Hawaii Health Systems Corporation

Consolidated Financial Statements as of and for the Year Ended June 30, 2009, Supplemental Information for the Year Ended June 30, 2009, 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, 2009, and the independent auditors' reports thereon.

Scope of the Audit

The financial 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, 2009, 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, 2009, 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, 2009, and the results of its operations and changes in net assets and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

As discussed in Note 1, in fiscal 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, 2009, 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, 2009, 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 April 9, 2010, 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 considered in assessing the results of our audit.

The management's discussion and analysis information on pages 4 through 12 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 36 and 37 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 38 through 39 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

April 9, 2010

HAWAII HEALTH SYSTEMS CORPORATION

MANAGEMENT'S DISCUSSION AND ANALYSIS
AS OF AND FOR THE YEAR ENDED JUNE 30, 2009

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 the consolidated financial statements.

Financial Analysis

Consolidated Statements of Net Assets

Summarized financial information of HHSC's consolidated statement of net assets as of June 30, 2009, is as follows:

ASSETS

Current assets	$ 145,404,076
Capital assets — net	276,695,726
Assets limited to use	1,781,827
Other assets	2,450,097
Total assets	$ 426,331,726

LIABILITIES

Current liabilities	$ 113,407,307
Capital lease obligations — less current portion	29,379,507
Long-term debt — less current portion	39,576,344
Accrued vacation — less current portion	22,108,017
Accrued workers' compensation — less current portion	14,645,000
Other postemployment benefit liability	65,782,538
Due to the State of Hawaii	44,122,507
Patient's safekeeping deposits and deferred income	434,779
Other liabilities	4,472,428
Total liabilities	333,928,427

NET ASSETS

Invested in capital assets — net of related debt	206,007,708
Restricted — primarily for capital acquisitions	847,048
Unrestricted	(114,451,457)
Total net assets	92,403,299
Total liabilities and net assets	$ 426,331,726

At June 30, 2009, 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 decrease of approximately $7.4 million is due to property additions of $25.6 million, offset by depreciation expense of $22 million and retirements of $11 million. The primary reason for the decrease is due to the write-off of $10.6 million in abandoned projects, primarily at KVMH and MMMC.

A summary of HHSC's capital assets as of June 30, 2009, is as follows:

Land and land improvements	$ 7,596,052
Buildings and improvements	332,942,982
Equipment	163,578,788
Construction in progress	12,674,584
	516,792,406
Less accumulated depreciation and amortization	(240,096,680)
Capital assets — net	$ 276,695,726

At June 30, 2009, HHSC's current assets approximated 34% of total assets. Current assets increased $1.6 million from the fiscal year 2008 balance due to an increase in patient accounts receivable offset by a decrease in estimated third party payor settlement receivable. The increase in patient accounts receivable of $17.5 million is primarily due to increases in patient accounts receivable balances at Hilo Medical Center ($3.6 million), Maui Memorial Medical Center ($7 million), Kula Hospital ($2 million), and Hale Hoʻola Hamakua ($1.4 million). The increase in patient accounts receivable at Hilo Medical Center is due to delays in medical records coding causing accounts receivable discharged but not final billed to increase, as well as a steady increase in gross patient accounts receivable greater than 90 days past due and greater than $10,000 of $2.2 million. As a result, gross days in accounts receivable for Hilo Medical Center rose from 83.8 days at June 30, 2008 to 92.1 days at June 30, 2009. The increase in patient accounts receivable at Maui Memorial Medical Center is due to revenue cycle process deficiencies that caused gross patient accounts receivable greater than 90 days past due and greater than $10,000 to increase by $12.9 million. As a result, gross days in accounts receivable for Maui Memorial Medical Center rose from 86.7 days at June 30, 2008 to 104.9 days at June 30, 2009. The increases in patient accounts receivable at Kula Hospital and Hale Hoʻola Hamakua are due to delays in receiving payments from the QUEST Expanded Access Plans administered by Evercare and Ohana health plans. Since the QUEST Expanded Access plan was formed in February 2009, HHSC's facilities have encountered several operational issues that have resulted in inconsistent or delayed payments from both Ohana and Evercare. The decrease in estimated third-party payor settlements receivable was primarily due to receipts of fiscal year 2008 cost report settlements in February and March 2009, while the estimates of settlement for the fiscal year 2009 cost reports were much smaller as adjustments were made to HHSC's interim payment rates based on the results of the fiscal year 2008 cost reports as filed.

At June 30, 2009, HHSC's current liabilities approximated 34% of total liabilities. The primary reason for the decrease from fiscal year 2008 is due to the current portion of long-term debt, classification of accrued workers' compensation, offset by an increase in the Due to State of Hawaii. On February 2, 2010, MMMC received a firm commitment to defer the loan payment terms to fiscal 2011 and remove the financial covenants, subject to the State agreeing to defer its $10 million advance. On March 30, 2010, the State agreed to defer repayment of the advance over four years after fiscal 2011. In June 2009, KVMH received a $3 million advance from the State of Hawaii to pay off its bridge loan with Academic Capital. This advance was repaid in July 2009 out of KVMH's general fund appropriations for fiscal year 2010.

At June 30, 2009, HHSC's total capital lease obligation balance decreased approximately $1.6 million from fiscal year 2008 due to scheduled payments, offset by $7.5 million in new leases.

At June 30, 2009, HHSC's long-term debt balances represented: 1) notes and term loans payable on the land, building, and medical equipment previously owned by Hilo Residency Training Program with a remaining balance of approximately $9.7 million, 2) a mortgage note payable relating to the acquisition of nursing cottages on the MMMC campus with a remaining balance of approximately $685,000, 3) a line of credit to

operate the Veterans Home with a remaining balance of approximately $1.6 million, 4) a taxable revolving line of credit facility of $11 million for working capital purposes, 5) a mortgage note payable relating to the acquisition of Roselani Place with a remaining balance of approximately $16.3 million, 6) a term loan with a remaining balance of approximately $63,000, and 7) a loan payable by the Veterans Home with a remaining balance of approximately $1.2 million.

At June 30, 2009, the portion of HHSC's net assets that is reflected as its investment in capital assets, net of related debt, of approximately $206 million, and restricted net assets of $.8 million are larger than the total net assets of approximately $92.4 million. This means that HHSC's net operations since inception have resulted in losses of approximately $114.5 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, 2009, is as follows:

Operating expenses:	
Salaries and benefits	$ 372,229,444
Purchased services and professional fees	55,858,767
Medical supplies and drugs	58,280,089
Other Supplies	14,619,102
Depreciation and amortization	22,000,124
Insurance	5,470,601
Repairs and Maintenance	9,963,517
Utilities	12,561,963
Rent and Lease	7,009,387
Other	7,317,313
Total operating expenses	565,310,307
Operating revenues	420,118,416
Loss from operations	(145,191,891)
Nonoperating revenues:	
General appropriations from State of Hawaii	66,918,042
Collective bargaining pay raise appropriation from State of Hawaii	25,122,302
Restricted contributions	1,487,334
Interest and dividend income	559,316
Interest Expense (net of capitalized interest)	(5,857,475)
Loss on disposal of fixed assets	(10,626,171)
Other nonoperating revenues (expenses) — net	1,052,353
Total nonoperating revenues	78,655,701
Loss before capital grants and contributions	(66,536,190)
Capital grants and contributions	4,709,297
Decrease in net assets	$ (61,826,893)

For the year ended June 30, 2009, HHSC's operating expenses exceeded its operating revenues by $145.1 million. The appropriations from the State of Hawaii for collective bargaining pay raises of $25.1 million, general fund appropriations from the State of Hawaii of $66.9 million, restricted contributions of $1.5 million, other non-operating revenues-net of $1.1 million, and the capital grants and contributions from the State of Hawaii and the federal government of $5.8 million resulted in a decrease in net assets of $60.8 million.

Operating expenses in fiscal year 2009 were approximately 8% higher than fiscal year 2008. The increase was mainly in the category of salaries and benefits expense. Salaries and benefits expense increased 11.2% from fiscal year 2008, due primarily to the following factors: 1) collective bargaining pay raises of 2.5% to 5% for HHSC's union employees totaling approximately $13.9 million, along with the associated fringe benefit expense increase associated with those raises totaling approximately $4.6 million, 2) increase in adjustment relating to HHSC's share of the State of Hawaii's retiree health insurance liability of $35 million, 3) additional salaries and benefits expense as a result of Kauai Region converting its physicians from contractors to employees in October 2008, totaling approximately $5.4 million.

