	3,789,747	493,893	101,311	555,958	2,898,167	253,607	6,603,107	300,924	80,864	733,045	371,348	98,783	1,382,362	426,905	18,090,021	1,420,847	-	19,510,868	-	767,278	19,005	-	20,297,151
Other supplies	4,108,914	372,503	131,658	125,433	1,163,202	151,575	4,950,211	849,968	107,522	992,436	752,865	95,142	793,842	590,423	15,185,694	57,699	-	15,243,393	1,745	262,901	64,925	-	15,572,964
Utilities	1,812,383	660,716	121,695	168,654	1,408,668	148,236	3,850,518	259,403	118,009	881,582	542,874	91,683	969,739	493,783	11,527,943	84,725	-	11,612,668	-	317,028	38,471	-	11,968,167
Repairs and maintenance	2,979,581	293,100	25,744	18,983	1,815,530	135,890	3,059,841	141,523	62,714	313,864	355,216	86,175	560,166	128,633	9,976,960	72,487	-	10,049,447	-	45,009	11,274	-	10,105,730
Professional fees	1,536,554	37,218	17,581	2,310	680,656	130,950	1,602,579	96,665	20,732	172,779	29,059	252,033	564,364	302,816	5,446,296	351,297	-	5,797,593	348	1,826,567	-	-	7,624,508
Rent and lease	1,613,907	20,647	30,919	-	362,725	19,998	2,123,050	27,304	7,312	14,187	18,524	42,185	705,325	42,726	5,028,809	69,464	(31,200)	5,067,073	-	630,627	126,553	-	5,824,253
Insurance	1,120,119	43,379	120,758	243,942	707,891	22,356	1,425,167	102,468	12,859	264,357	127,894	128,995	280,564	148,157	4,748,906	5,733	-	4,754,639	-	87,843	81,119	-	4,923,601
Other	1,166,763	38,735	59,385	1,305,228	908,968	22,555	1,758,404	94,597	49,924	122,363	71,960	24,896	638,537	119,586	6,381,901	348,547	-	6,730,448	5,621	680,227	725,535	-	8,141,831
Total operating expenses	126,121,849	9,842,237	6,000,285	3,858,207	64,974,253	5,959,541	170,190,269	20,408,438	4,147,354	24,526,989	18,481,424	2,462,925	32,710,696	16,596,723	506,281,190	10,610,505	(405,961)	516,485,734	11,934	4,635,056	2,426,142	-	523,558,866
INCOME (LOSS) FROM OPERATIONS	(28,898,964)	(1,450,422)	(1,128,045)	(3,164,282)	(16,781,607)	(516,105)	(37,255,656)	(4,074,084)	(1,670,237)	(6,736,588)	(5,335,800)	(296,264)	(7,804,342)	(3,396,803)	(118,509,199)	(10,610,505)	193,883	(128,925,821)	(11,934)	(1,281,371)	(438,099)	-	(130,657,225)
NONOPERATING REVENUES (EXPENSES)																							
General operating appropriations from State of Hawaii	-	-	-	-	-	-	-	-	-	-	-	1,088,851	-	-	1,088,851	67,612,232	-	68,701,083	-	-	-	-	68,701,083
Collective bargaining pay raise appropriation from State of Hawaii	2,767,259	234,521	140,193	-	1,374,753	160,242	3,476,302	549,949	86,805	743,918	558,209	-	615,742	361,919	11,069,812	124,204	-	11,194,016	-	-	-	-	11,194,016
Noncapital restricted contributions	-	38,504	17,042	-	283,043	50,076	391,908	-	-	-	-	-	(11,146)	347	769,774	283,306	-	1,053,080	303,386	-	-	-	1,356,466
Interest and dividend income	22,384	-	90	-	7,213	-	22,247	38	158	43,745	23,144	-	1,187	2,263	122,469	893,049	-	1,015,518	14,826	403	-	-	1,030,747