Fiscal year 2009 operating revenues increased by approximately 6.9% over fiscal year 2008 primarily as a result of the revenue increase associated with a full year of operations for certain HHSC facilities, a one-time adjustment for the provision for doubtful accounts recorded in fiscal year 2008, and negotiated rate increases from third-party payors. The Yukio Okutsu Veterans Care Home-Hilo, Kahuku Medical Center, and Alii Health Center began operations in fiscal year 2008, and the first full year of operations was in fiscal year 2009. The Yukio Okutsu Veterans Care Home-Hilo began operations in November 2007, and the increase in operating revenues from fiscal year 2008 to fiscal year 2009 was approximately $5.5 million. Along with the first full year of operations in fiscal year 2009, the facility received its Medicare and Medicaid certification in March 2008, which limited the ability of the facility to accept Medicare and Medicaid patients prior to that date and which allowed the facility to receive Medicare and Medicaid reimbursements from March 2008 going forward. The facility also received its certification from the U.S. Department of Veterans Affairs in May 2009, which enabled the facility to receive additional per-diem reimbursement for each qualified resident's daily per-diem charges, retroactive to February 2009. These certifications allowed the facility to significantly increase its operating revenues from fiscal year 2008 to fiscal year 2009. Kahuku Medical Center began operations on March 14, 2008, and the increase in operating revenues from fiscal year 2008 to fiscal year 2009 was approximately $4.5 million. Alii Health Center began operations on October 22, 2007, and the increase in operating revenues from fiscal year 2008 to fiscal year 2009 was approximately $2.4 million, and much of the additional revenue was driven by the addition of specialty physicians which grew the patient base of the patient clinics. In fiscal year 2008, Hilo Medical Center and Maui Memorial Medical Center recorded significant adjustments to the provision for doubtful accounts as a result of the worsening aging of their patient accounts receivable. Hilo Medical Center recorded an increase in provision for doubtful accounts of $1.5 million, while Maui Memorial Medical Center recorded an increase in provision for doubtful accounts of $6.2 million. HHSC made adjustments to its contractual allowance and bad debt allowance template methodology in fiscal year 2009 to refine its computation to be more in line with the audit findings in fiscal year 2008. Finally, HHSC was able to negotiate reimbursement rate increases for its acute and ASC lines of business with its commercial third-party payors, which offset an overall 3.5% decrease in average daily census at its facilities.

Fiscal year 2009 non-operating revenues (expenses) – net decreased $4.7 million from fiscal year 2008, due primarily to the write-off of $7.2 million in design and architectural fees for an abandoned construction project. In February 2009, the Kauai Regional Board directed Kauai Region management to cease work on the design and construction of a new hospital building and renovation of the existing hospital and medical office buildings located at Kauai Veterans Memorial Hospital, based on the results of an independent third-party feasibility study, and, accordingly, the accumulated design and construction fees were written-off as a non-operating expense.

For the years ended June 30, 2009 and 2008, General Fund Appropriations from the State of Hawaii consisted of $66.9 million and $68.7 million, respectively, approved for HHSC's operating purposes by the 2007 Legislature.

HHSC's management believes that the significant excess of operating expenses over operating revenues in both 2009 and 2008, 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 2009, 62% of HHSC's total gross revenues were from government-type payors (approximately 24% from Medicare and approximately 28% from Medicaid and QUEST). In fact, government-type payors account for 90% of HHSC's long-term care revenues. Reimbursements from government-type payors has not kept up with the increasing costs of health care providers since the Balanced Budget Act of 1997 was passed, which dramatically reduced the level of reimbursements from government-type payors. According to the November 2009 "Hawaii's Healthcare System-What Lies Ahead?" report presented by the Healthcare Association of Hawaii ("HAH"), Medicare and Medicaid/QUEST pays only 75% and 77% of cost, respectively, for all Hawaii hospitals, the lowest as compared to all other third-party payors. This impact is compounded that for all Hawaii hospitals, private insurance and other payors pays only 106% of cost, the lowest percentage out of all hospitals in the United States of America. The report also notes that Hawaii had the lowest Medicare spending per enrollee in 2006, and Hawaii also had the lowest growth in Medicare spending per enrollee from 1992 to 2006.

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 required 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 estimated that even with the phased implementation, the cost to HHSC was approximately $43 million over the six-year phase-in period. Upon the implementation of Act 294, management estimates that the cost to HHSC is approximately $13 million per year. Management believes that such large annual costs has served 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.

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 HAH, was able to use HHSC's fiscal years 2009 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 2009 and 2008. 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 2009 and 2008. 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 has developed an estimate of potential RAC takebacks based on management's auditing of specific risk areas that have been the focus of the RAC contractors in the demonstration program. However, there is a risk that the RAC's will focus on other areas of reimbursement than what has been documented in the demonstration program, and there is no provision in management's estimate for the potential takeback for such possible exposure areas. One of the versions of the Healthcare Overhaul bill being proposed in the U.S. Congress also proposes to expand the RAC program to Medicaid.

Second, HHSC's facilities on the neighbor islands suffer from an insufficient supply of long-term care beds. For fiscal year 2009, HHSC's long-term care occupancy percentage was 95%, 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. Medicare does not pay any additional money to hospitals for the additional days spent by the patient in the hospital for while the patient waits for a long-term care placement. Medicaid pays approximately 20-30% of the cost of those additional waitlisted days to Hawaii hospitals. 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 41 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 66% 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 for fiscal year 2009 were $5,972,034. 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 $7.8 million in fiscal year 2006 to $13 million in fiscal year 2009. 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 $8.9 million in fiscal year 2008 and $10.8 million in fiscal year 2009.

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. As a result, HHSC's average age of plant in fiscal year 2009 was 12.4 years, whereas the median average age of plant for all U.S. non-profit hospitals and health systems is 9.9 years. Management has identified over $900 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 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. On March 14, 2008, the asset purchase was completed and the facility is now operates 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 changed the structure and operations of HHSC, and that the new governance model has enhanced the ability of HHSC's five regions to respond to the healthcare needs of their communities.

In 2009, the Legislature passed Act 182, S.B. 1673, effective July 1, 2009, which allowed the individual facilities or regions of HHSC to transition into a new legal entity in any form recognized under the laws of the State of Hawaii, including but not limited to a non-profit corporation, a for-profit corporation, a municipal facility, a public benefit corporation, or a combination of the above. The Act also amended the requirement for maintenance of services to outline a process that must be followed in order for a facility to substantially reduce or eliminate a direct patient care service. Further, the Act reconstituted the HHSC board of directors to a twelve-member board of directors which includes the five regional chief executive officers, one representative each appointed by the East Hawaii, West Hawaii, Kauai, and Oahu regional boards, two members appointed by the Maui regional board, and the Director of the Department of Health as an ex-officio non-voting member.

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 hospital services for several isolated neighbor island communities (e.g. Kaʻu, 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. 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
AS OF JUNE 30, 2009

ASSETS

CURRENT ASSETS:	
Cash and cash equivalents:	
On deposit with the State of Hawaii	$ 13,688,436
On deposit with banks and on hand	18,484,516
Patient accounts receivable — less allowances of $163,298,604 for contractual adjustments and doubtful accounts	74,960,004
Due from Medicaid for Act 294	1,177,325
Supplies and other current assets	14,674,069
Due from the State of Hawaii	21,697,996
Estimated third-party payor settlements	721,730
Total current assets	145,404,076
CAPITAL ASSETS — Net	276,695,726
ASSETS LIMITED AS TO USE	1,781,827
OTHER ASSETS	2,450,097
TOTAL	$ 426,331,726

(Continued)

HAWAII HEALTH SYSTEMS CORPORATION

CONSOLIDATED STATEMENT OF NET ASSETS
AS OF JUNE 30, 2009

LIABILITIES AND NET ASSETS

CURRENT LIABILITIES:	
Accounts payable and accrued expenses	$ 80,580,341
Current portion of accrued vacation	15,279,758
Current portion of capital lease obligations	8,971,077
Current portion due to the State of Hawaii	3,000,000
Current portion of workers' compensation	1,500,000
Current portion of long-term debt	905,146
Other current liabilities	3,170,985
Total current liabilities	113,407,307
CAPITAL LEASE OBLIGATIONS — Less current portion	29,379,507
LONG-TERM DEBT — Less current portion	39,576,344
ACCRUED VACATION — Less current portion	22,108,017
ACCRUED WORKERS' COMPENSATION — Less current portion	14,645,000
OTHER POSTEMPLOYMENT BENEFIT LIABILITY	65,782,538
DUE TO THE STATE OF HAWAII — Less current portion	44,122,507
PATIENTS' SAFEKEEPING DEPOSITS AND DEFERRED INCOME — Restricted contributions	434,779
OTHER LIABILITIES	4,472,428
Total liabilities	333,928,427
COMMITMENTS AND CONTINGENCIES	
NET ASSETS:	
Invested in capital assets — net of related debt	206,007,708
Restrictions — primarily for capital acquisitions	847,048
Unrestricted	(114,451,457)
Total net assets	92,403,299
TOTAL	$ 426,331,726

See notes to consolidated financial statements. (Concluded)