Interest expense (net of capitalized interest)	(699,581)	(2,510)	-	(52,023)	(143,405)	(1,587)	(476,554)	(10,145)	(13)	(899)	(13)	(2,563)	(4,151)	-	(1,393,444)	(2,405,720)	-	(3,799,164)	-	(649,000)	-	-	(4,448,164)
Corporate allocation expense	(2,943,834)	(225,518)	(140,375)	-	(1,489,351)	(139,655)	(4,028,346)	(482,590)	(97,096)	(568,158)	(434,269)	-	(737,991)	(387,675)	(11,674,858)	11,674,858	-	-	-	-	-	-	-
Act 290 appropriation from the State of Hawaii	70,000	-	-	-	70,000	-	70,000	-	-	70,000	-	-	70,000	-	350,000	400,000	-	750,000					750,000
Other nonoperating revenues (expenses) - net	2,651,513	130,998	11,983	-	172,681	35,710	749,984	93,628	39,510	378,357	(6,384)		328,235	291,820	4,878,035	(33,488)	(193,883)	4,650,664	(283,095)	-	(3,900)	447,506	4,811,175
Nonoperating revenues (expenses) - net	1,867,741	175,995	28,933	(52,023)	274,934	104,786	205,541	150,880	29,364	666,963	140,687	1,086,288	261,876	268,674	5,210,639	78,548,441	(193,883)	83,565,197	35,117	(648,597)	(3,900)	447,506	83,395,323
INCOME (LOSS) BEFORE CAPITAL CONTRIBUTIONS, TRANSFERS, AND SPECIAL ITEM	(27,031,223)	(1,274,427)	(1,099,112)	(3,216,305)	(16,506,673)	(411,319)	(37,050,115)	(3,923,204)	(1,640,873)	(6,069,625)	(5,195,113)	790,024	(7,542,466)	(3,128,129)	(113,298,560)	67,937,936	-	(45,360,624)	23,183	(1,929,968)	(441,999)	447,506	(47,261,902)
CAPITAL GRANTS AND CONTRIBUTIONS	3,310,347	-	30,881	-	(71,409)	500,000	91,332	871,208	247,647	13,401	205,329	2,454,895	1,592,348	1,397,486	10,643,465	750,000	-	11,393,465	-	-	-	-	11,393,465
DECREASE IN NET ASSETS BEFORE CHANGE IN ACCOUNTING PRINCIPLE	(23,720,876)	(1,274,427)	(1,068,231)	(3,216,305)	(16,578,082)	88,681	(36,958,783)	(3,051,996)	(1,393,226)	(6,056,224)	(4,989,784)	3,244,919	(5,950,118)	(1,730,643)	(102,655,095)	68,687,936	-	(33,967,159)	23,183	(1,929,968)	(441,999)	447,506	(35,868,437)
CHANGE IN ACCOUNTING FOR STATE APPROPRIATIONS	1,406,354	8,338,770	333,839	1,807	248,088		17,805,113	876,616	79,327	976,647	746,232		1,944		30,814,737			30,814,737					30,814,737
DECREASE IN NET ASSETS	(22,314,522)	7,064,343	(734,392)	(3,214,498)	(16,329,994)	88,681	(19,153,670)	(2,175,380)	(1,313,899)	(5,079,577)	(4,243,552)	3,244,919	(5,948,174)	(1,730,643)	(71,840,358)	68,687,936	-	(3,152,422)	23,183	(1,929,968)	(441,999)	447,506	(5,053,700)
NET ASSETS - BEGINNING OF YEAR	(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)	(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
NET ASSETS - END OF YEAR	$ (57,027,968)	$ 16,325,315	$ (8,888,519)	$ 25,241,005	$ (41,001,130)	$ (6,840,799)	$ 75,355,405	$ (18,743,047)	$ (11,742,640)	$ (19,757,372)	$ (23,538,990)	$ 3,244,919	$ (40,782,492)	$ (16,261,913)	$ (124,418,226)	$ 291,421,535	$ -	$ 167,003,309	$ 120,655	$ (12,801,457)	$ (441,999)	$ 349,684	$ 154,230,192