HAWAII HEALTH SYSTEMS CORPORATION

CONSOLIDATED STATEMENT OF REVENUES, EXPENSES, AND CHANGES IN NET ASSETS FOR THE YEAR ENDED JUNE 30, 2009

OPERATING REVENUES:	
Net patient service revenues (net of contractual adjustments and provision for doubtful accounts of $476,626,004)	$ 412,550,881
Other operating revenues	7,567,535
Total operating revenues	420,118,416
OPERATING EXPENSES:	
Salaries and benefits	372,229,444
Medical supplies and drugs	58,280,089
Purchased services	47,666,430
Depreciation and amortization	22,000,124
Other supplies	14,619,102
Utilities	12,561,963
Repairs and maintenance	9,963,517
Professional fees	8,192,337
Rent and lease	7,009,387
Insurance	5,470,601
Other	7,317,313
Total operating expenses	565,310,307
LOSS FROM OPERATIONS	(145,191,891)
NONOPERATING REVENUES (EXPENSES):	
General appropriations from the State of Hawaii	66,918,042
Collective bargaining pay raise appropriation from the State of Hawaii	25,122,302
Noncapital restricted contributions	1,487,334
Interest and dividend income	559,316
Interest expense (net of capitalized interest)	(5,857,475)
Loss on disposal of fixed assets	(10,626,171)
Other nonoperating revenues — net	1,052,353
Total nonoperating revenues (expenses) — net	78,655,701
LOSS BEFORE CAPITAL GRANTS AND CONTRIBUTIONS	(66,536,190)
CAPITAL GRANTS AND CONTRIBUTIONS	4,709,297
DECREASE IN NET ASSETS	(61,826,893)
NET ASSETS — Beginning of year	154,230,192
NET ASSETS — End of year	$ 92,403,299

See notes to consolidated financial statements.

HAWAII HEALTH SYSTEMS CORPORATION

CONSOLIDATED STATEMENT OF CASH FLOWS
FOR THE YEAR ENDED JUNE 30, 2009

OPERATING ACTIVITIES:	
Receipts from government, insurance, and patients	$ 405,949,126
Payments to employees	(333,368,297)
Payments to suppliers and others	(162,989,813)
Other receipts — net	7,567,535
Net cash used in operating activities	(82,841,449)
NONCAPITAL FINANCING ACTIVITIES:	
Appropriations from the State of Hawaii	92,040,344
Advances from the State of Hawaii	13,000,000
Interest on lines of credit	(1,318,214)
Other nonoperating revenues — net	1,912,429
Payments on lines of credit	(37,709)
Net cash provided by noncapital financing activities	105,596,850
CAPITAL AND RELATED FINANCING ACTIVITIES:	
Repayments on capital lease obligations	(9,261,556)
Capital expenditures	(8,796,140)
Payments on long-term debt	(7,287,312)
Interest on capital lease obligations and long-term debt	(4,539,261)
Additions to long-term debt	3,374,230
Proceeds from sale of assets	31,862
Proceeds from federal grants	836,045
Net cash used in capital and related financing activities	(25,642,132)
INVESTING ACTIVITIES:	
Redemption of amounts held in escrow	1,000,000
Purchase of investment	(338,064)
Interest income	559,316
Net cash provided by investing activities	1,221,252
NET DECREASE IN CASH AND CASH EQUIVALENTS	(1,665,479)
CASH AND CASH EQUIVALENTS — Beginning of year	33,838,431
CASH AND CASH EQUIVALENTS — End of year	$ 32,172,952

HAWAII HEALTH SYSTEMS CORPORATION

CONSOLIDATED STATEMENT OF CASH FLOWS
FOR THE YEAR ENDED JUNE 30, 2009

RECONCILIATION OF LOSS FROM OPERATIONS TO NET CASH USED IN OPERATING ACTIVITIES:	
Loss from operations	$ (145,191,891)
Adjustments to reconcile loss from operations to net cash used in operating activities:	
Provision for doubtful accounts	27,980,497
Depreciation and amortization	22,000,124
Changes in operating assets and liabilities:	
Patient accounts receivable and amounts due from Medicaid for Act 294	(42,852,507)
Supplies and other assets	(558,998)
Accounts payable, accrued expenses, and other liabilities	10,759,660
Accrued workers' compensation	(2,154,000)
Postretirement benefits	35,532,846
Estimated third-party payor settlements	8,270,255
Accrued vacation	3,372,565
NET CASH USED IN OPERATING ACTIVITIES	$ (82,841,449)
SUPPLEMENTAL CASH FLOW INFORMATION — Interest paid — primarily on capital lease obligations	$ 5,857,475
NONCASH FINANCING AND INVESTING ACTIVITIES:	
Assets acquired under capital leases and debt	7,640,742
Capital assets contributed by the State of Hawaii and others	8,367,969
Capital asset purchases included in accounts payable	4,076,447
Rental income contributed to and equity in earnings of the Clinical Laboratories of Hawaii partnership	924,477
Reduction of payable to Clinical Laboratories of Hawaii partnership due to sale of investment	8,484,290
Loss on disposal of capital assets	10,626,171
Change in allotment	4,178,771
Change in purchase price allocation	846,134

See notes to consolidated financial statements

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 12-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, 2009. 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.

In 2009, the Legislature passed Act 182, S.B. 1673, effective July 1, 2009, which allowed the individual facilities or regions of HHSC to transition into a new legal entity in any form recognized under the laws of the State of Hawaii, including but not limited to a non-profit corporation, a for-profit corporation, a municipal facility, a public benefit corporation, or a combination of the above. The Act also amended the requirement for maintenance of services to outline a process that must be followed in order for a facility to substantially reduce or eliminate a direct patient care service. Further, the Act reconstituted the HHSC board of directors to a twelve-member board of directors which includes the five regional chief executive officers, one representative each appointed by the East Hawaii, West Hawaii, Kauai, and Oahu regional boards, two members appointed by the Maui regional board, and the Director of the Department of Health as an ex-officio non-voting member.

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. 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. Kahuku Medical Center is not material to HHSC's consolidated results of operations, financial position or cash flows.

Liquidity — During the year ended June 30, 2009, HHSC incurred losses from operations of approximately $145.2 million and had negative cash flows from operations of $82.8 million, which was offset by appropriations and advances from the State of Hawaii of $92 million and $13 million, respectively. HHSC expects continued operating losses for fiscal years 2010 and 2011 that will need to be funded by State of Hawaii appropriations for general operations as well as reimbursements from the Department of Human Services through the Medicaid program. In addition, in fiscal 2010, the State of Hawaii negotiated a temporary reduction in certain union wages of 5%.

Further, at June 30, 2009, one of their facilities was unable to comply with certain of its financial covenants on a bank loan. However on February 2, 2010, the facility obtained a firm commitment from the lender to remove the financial covenants, and to fix repayments of the loan through fiscal 2011, subject to the State deferring repayment of its $10 million advance. On March 30, 2010, the State agreed to defer payment of its advance to after fiscal 2011.

Therefore, continued liquidity and ability of HHSC to pay obligations as they come due in the foreseeable future are dependent upon continued appropriations from the State of Hawaii.

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, 2009, 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 $22,943,743 at June 30, 2009. 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 using the straight-line method with these asset lives:

Buildings and improvements	5-40 years
Equipment	3-20 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, 2009, assets limited as to use consisted of restricted cash of $1,781,827.

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 records an expense for postemployment benefits expense, such as retiree medical and dental costs, over the years of service on an accrual basis based on an allocation from the State of Hawaii primarily based on payroll. At June 30, 2009, the outstanding liability was $65,782,538.

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, 2009, was $4.2 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 2009 consolidated financial statements.

The estimated third-party payor settlement receivable of $721,730 as of June 30, 2009, 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 Hoʻola Hamakua, Kauai Veterans Memorial Hospital, Kahuku Medical Center, Kaʻu 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 — HHSC recognizes general and capital appropriations at the time allotments are made available to the Facility for expenditure.

Effective July 1, 2008, HHSC – Corporate permanently allocated general appropriations to each facility. General appropriations are reflected as nonoperating revenues and capital appropriations are included in capital grants and contributions after the nonoperating revenue (expenses) subtotal in the 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, 2009, the amount of bond interest allocated to HHSC was approximately $5,801,000.

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 13.

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 as of June 30, 2009, was as follows:

Medicare	21 %
Medicaid	23
HMSA	16
Other third-party payors	23
Patients and other	17
	100 %

Newly Adopted Accounting Pronouncements — GASB Statement No. 49, *Accounting and Financial Reporting for Pollution Remediation Obligations*. This statement addresses how state and local governments should account for pollution (including contamination) remediation obligations, which are obligations to address the current or potential detrimental effects of existing pollution by participating in pollution remediation activities such as site assessments and cleanups. The statement became effective on July 1, 2008, and the adoption did not have a material effect 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 became effective on July 1, 2008, and the adoption did not have a material effect 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 GASB 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, and did not have a material effect on HHSC's consolidated financial statements.

GASB Statement No. 56, *Codification of Accounting and Financial Reporting Guidance Contained in the AICPA Statements on Auditing Standards* — This statement incorporates into the GASB authoritative literature certain accounting and financial reporting guidance presented in the American Institute of Certified Public Accountants' Statements 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, and did not have a material effect on HHSC's consolidated financial statements.

New Accounting Pronouncements — The following accounting pronouncements will become effective after June 30, 2009:

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. 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.

GASB 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.

3. BOARD-DESIGNATED FUNDS

HHSC's Board of Directors had designated cash reserves as of June 30, 2009, 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, 2009, 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, 2009, were as follows:

	Beginning of Year	Additions	Retirements	Transfers	End of Year
Assets not subject to depreciation:					
Land and land improvements	$ 7,139,880	$ -	$ -	$ 456,172	$ 7,596,052
Construction in progress	28,445,947	20,085,461	(11,273,455)	(24,583,369)	12,674,584
Assets subject to depreciation:					
Buildings and improvements	320,063,549	96,691	(23,028)	12,805,770	332,942,982
Equipment	149,573,318	5,422,652	(2,738,609)	11,321,427	163,578,788
	505,222,694	25,604,804	(14,035,092)	-	516,792,406
Less accumulated depreciation and amortization	(221,079,780)	(22,000,124)	2,983,224	-	(240,096,680)
Capital assets — net	$ 284,142,914	$ 3,604,680	$ (11,051,868)	$ -	$ 276,695,726

In 2009, the State Department of Accounting and General Services and others transferred capital assets aggregating $6.9 million and $1.5 million, respectively to HHSC as a contribution of capital. During 2009, HHSC wrote-off $10.6 million in fixed assets relating to abandoned projects at KVMH, MMMC and Corporate. Management determined in 2009 that $6.0 million reported as buildings and improvements in the June 30, 2008 consolidated financial statements should have been reported as equipment. The beginning of the year amounts in this table have been updated for this correction.

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, 2009, 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 2010. Accordingly, the advance is classified as a noncurrent liability at June 30, 2009. The amount due to the State of $47,122,507 at June 30, 2009, consists of the $14 million 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, and $13 million in advances from the State of which $3 million is due in 2010. On March 30, 2010, the State agreed to defer payment of a $10 million advance over four years beginning in fiscal 2012. At June 30, 2009, $21.7 million was due from the State for allotments made to HHSC before June 30, 2009.

6. ESTIMATED THIRD-PARTY PAYOR SETTLEMENTS

The estimated amounts due (to) from government reimbursement programs at June 30, 2009, consisted of the following:

Cost reports:	
Medicare	$ (2,231,385)
Medicaid	2,272,609
HMSA 65 C Plus	680,506
Total	$ 721,730

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, 2009, was as follows:

	Beginning of Year	Additions	Reductions	End of Year	Current Portion	Noncurrent Portion
Accrued vacation	$ 34,015,210	$ 19,971,797	$ (16,599,232)	$ 37,387,775	$ 15,279,758	$ 22,108,017
Capital lease obligations	$ 39,971,398	7,640,742	(9,261,556)	38,350,584	8,971,077	29,379,507

Future capital lease payments as of June 30, 2009, were as follows:

Years Ending June 30	
2010	$ 11,211,283
2011	10,112,379
2012	7,783,451
2013	4,898,246
2014	3,722,891
2015–2019	6,536,607
2020–2024	1,601,689
2025–2029	822,103
Total future minimum payments	46,688,649
Less amount representing interest	(8,338,065)
Total capital lease obligations	38,350,584
Current portion	8,971,077
Noncurrent portion	$ 29,379,507

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, 2009, interest capitalized was not material.

8. LONG-TERM DEBT

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. At June 30, 2009, the balance payable was $16,285,976.

MMMC Working 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, 2009, MMMC was in violation of the liquidity covenant requiring a minimum of 30 days cash on hand and the debt to capitalization ratio, making the loan payable upon demand from JP Morgan Chase Bank. On February 2, 2010, MMMC received a firm commitment from the bank to remove the financial covenants, and to restructure repayment of the loan in fiscal 2011, subject to the State agreeing to defer payment of the State's $10 million advance. On March 30, 2010, the State agreed to defer the payment of its advance over four years beginning in fiscal 2012.

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. At June 30, 2009, the balance payable was $9,714,379.

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 2010. At June 30, 2009, the balance payable was $1,554,688.

KVMH Port Allen Clinic — In April 2008, HHSC Corporate entered into a promissory note with a bank to finance the leasehold improvements for KVMH's Port Allen clinic. The note requires monthly principal and interest payments of $16,207 through maturity of November 23, 2017. The note is secured by a security interest in the leasehold improvements of the clinic and has a balance outstanding at June 30, 2009 of $1,178,300.

Maui Memorial Medical Center Nurses' Cottages — During fiscal year 2003, Corporate acquired buildings for $1,690,000 on behalf of Maui Memorial Medical Center (MMMC) for use in its operations. The loan is payable to a municipal lessor with interest at 6.3%, and monthly principal and interest payments of $19,028 through November 2012. 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. At June 30, 2009, the loan payable outstanding was $684,908.

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 Kauai Veterans Memorial Hospital (KVMH). The original term loan required monthly payments of interest at the London InterBank Offered Rate, plus 3%, and the principal balance was initially due on August 2007, but was extended in August 2007 to August 2009. The new terms require $31,583 in monthly principal payments, plus interest. At June 30, 2009, the term loan outstanding was $63,239. The loan was paid in full in August 2009.

Bridge Loan — In April 2008, Corporate entered into a bridge loan for $10 million 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 amount required monthly payments of interest from 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 million due and payable on June 1, 2009. In 2009, Corporate transferred $4,010,199 of the balance to KVMH. In June 2009, KVMH repaid this loan from the proceeds of a $3,000,000 advance from the State of Hawaii.

Transactions in long-term debt during the year ended June 30, 2009, were as follows:

	Beginning of Year	Additions	Reductions	End of Year
Long-term debt	$ 44,432,281	$ 3,374,230	$ (7,325,021)	$ 40,481,490

Long-term debt as of June 30, 2009, consisted of the following:

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	$ 16,285,976
Line of credit 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
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	9,714,379
Line of credit payable to Pacific Rim Bank; variable rate based on lender's base rate; interest only until maturity on December 5, 2010	1,554,688
Loan payable to Pacific Rim Bank, interest at 8.5% due monthly payments of $16,207 and matures on November 23, 2017	1,178,300
Loan payable to Academic Capital; $1,690,900; interest at 6.3%; monthly principal and interest payments of $19,028; due November 4, 2012	684,908
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	63,239
Total	40,481,490
Less current portion	(905,146)
Noncurrent portion	$ 39,576,344

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

Years Ending June 30	Principal	Interest	Total
2010	$ 905,146	$ 1,647,519	$ 2,552,665
2011	13,427,120	1,599,505	$ 15,026,625
2012	938,455	1,542,247	$ 2,480,702
2013	999,272	1,481,390	$ 2,480,662
2014	1,063,421	1,417,208	$ 2,480,629
2015–2019	6,122,038	5,985,778	$ 12,107,816
2020–2024	7,432,394	3,998,329	$ 11,430,723
2025–2029	9,593,644	1,145,854	$ 10,739,498
Total	$ 40,481,490	$ 18,817,830	$ 59,299,320

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 $19,044,278 during fiscal year 2009.

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 $1,377,006 during fiscal year 2009. 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 $667,674 during fiscal year 2009.

10. EMPLOYEE BENEFITS

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

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

HHSC is required by State statute to contribute the remaining amounts necessary to pay contributory plan benefits when due. In the noncontributory plan, employees may elect normal retirement at age 62 with 10 years of credited service or at age 55 with 30 years of credited service, or elect early retirement at age 55 with 20 years of credited service. Such employees are entitled to retirement benefits, payable monthly for life, of 1.25% of their average final salary, as defined, for each year of credited service. Benefits fully vest on reaching ten years of service; retirement benefits are actuarially reduced for early retirement. HHSC is required by State statute to contribute all amounts necessary to pay noncontributory plan benefits when due.

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

HHSC's contribution to the ERS for the years ended June 30, 2009, 2008 and 2007, was approximately $33.8 million, $34.7 million and $26.1 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 postretirement benefits approximated $21,998,957 for the year ended June 30, 2009.

Sick Leave — Accumulated sick leave as of June 30, 2009, was approximately $64,170,164. 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 Hoʻola Hamakua, Kaʻu 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 2009.

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. In addition, the terms of the agreement requires HHSC to continue to provide laboratory space and certain ancillary services until 2011. As a result, $4 million of the proceeds was deferred and is being amortized on a straight-line basis through 2012 for the obligation to provide this space.