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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*

To the 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, 2008, and have issued our report thereon (which report expresses an unqualified opinion and includes an emphasis of a matter paragraph on HHSC's ability to continue as a going concern, and explanatory paragraphs relating to the accounting and reporting for postretirement benefits, and on the change in accounting method for state appropriations) dated May 15, 2009. 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 accounting principles generally accepted in the United States of America 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 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 instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards* and which are described in the accompanying schedule of findings.

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

May 15, 2009

HAWAII HEALTH SYSTEMS CORPORATION

SCHEDULE OF FINDINGS
YEAR ENDED JUNE 30, 2008

ALL FACILITIES

2008-1 Compliance with Procurement Code

Criteria — The facilities are required to comply with the State Procurement Code.

Condition — The facilities have designed internal controls over the procurement process, however, several of our selections lacked adequate documentation to support that the procurement procedures were properly followed:

Kauai Veterans Memorial Hospital	The facility incurred architectural services of $3.2 million prior to a signed executed contract. Lack of documentation to support procurement requirements for a selection related to expenditures to HFM Food Service
Maui Memorial Hospital	Lack of documentation to support procurement requirements for certain selections related to expenditures to Hawaiian Dredging Construction Company.

Cause — Facility personnel lack the full knowledge of the State Procurement Code.

Effect — The facilities violated the State Procurement Code. However, in certain situations, the facilities self-reported the violation.

Recommendation — Review procedures over procurement at the facilities and consider having internal audit perform an audit over procurement during the fiscal year.

Kahuku Medical Center

Kahuku 2008-1 Purchase Price Allocation

Criteria — Assets acquired should be stated at their fair values.

Condition — The facility did not properly allocate the purchase price to the tangible and intangible assets and contracts acquired during 2008.

Cause — Management did not have the expertise, nor did it engage a valuation specialist to determine the fair value of the assets and contracts acquired.

Effect — The total purchase price of $3.9 million for the Kahuku Medical Center assets was temporarily recorded to buildings, and no amounts were allocated to the other assets purchased.

Recommendation — Engage a valuation specialist to assist management in determining the fair value of the assets and contracts acquired.

YUKIO OKUTSU VETERANS CARE HOME (VA) — HILO

Yukio 2008-1 Capital Assets

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

Condition — The facility did not reclassify building improvements and equipment from construction in progress at the time the building was completed and did not record the individual assets into a capital asset subsidiary ledger to the proper capital asset accounts.

Cause — The facility's accounting records are maintained by a management company, and it appears that they did not update the records on a timely basis, and management failed to detect the error.

Effect — A reclassification of approximately $29 million was recorded to reclassify the building improvements and equipment from construction in progress, and an audit adjustment of $536,000 was recorded for the related depreciation during the period the assets were placed into service.

Recommendation — Ensure that all capital assets and related deprecation are properly recorded and updated in fixed asset subledgers.

Yukio 2008-2 Financial Reporting

Criteria — The facility should have a complete set of accounting records.

Condition — The facility did not record all transactions into a single trial balance. Transactions were recorded separately by both HHSC Corporate Office and the consultant used to manage and account for the operations at the facility.

Cause — There is a division of responsibility between the HHSC Corporate Office and the management company for the accounting records of the VA facility. Accounting policies have not been established, which address the responsibility for combining the separate accounting records.

Effect — There was a lack of a complete set of financial statements for the VA facility, until it was combined during the audit.

Recommendation — Establish accounting policies to ensure that all transactions are properly recorded into a single set of financial statements and develop controls to ensure that the financial statements are properly reviewed by management.

ALII COMMUNITY CARE

Alii 2008-1 Allocation of Purchase Price

Criteria — Assets acquired should be stated at their fair values. In addition, the capital assets detail should be updated, reconciled to the general ledger, and reviewed by management on a timely basis.

Condition — The facility did not allocate the $16 million purchase price of Roselani Place to the assets acquired and lease assumed, the fixed asset subsidiary ledger was not updated, and depreciation was not recorded to the general ledger.

Cause — Management did not have the expertise, nor did it engage a valuation specialist to determine the fair value of the assets acquired and lease assumed, and no amounts were recorded to depreciation because the assets were not included in the fixed asset subledger.

Effect — An audit adjustment of $767,000 was recorded for the related depreciation, and no amounts were allocated to equipment or the lease assumed.

Recommendation — Engage a valuation specialist to assist management in allocating the purchase price to the fair value of the assets acquired and the lease assumed.

MAUI MEMORIAL MEDICAL CENTER

MMMC 2008-1 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 entries related to capital assets; however, the internal controls were not implemented properly during the year. Capital asset disposals were not recorded timely in the accounting records of MMMC.

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 and properly updating the general ledger for disposals.

Effect — An audit adjustment of approximately $1 million of cost and related accumulated depreciation was recorded for the disposal of the asset.

Recommendation — Ensure that capital asset details are updated and reconciled to the general ledger control accounts on a timely basis. Management should review procedures over identifying disposals of assets.

MMMC 2008-2 Unrecorded Payables

Criteria — A search for unrecorded payables should be performed by management prior to the closing of its financial statements.

Condition — The facility had designed internal controls over the recording of accounts payable; however, the internal controls were not implemented properly during the year.

Cause — The cutoff date to ensure that payables are properly accrued at year-end was limited to 25 days, and certain accrual documents were not received by accounting from other departments.

Effect — An audit adjustment of approximately $1 million to accrue capital assets and expenses.

Recommendation — Review management’s procedures for obtaining invoices and contracts from other departments on a timely basis, and reevaluate the cutoff date for recording accounts payable.