12. TEMPORARILY RESTRICTED NET ASSETS

Changes in temporarily restricted net assets for the year ended June 30, 2009, were as follows:

Balance — beginning of year	$ 2,116,477
Restricted contributions received	1,627,995
Restricted cash	100,000
Capital assets purchased and expenditures for restricted purposes	(2,997,424)
Balance — end of year	$ 847,048

13. 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 $16,145,000 for unpaid claims as of June 30, 2009.

Corporate Integrity Agreement — In July 2007, HMC and the Office of the Inspector General (OIG) of the U.S. Department of Health and Human Services entered into a settlement agreement and a three-year 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 and MMMC entered into various operating lease and related sublease agreements. Future minimum lease payments and sublease receipts at June 30, 2009, were as follows:

Years Ending June 30	Lease Payments	Sublease Receipts
2010	$ 733,200	$ 181,981
2011	755,040	187,174
2012	776,880	192,580
2013	776,880	
2014	776,880	
2015–2017	2,330,640	
Total	$ 6,149,520	$ 561,735

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, 2009, there were no payments made to 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.

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SUPPLEMENTAL INFORMATION

HAWAII HEALTH SYSTEMS CORPORATION

SUPPLEMENTAL SCHEDULE OF RECONCILIATION OF CASH ON DEPOSIT WITH THE STATE OF HAWAII
JUNE 30, 2009

	Appropriation Symbol	
CASH ON DEPOSIT WITH THE STATE OF HAWAII:		
SPECIAL FUNDS:		
	S-07-352-H	$ 182,151
	S-08-384-H	2,142
	S-09-312-H	800,661
	S-09-350-H	3,183,938
	S-09-351-H	267,226
	S-09-353-H	180,915
	S-09-354-H	1,576,298
	S-09-355-H	4,453,482
	S-09-358-H	118,804
	S-09-359-H	1,112,238
	S-09-365-H	640,001
	S-09-371-H	676,409
	S-09-373-H	472,044
	S-93-353-H	6,563
	S-93-359-H	2,818
	S-96-359-H	2,007
	S-97-359-H	3,556
	S-98-396-H	39,217
TRUST FUNDS:		
	T-04-918-H	1,273
TOTAL PER STATE		13,721,743
RECONCILING ITEMS		(33,307)
TOTAL PER HHSC		$13,688,436

(Continued)

HAWAII HEALTH SYSTEMS CORPORATION

SUPPLEMENTAL SCHEDULE OF RECONCILIATION OF CASH ON DEPOSIT WITH THE STATE OF HAWAII
JUNE 30, 2009

	Appropriation Symbol	
ASSETS LIMITED AS TO USE:		
PATIENT TRUST FUNDS:		
	T-04-911-H	$ 22,912
	T-04-923-H	4,129
	T-09-909-H	7,952
	T-09-915-H	12,763
	T-04-919-H	1,044
	T-04-921-H	6,679
	T-09-925-H	106,445
TOTAL PER STATE		161,924
RECONCILING ITEMS:		
Patients' safekeeping deposits held by financial institutions		763,124
Restricted assets held by financial institutions		680,571
Other		176,208
TOTAL PER HHSC		$1,781,827

(Concluded)

HAWAII HEALTH SYSTEMS CORPORATION

SUPPLEMENTAL COMBINING AND CONSOLIDATING STATEMENT OF NET ASSETS INFORMATION
JUNE 30, 2009

	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	Alii-Kona Community Care	Reclassifi-cations and Eliminations	HHSC Consolidated
ASSETS																							
CURRENT ASSETS:																							
Cash and cash equivalents:																							
On deposit with the State of Hawaii	$ 3,183,938	$ 268,499	$ 182,151	$ -	$ 1,576,336	$ 187,478	$ 4,453,482	$ 676,409	$ 118,804	$ 800,661	$ 640,001	$ -	$ 1,120,618	$ 472,045	$ 13,680,422	$ 8,014	$ -	$ 13,688,436	$ -	$ -	$ -	$ -	$ 13,688,436
On deposit with banks and on hand	8,283,311	11,349	59,302	200	312,850	349,744	2,539,856	10,138	41,651	119,547	395,096	379,083	92,084	105,251	12,699,462	5,563,804		18,263,266	48,222	104,065	68,963		18,484,516
Patient accounts receivable — less allowances for contractual adjustments and doubtful accounts	17,564,343	1,844,894	400,877	1,685,328	6,598,156	880,478	28,557,347	3,762,017	564,662	1,868,168	1,661,442	2,000,736	4,478,529	2,480,407	74,347,384			74,347,384			612,620		74,960,004
Due from Medicaid for Act 294	257,000	155,325			83,000					682,000					1,177,325			1,177,325					1,177,325
Supplies and other current assets	2,250,097	81,556	58,352	89,835	1,817,619	55,369	6,067,118	376,322	132,176	912,581	1,484,947	235,222	719,157	207,925	14,488,276	14,662		14,502,938		84,734	86,397		14,674,069
Due from State of Hawaii	711,335	6,399,087	561,480		247,097	652,656	6,959,654	1,153,655	324,244	948,057	535,498		1,491,348	963,885	20,947,996	750,000		21,697,996					21,697,996
Estimated third-party payor settlements	(841,476)	(63,683)	501,916		(105,613)	379,688	(2,918,577)	1,118,234	147,190	243,389	139,000	249,377	1,302,250	570,035	721,730			721,730					721,730
Total current assets	31,408,548	8,697,027	1,764,078	1,775,363	10,529,445	2,505,413	45,658,880	7,096,775	1,328,727	5,574,403	4,855,984	2,864,418	9,203,986	4,799,548	138,062,595	6,336,480		144,399,075	48,222	188,799	767,980		145,404,076
DUE FROM AFFILIATES — Net																341,402,950	(329,597,627)	11,805,323				(11,805,323)	
CAPITAL ASSETS — Net	42,627,943	15,237,281	1,115,081	28,270,290	24,597,989	1,535,886	107,699,540	4,996,237	769,710	4,252,997	5,403,677	2,637,316	13,249,613	5,196,384	257,589,944	4,390,332		261,980,276		14,575,227	140,223		276,695,726
ASSETS LIMITED AS TO USE	449,111	20,114	10,449	79,810	114,715	2,148	184,143	122,338	1,915	129,605	75,847	140	48,486	43,006	1,281,827	500,000		1,781,827					1,781,827
OTHER ASSETS	498,236			1,636	874,345		566,459						133,650		2,074,326	448,218		2,522,544			25,375	(97,822)	2,450,097
TOTAL	$ 74,983,838	$ 23,954,422	$ 2,889,608	$ 30,127,099	$ 36,116,494	$ 4,043,447	$ 154,109,022	$ 12,215,350	$ 2,100,352	$ 9,957,005	$ 10,335,508	$ 5,501,874	$ 22,635,735	$ 10,038,938	$ 399,008,692	$ 353,077,980	$(329,597,627)	$ 422,489,045	$ 48,222	$ 14,764,026	$ 933,578	$(11,903,145)	$ 426,331,726
LIABILITIES AND NET ASSETS (DEFICIT)																							
CURRENT LIABILITIES:																							
Accounts payable and accrued expenses	$ 17,271,936	$ 1,667,399	$ 495,844	$ 630,227	$ 10,007,922	$ 376,825	$ 31,699,554	$ 2,088,445	$ 424,471	$ 1,853,073	$ 1,149,546	$ 497,550	$ 3,125,110	$ 1,442,483	$ 72,730,385	$ 6,907,637	$ -	$ 79,638,022	$ -	$ 301,631	$ 625,411	$ 15,277	$ 80,580,341
Current portion of accrued vacation	2,627,425	311,301	134,456	23,824	2,482,698	206,810	4,347,813	601,848	81,898	1,119,032	470,791	114,803	1,719,471	687,423	14,929,593	350,165		15,279,758					15,279,758
Current portion of capital lease obligations							8,601								8,601	8,962,476		8,971,077					8,971,077
Current portion due to the State of Hawaii													3,000,000		3,000,000			3,000,000					3,000,000
Current portion of accrued workers' compensation	477,000				236,000		645,000						142,000		1,500,000			1,500,000					1,500,000
Current portion of long-term debt	201,059			8,765									104,323		314,147	253,798		567,945		337,201			905,146
Other current liabilities	450,431	35,552	9,722	1,162,795	152,448	34,504	221,136	6,916		198,162	229,844		327,146		2,828,656			2,828,656		342,145	184		3,170,985
Total current liabilities	21,027,851	2,014,252	640,022	1,825,611	12,879,068	618,139	36,922,104	2,697,209	506,369	3,170,267	1,850,181	612,353	8,418,050	2,129,906	95,311,382	16,474,076	-	111,785,458	-	980,977	625,595	15,277	113,407,307
CAPITAL LEASE OBLIGATIONS — Less current portion																29,379,507		29,379,507					29,379,507
LONG-TERM DEBT — Less current portion	9,513,320			1,545,923			11,000,000						1,073,977		23,133,220	494,349		23,627,569		15,948,775			39,576,344
ACCRUED VACATION — Less current portion	5,702,985	448,928	209,807		1,784,505	215,387	6,431,994	1,469,024	178,940	1,400,214	1,525,520		1,036,761	820,560	21,224,625	835,601		22,060,226			47,791		22,108,017
ACCRUED WORKER'S COMPENSATION — Less current portio	3,432,000	333,000	179,000		1,707,000	250,000	3,785,000	1,434,000	89,000	895,000	615,000		1,017,000	663,000	14,399,000	246,000		14,645,000					14,645,000
OTHER POSTEMPLOYMENT BENEFIT LIABILITY	15,678,128	1,239,604	856,737		7,514,779	807,939	20,901,991	3,085,856	461,197	3,855,451	2,998,335		4,771,565	2,236,941	64,408,523	1,374,015		65,782,538					65,782,538
DUE TO AFFILIATES — Net	82,006,341	2,779,412	10,075,951	464,378	52,443,278	8,729,687	16,939,530	20,891,400	13,639,490	16,597,300	27,531,101	1,553,972	56,338,017	19,607,770	329,597,627		(329,597,627)			11,347,962	591,420	(11,939,382)	
DUE TO THE STATE OF HAWAII		506,153			7,605,205	528,149	10,000,000	1,114,264		6,416,791	491,450		1,043,345	2,417,150	30,122,507	14,000,000		44,122,507					44,122,507
PATIENTS' SAFEKEEPING DEPOSITS AND DEFERRED INCOME — Restricted contributions	48,341	20,114	10,449		6,161	2,148		122,338	1,915	121,525	51,312	140	8,377	41,959	434,779			434,779					434,779
OTHER LIABILITIES	1,322,680		22,285	1,939,604	464,181		661,667	18,581			13,296		22,985	7,149	4,472,428			4,472,428					4,472,428
Total liabilities	138,731,646	7,341,463	11,994,251	5,775,516	84,404,177	11,151,449	106,642,286	30,832,672	14,876,911	32,456,548	35,076,195	2,166,465	73,730,077	27,924,435	583,104,091	62,803,548	(329,597,627)	316,310,012	-	28,277,714	1,264,806	(11,924,105)	333,928,427
COMMITMENTS AND CONTINGENCIES																							
NET ASSETS:																							
Invested in capital assets— net of related debt	32,631,588	14,236,171	1,115,081	26,715,602	24,337,057	1,535,886	107,014,118	4,764,454	744,315	3,875,070	5,403,677	2,637,316	12,071,313	5,196,384	242,278,032	(34,699,798)		207,578,234		(1,710,749)	140,223		206,007,708
Restrictions — primarily for capital acquisitions	400,770		79,810	108,554	8,080	24,535	1,047	847,048			847,048												
Unrestricted	(96,780,166)	2,376,788	(10,219,724)	(2,443,829)	(72,733,294)	(8,643,888)	(59,731,525)	(23,381,776)	(13,520,874)	(26,382,693)	(30,168,899)	698,093	(63,205,764)	(23,082,928)	(427,220,479)	324,974,230		(102,246,249)	48,222	(11,802,939)	(471,451)	20,960	(114,451,457)
Total net assets	(63,747,808)	16,612,959	(9,104,643)	24,351,583	(48,287,683)	(7,108,002)	47,466,736	(18,617,322)	(12,776,559)	(22,499,543)	(24,740,687)	3,335,409	(51,094,342)	(17,885,497)	(184,095,399)	290,274,432	-	106,179,033	48,222	(13,513,688)	(331,228)	20,960	92,403,299
TOTAL	$ 74,983,838	$ 23,954,422	$ 2,889,608	$ 30,127,099	$ 36,116,494	$ 4,043,447	$ 154,109,022	$ 12,215,350	$ 2,100,352	$ 9,957,005	$ 10,335,508	$ 5,501,874	$ 22,635,735	$ 10,038,938	$ 399,008,692	$ 353,077,980	$(329,597,627)	$ 422,489,045	$ 48,222	$ 14,764,026	$ 933,578	$(11,903,145)	$ 426,331,726

(Continued)

(Concluded)

HAWAII HEALTH SYSTEMS CORPORATION

SUPPLEMENTAL COMBINING AND CONSOLIDATING STATEMENT OF REVENUES, EXPENSES, AND CHANGES IN NET ASSETS INFORMATION
YEAR ENDED JUNE 30, 2009

	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	Alii-Kona Community Care	Reclassifi-cations and Eliminations	HHSC Consolidated
OPERATING REVENUES:																							
Net patient service revenue	$ 100,611,083	$ 8,419,940	$ 4,642,057	$ 6,155,497	$ 45,475,456	$ 5,344,895	$ 140,504,283	$ 17,771,776	$ 2,427,600	$ 16,454,145	$ 14,438,006	$ 6,268,356	$ 27,081,828	$ 13,526,516	$ 409,121,438	$ -	$ -	$ 409,121,438	$ -	$ -	$ 3,429,443	$ -	$ 412,550,881
Other operating revenues	1,188,875	104,087	17,086		476,396	5,269	1,045,730	80,344	19,157	283,674	51,497	380,162	301,800	27,693	3,981,770			3,981,770		3,533,291	990,907	(938,433)	7,567,535
Total operating revenues	101,799,958	8,524,027	4,659,143	6,155,497	45,951,852	5,350,164	141,550,013	17,852,120	2,446,757	16,737,819	14,489,503	6,648,518	27,383,628	13,554,209	413,103,208	-	-	413,103,208	-	3,533,291	4,420,350	(938,433)	420,118,416
OPERATING EXPENSES:																							
Salaries and benefits	83,628,456	6,722,617	4,761,701	3,269,147	42,269,009	4,748,312	114,172,127	17,210,412	2,781,107	20,506,692	16,941,568	4,445,433	25,634,102	14,397,634	361,488,317	7,548,113		369,036,430			3,193,014		372,229,444
Medical supplies and drugs	14,752,345	297,193	126,727	194,292	6,604,832	117,633	31,414,733	544,097	295,463	475,904	283,887	590,270	2,086,769	314,909	58,099,054			58,099,054			181,035		58,280,089
Professional Fees	2,269,539	27,147	23,904	53,838	698,071	97,173	1,649,749	141,995	21,228	92,915	39,277	932,956	662,979	441,410	7,152,181	118,238		7,270,419		1,860,351		(938,433)	8,192,337
Purchased services	14,031,240	955,039	1,011,797	136,781	6,875,004	1,018,953	13,853,274	1,510,206	803,998	429,497	659,070	641,384	4,624,181	907,124	47,457,548	51,391	(388,336)	47,120,603		5,395	540,432		47,666,430
Depreciation and amortization	3,892,924	490,121	118,975	919,910	2,909,810	255,431	6,954,519	299,370	73,293	701,984	409,352	424,012	1,348,052	443,052	19,240,805	1,815,609		21,056,414		905,330	38,380		22,000,124
Other supplies	3,798,739	307,026	136,367	348,556	1,045,148	158,051	4,260,661	936,068	125,343	997,965	680,353	250,117	651,062	540,133	14,235,589	60,351		14,295,940	157	272,711	50,294		14,619,102
Utilities	2,096,132	644,449	116,341	367,558	1,473,886	149,128	3,689,392	309,299	119,175	935,103	556,656	326,174	862,816	446,270	12,092,379	106,655		12,199,034		285,073	77,856		12,561,963
Repairs and maintenance	3,201,857	877,769	35,430	54,908	1,412,364	181,950	2,566,042	111,356	70,477	279,588	181,127	185,236	612,556	65,436	9,836,096	77,959		9,914,055		44,149	5,313		9,963,517
Rent and lease	2,080,656	21,755	27,375	4,163	349,717	23,166	2,947,061	67,105	8,931	27,924	25,984	171,390	754,115	76,129	6,585,471	73,488	(10,200)	6,648,759		108,035	252,593		7,009,387
Insurance	1,454,042	50,147	94,996	362,063	623,947	37,627	1,248,683	160,326	22,036	316,878	172,855	145,759	361,580	98,416	5,149,355	4,335		5,153,690		87,111	229,800		5,470,601
Other	1,063,847	42,781	70,543	2,085,151	481,875	62,884	1,515,137	76,118	51,414	76,261	34,744	78,965	480,966	72,307	6,192,993	320,044		6,513,037	2,780	207,112	594,384		7,317,313
Total operating expenses	132,269,777	10,436,044	6,524,156	7,796,367	64,743,663	6,850,308	184,271,378	21,366,352	4,372,465	24,840,711	19,984,873	8,191,696	38,079,178	17,802,820	547,529,788	10,176,183	(398,536)	557,307,435	2,937	3,775,267	5,163,101	(938,433)	565,310,307
INCOME (LOSS) FROM OPERATIONS	(30,469,819)	(1,912,017)	(1,865,013)	(1,640,870)	(18,791,811)	(1,500,144)	(42,721,365)	(3,514,232)	(1,925,708)	(8,102,892)	(5,495,370)	(1,543,178)	(10,695,550)	(4,248,611)	(134,426,580)	(10,176,183)	398,536	(144,204,227)	(2,937)	(241,976)	(742,751)	-	(145,191,891)
NONOPERATING REVENUES (EXPENSES):																							
General operating appropriations from State of Hawaii	20,333,402	1,469,760	927,360		9,929,440	748,800	12,979,200	2,243,520	770,880	3,707,520	3,050,880	1,440,000	7,442,400	1,874,880	66,918,042			66,918,042					66,918,042
Collective bargaining pay raise appropriation from State of Hawaii	6,211,000	526,000	315,000		3,085,000	360,000	7,802,000	1,234,000	195,000	1,670,000	1,252,065		1,382,000	811,237	24,843,302	279,000		25,122,302					25,122,302
Noncapital restricted contributions	1,086,983	197,125	76,075		5,272	19,133	102,746								1,487,334			1,487,334					1,487,334
Interest and dividend income	115,194	35	248		28,326		89,848	299	48	46,896	48,298		2,659	2,694	334,545	224,164		558,709	504	103			559,316
Interest expense (net of capitalized interest)	(659,690)	(14,047)		(84,597)	(169,059)	(599)	(1,226,723)	(6,894)		(247)		(39,035)	(74,762)	(31)	(2,275,684)	(2,611,947)		(4,887,631)		(969,844)			(5,857,475)
Corporate allocation expense	(3,153,986)	(251,840)	(152,008)		(1,538,217)	(152,784)	(4,393,344)	(502,590)	(107,571)	(581,834)	(468,959)		(839,150)	(413,253)	(12,555,536)	12,555,536							
Loss on disposal of fixed assets							(1,396,221)	(10,136)					(7,815,309)		(9,221,666)	(1,404,505)		(10,626,171)					(10,626,171)
Other nonoperating revenues (expenses) — net	(965,284)	179,597	95,608		(58,957)	11,549	365,666	84,226	33,432	194,066	(145)		285,862	284,153	509,773	(13,168)	(398,536)	98,069	(70,000)	499,486	853,522	(328,724)	1,052,353
Nonoperating revenues (expenses) — net	22,967,619	2,106,630	1,262,283	(84,597)	11,281,805	986,099	14,323,172	3,042,425	891,789	5,036,401	3,882,139	1,400,965	383,700	2,559,680	70,040,110	9,029,080	(398,536)	78,670,654	(69,496)	(470,255)	853,522	(328,724)	78,655,701
INCOME (LOSS) BEFORE CAPITAL CONTRIBUTIONS, TRANSFERS, AND SPECIAL ITEM	(7,502,200)	194,613	(602,730)	(1,725,467)	(7,510,006)	(514,045)	(28,398,193)	(471,807)	(1,033,919)	(3,066,491)	(1,613,231)	(142,213)	(10,311,850)	(1,688,931)	(64,386,470)	(1,147,103)	-	(65,533,573)	(72,433)	(712,231)	110,771	(328,724)	(66,536,190)
CAPITAL GRANTS AND CONTRIBUTIONS	782,360	93,031	386,606	836,045	223,453	246,842	509,524	597,532		324,320	411,534	232,703		65,347	4,709,297			4,709,297					4,709,297
DECREASE IN NET ASSETS	(6,719,840)	287,644	(216,124)	(889,422)	(7,286,553)	(267,203)	(27,888,669)	125,725	(1,033,919)	(2,742,171)	(1,201,697)	90,490	(10,311,850)	(1,623,584)	(59,677,173)	(1,147,103)	-	(60,824,276)	(72,433)	(712,231)	110,771	(328,724)	(61,826,893)
NET ASSETS — Beginning 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
NET ASSETS — End of year	$ (63,747,808)	$ 16,612,959	$ (9,104,643)	$ 24,351,583	$ (48,287,683)	$ (7,108,002)	$ 47,466,736	$ (18,617,322)	$ (12,776,559)	$ (22,499,543)	$ (24,740,687)	$ 3,335,409	$ (51,094,342)	$ (17,885,497)	$ (184,095,399)	$ 290,274,432	$ -	$ 106,179,033	$ 48,222	$ (13,513,688)	$ (331,228)	$ 20,960	$ 92,403,299

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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, 2009, and have issued our report thereon (which report expresses an unqualified opinion and includes an explanatory paragraph regarding finalizing negotiations of assets and liabilities transferred from the State Department of Health) dated April 9, 2010. 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

April 9, 2010

HAWAII HEALTH SYSTEMS CORPORATION

SCHEDULE OF FINDINGS
YEAR ENDED JUNE 30, 2009

SIGNIFICANT DEFICIENCIES

HHSC CORPORATE

Corporate 2009-1 Business Continuity and Information Technology Disaster Recovery Planning

Criteria — An appropriately developed Business Continuity Management (BCM) program provides a critical roadmap and priority list to assist organizations with recovering essential data and resuming operations when faced with natural disasters, major system outages, or other unexpected disruptions of business. An Information Technology Disaster Recovery Plan (IT-DRP) is a critical component of the BCM program. An IT-DRP is the process, policies, and procedures related to the recovery and continuation of critical information systems in the event of a disaster. Management should have a comprehensive Business Continuity Plan/ IT Disaster Recovery Plan.

Condition — HHSC has a high level Corporate Data Center (CDC – HHSC's IT Department) Business Continuity Plan (BCP) and IT-DRPs. In addition, per inquiry with management, each hospital has a documented Emergency Mode Plan stored at their individual hospital locations. However, a detailed version of the BCP/IT-DRP has not been formulated, including:

- An Emergency Access Procedure to address obtaining necessary electronic protected health information (PHI) during an emergency has not been documented.
- Detailed backup and recovery procedures have not been documented for information systems.
- An alternate recovery location for IT systems has not been identified.

Cause — Management has not developed a comprehensive Business Continuity Plan/ IT Disaster Recovery Plan.

Effect — Without a comprehensive BCP and IT-DRP, HHSC may not be able to recover its core operations in the event of a disaster and in turn, minimize the impact of the disaster. HHSC may also be at increased risk of non-compliance with HIPAA Security Rule 164.308(a)(7)(i).

Recommendation — BCP's involve the prioritization of business objectives and critical operations that are essential for recovery. We recommend management perform a business impact analysis to identify the areas that would suffer the greatest financial and operational loss in the event of a disaster or disruption. Once this is performed, a formal business continuity plan should then be developed.

Once a BCP has been established, HHSC should further develop its IT-DRP. Typically an IT-DRP includes maintaining a comprehensive inventory of critical applications, systems, hardware and software; identifying necessary back-up methods and appropriate back-up schedules for critical records; and detailed restoration methods of critical systems.

An IT-DRP should also include acceptable timelines in which critical systems must be recovered to avoid unacceptable breaks in HHSC's business processes. The BCP team or coordinator should also identify and document requirements from non-IT personnel. For example, procedures should be documented, in the event of a disaster, directing nurses at a hospital:

- To an alternate processing location to either obtain necessary electronic protected health information.
- To document procedures performed on patients using a secured personal computer while IT continues to recover its core systems.

HHSC should also make arrangements for alternate processing capability in the event their data processing site becomes inoperable or inaccessible. When choosing a site, HHSC should consider location, size, capacity (computer and telecommunications), and required amenities, such as workspace, telephones, workstations, network connectivity, etc) necessary to recover the level of service required by the critical business functions. The type of recovery alternative selected will depend on the guidelines around the criticality and acceptable downtimes of the business process and IT systems set by the BCP.

After the development of a written plan, HHSC should also regularly update the plan, and conduct training and testing for potential scenarios.

Corporate 2009-2 Capital Assets

Criteria — Capital assets should be reported in the proper classifications, construction in progress and capitalized interest should be recorded to fixed assets and depreciated on a timely basis, and a review of projects not complete should be reviewed for viability on a timely basis.

Condition — The entity had designed controls over the review and reconciliation of fixed asset detail to the general ledger, however the review process was not effective.

Cause — Management did not review the capital assets for proper classification and viability of incomplete projects on a timely basis.

Effect — Capital assets were not properly reported until the following audit adjustments were recorded:

- $6,097,787 to reclassify building and improvements to equipment
- $1,404,055 to write-off abandoned projects
- $911,498 to reclassify capitalized interest and CIP to assets placed in service, and record related depreciation

Recommendation — Review capital assets and construction in progress projects for proper classification and ensure that fixed assets are recorded, reviewed for viability, and depreciated on a timely basis.

KOHALA HOSPITAL

KH 2009-1 Accounting for Allotments

Criteria — Contributions from the State of Hawaii should be recorded when amounts are allotted.

Condition — The Facility recorded $1 million in construction-in-progress and contributions from the State of Hawaii for amounts that were appropriated by the State of Hawaii but had not been allotted as of June 30, 2009, and for amounts that were allotted and recorded in the previous year.

Cause — Management was not familiar with the reports issued by the State of Hawaii that distinguished between appropriations and allotments.

Effect — An audit adjustment of approximately $1 million was recorded to remove the contribution and construction-in-progress recorded by management.

Recommendation —The facility should refer to HHSC accounting policies regarding property contributed by the State of Hawaii.

KONA COMMUNITY HOSPITAL

KCH 2009-1 Classification of account balances

Criteria — Account balances should be properly classified in the financial statements.

Condition — The facility did not properly classify receivables in the financial statements until an audit adjustment was recorded.

Cause — Lack of management review of credit balances in receivables to properly classify the current and noncurrent balances.

Effect — An audit reclassification of credit balances in accounts receivable of $380,941 was recorded.

Recommendation — Management should implement procedure to review classification of credit balances in accounts receivable.

MAUI MEMORIAL MEDICAL CENTER

MMMC 2009-1 Inventory

Criteria — The inventory details should be properly reconciled to the general ledger, and reviewed by management for accuracy.

Condition — MMMC had designed internal controls over the recording of entries related to inventory; however, the internal controls were not implemented properly.

Cause — The individual responsible for the reconciliation of the inventory account balances did not perform their assigned tasks properly and a review by management did not identify the misstatement.

Effect — A misstatement of approximately $873,000 to inventory and expenses in fiscal year 2008 was corrected in fiscal year 2009.

Recommendation — Ensure that inventory details are properly reconciled to the general ledger. Management should review the inventory details for accuracy.

HALE HO‘OLA HAMAKUA

HHH 2009-1 Accounting for Capital Assets

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

Condition — During fiscal year 2009, HHH did not properly account for contributions of property from the State of Hawaii (SOH) and did not accrue for construction in progress billings for services provided in the current fiscal year.

Cause — Capital assets details were not updated for contributions from third parties (i.e., the SOH) and proper cutoff was not maintained as construction in progress invoices were not accrued at June 30, 2009.

Effect — The following audit adjustments were recorded to the preliminary capital assets balances:

- An adjustment to accrue construction in progress and accounts payable of $1,001,000 was recorded for construction services provided in the current fiscal year.

- An adjustment to record contributions from the SOH of $200,000 for repairs and maintenance related to earthquake damage was recorded.

Recommendation — Ensure that all property additions are properly accounted for, and all services provided and goods received prior to year-end are properly accrued.

HHH 2009-2 Accounting for Contractual and Bad Debt Allowances

Criteria – Contractual and bad debt allowances related to accounts receivable should be reviewed by management on a timely basis.

Condition – Beginning in fiscal year 2008, contractual and bad debt allowances are calculated by HHSC – Corporate. However, in fiscal year 2009, the calculated allowances did not properly account for adjustments related to advances, and allowances on patient accounts that are aged greater than 365 days.

Cause — Reserves prepared by HHSC – Corporate did not account for certain information that was specific to HHH and adjustments were not identified timely by management.

Effect — The following audit adjustments were recorded to the contractual and bad debt allowances in the general ledger:

- An advance received prior to year end was not applied to the patient accounts timely, resulting in an over-reserve of $175,000.

- Patient accounts aged greater than 365 days were not fully reserved for, as required by HHSC – Corporate policy. An adjustment of $394,000 was recorded to increase the reserve for these outstanding amounts.

Recommendation — Ensure that contractual and bad debt allowances computed by HHSC – Corporate are reviewed by management and specific reserves are identified and recorded in a timely manner.

HILO MEDICAL CENTER

HMC 2009-3 Accounting for Contractual and Bad Debt Allowances

Criteria — Contractual and bad debt allowances related to accounts receivable should be reviewed by management on a timely basis.

Condition — Beginning in fiscal year 2008, contractual and bad debt allowances were calculated by HHSC – Corporate. However, in fiscal year 2009, the calculated allowances did not properly account for significant credit balances in accounts receivables, additional reserves required on outlier accounts and delayed billings, adjustments related to advances, and allowances on patient accounts that are aged greater than 365 days.

Cause — Reserves prepared by HHSC – Corporate did not account for certain information that was specific to HMC and adjustments were not identified timely by management.

Effect — The following audit adjustments were recorded to the contractual and bad debt allowances in the general ledger:

- Certain account balances were individually analyzed and management determined that an additional reserve of $139,000 was necessary, but had not recorded an adjustment until the audit
- HMC recorded reserves related to delayed billings were over-reserved by $450,000.

Recommendation – Ensure that contractual and bad debt allowances computed by HHSC- Corporate are reviewed by management, and specific reserves are identified in a timely manner.

HMC 2009-4 Classification of account balances

Criteria — Amounts reported in the financial statements should be properly classified between current and noncurrent, and within operating and nonoperating in the statement of revenues and expenses, and reviewed for consistency.

Condition — Various balance sheet and income statement accounts were not classified properly for financial statement presentation.

Cause — A review of the accounts for proper classification is not performed by management on a timely basis.

Effect — The following audit adjustments were recorded by management:

- Reclassification of $616,681 in credit balances in accounts receivable
- Reclassification of a noncurrent deferred liability balance of $435,504
- Reclassification of restricted net assets of $400,770

Recommendation — Ensure that HMC's restricted contributions are monitored and appropriately accounted for and reported in the financial statements.

YUKIO OKUTSU VETERANS CARE HOME (VA) — HILO

Yukio 2009-1 Depreciation Expense

Criteria — Depreciation expense should be calculated using appropriate useful lives that are consistent with HHSC Corporate.

Condition — The Facility recorded building depreciation expense based on 27.5 years of useful life; however, the Facility should have utilized a 40 year life in accordance with HHSC Corporate's policies.

Cause — The Facility's accounting records are maintained by a management company. Facility management did not review the estimated useful life used to calculate depreciation and the error was undetected in the current year.

Effect — An audit adjustment of $281,470 was recorded to correct the amount of depreciation expense taken in the current year.

Recommendation — Review useful lives used to calculate depreciation expense to ensure useful lives are reasonable and consistent with HHSC policies.

Yukio 2009-2 Posting of Entries

Criteria — Journal entries allocated from HHSC Corporate should be recorded in the proper period.

Condition — Capitalized interest allocated from HHSC Corporate in 2008 was not recorded to the general ledger account balances.

Cause — The Facility's account records were not updated on a timely basis.

Effect — An adjustment of $187,469 was made to record the 2008 audit adjustment.

Recommendation — Year-end adjustments and entries should be recorded timely, and financial statements should be reviewed to ensure amounts are properly posted in the proper period.

ALII COMMUNITY CARE

Alii 2009-1 Allocation of Purchase Price

Criteria — The acquisition price of Roselani Place for $16 million should be allocated to the fair value of the assets acquired and the lease assumed. In addition, the capital assets detail should be updated, reconciled to the general ledger and reviewed by management on a timely basis.

Condition – In September 2007, the facility did not allocate the $16 million purchase price of the Roselani Place to the assets acquired and lease assumed, the fixed asset subledger was not updated, and depreciation expense was not recorded to the general ledger. This finding was also reported in the prior year.

Cause — The facility did not engage a specialist to assist management to fair value the assets acquired and lease assumed, and no amounts were recorded to depreciation expense because the assets were not included in the fixed asset subledger.

Effect — Depreciation expense was understated by $700,000, and no amounts were allocated to equipment or the lease assumed.

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

Alii 2009-2 Fixed Assets

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

Condition — In September 2007, the facility did not allocate the $16 million purchase price of the Roselani Place to the assets acquired and lease assumed, the fixed asset detail was not updated, and depreciation expense was not recorded to the general ledger.

Cause — The facility did not record depreciation expense because the assets were not included in the fixed asset detail.

Effect — Audit adjustments of $800,000 and $105,330 was recorded for the related depreciation for the building and equipment, respectively.

Recommendation — Ensure that capital asset details are updated and reconciled to the general ledger on a timely basis.

Alii 2009-3 Intercompany

Criteria — The intercompany accounts for HHSC-Corporate should be reconciled with HHSC-Corporate on a timely basis.

Condition — Intercompany accounts with HHSC did not reconcile at year end.

Cause — The facility failed to record the prior year adjustment of $500,000 relating to a settlement reserve, and had also incorrectly recorded $600,000 to buildings.

Effect — An audit adjustment of approximately $600,000 was recorded to properly record building, and an audit adjustment of $500,000 was recorded to reflect the prior year adjustment.

Recommendation — Ensure that intercompany accounts are reconciled with other facilities on a timely basis, and that all prior period adjustments are recorded timely.