Hawaii Health Systems Corporation

Financial Report
with Other Supplemental Information
June 30, 2010

Contents

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Independent Auditor's Report

To the Board of Directors
Hawaii Health Systems Corporation

We have audited the accompanying financial statements of Hawaii Health Systems Corporation (HHSC), a component unit of the State of Hawaii, as of and for the year ended June 30, 2010 as listed in the table of contents. These financial statements are the responsibility of HHSC's management. Our responsibility is to express an opinion on these financial statements based on our audit. The financial statements of Hawaii Health Systems Corporation as of June 30, 2009 were audited by other auditors, whose report dated April 9, 2010 expressed an unqualified opinion on those statements.

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

As discussed in Note 1, the financial statements present only HHSC (a component unit of the State of Hawaii) and do not purport to, and do not, present fairly the financial position of the State of Hawaii as of June 30, 2010, the changes in its financial position, or its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Hawaii Health Systems Corporation at June 30, 2010 and the changes in financial position 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 (the "State") to HHSC. At June 30, 2010, negotiations between the State and HHSC relating to the transfer of HHSC's assets and liabilities (including amounts to the State) still had not been finalized. Accordingly, the assets, liabilities, and net assets reflected in the accompanying balance sheet at June 30, 2010 may be significantly different from those eventually included in the final settlement.

To the Board of Directors
Hawaii Health Systems Corporation

The management's discussion and analysis is not a required part of the financial statements but is supplemental 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 supplemental 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 financial statements that collectively comprise Hawaii Health Systems Corporation's (HHSC) financial statements. The accompanying other supplemental information, as identified in the table of contents, is presented for purposes of additional analysis and is not a required part of the financial statements. The other supplemental information has been subjected to the auditing procedures applied in the audit of the financial statements and, in our opinion, is fairly stated in all material respects in relation to the financial statements taken as a whole.

In accordance with *Government Auditing Standards*, we have also issued our report dated August 24, 2011 on our consideration of Hawaii Health Systems Corporation's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements. The purpose of that report is to describe the scope of our testing of internal control 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.

Plante & Moran, PLLC

August 24, 2011

This discussion and analysis of Hawaii Health Systems Corporation's (HHSC or the "Corporation") financial performance provides an overview of the Corporation's financial activities for the fiscal years ended June 30, 2010, 2009, and 2008. Please read it in conjunction with the Corporation's financial statements, which begin on page 15.

Using this Annual Report

The Corporation's financial statements consist of three statements: (a) a balance sheet; (b) a statement of revenues, expenses, and changes in net assets; and (c) a statement of cash flows. These financial statements and related notes provide information about the activities of the Corporation, including resources held by the Corporation but restricted for specific purposes.

The Balance Sheet and Statement of Revenues, Expenses, and Changes in Net Assets

The analysis of the Corporation's finances begins on page 4. One of the most important questions asked about the Corporation's finances is, "Is the Corporation as a whole better or worse off as a result of the year's activities?" The balance sheet and the statement of revenues, expenses, and changes in net assets report information about the Corporation's resources and its activities in a way that helps answer this question. These statements include all restricted and unrestricted assets and all liabilities using the accrual basis of accounting. All of the current year's revenues and expenses are taken into account regardless of when cash is received or paid.

These two statements report the Corporation's net assets and changes in them. You can think of the Corporation's net assets - the difference between assets and liabilities - as one way to measure the Corporation's financial health, or financial position. Over time, increases or decreases in the Corporation's net assets are one indicator of whether its financial health is improving or deteriorating. You will need to consider other nonfinancial factors, however, such as changes in the Corporation's patient base and measures of the quality of service it provides to the community, as well as local economic factors, to assess the overall health of the Corporation.

The Statement of Cash Flows

The final required statement is the statement of cash flows. The statement reports cash receipts, cash payments, and net changes in cash resulting from operations, investing, and financing activities. It provides answers to such questions as, "Where did cash come from?", "What was cash used for?", and "What was the change in cash balance during the reporting period?"

The Corporation's Net Assets

The Corporation's net assets are the difference between its assets and liabilities reported in the balance sheet on page 15. The Corporation's net assets increased by $36,452,169 (39.4 percent) in 2010, decreased by $61,826,893 (40.1 percent) in 2009, and decreased $5,053,700 (3.2 percent) in 2008, as you can see from the following table.

Assets, Liabilities, and Net Assets

Summarized financial information of HHSC's balance sheet as of June 30, 2010, 2009, and 2008 is as follows:

	2010	2009	2008
Assets			
Current assets	$ 195,301,745	$ 145,404,076	144,830,380
Capital assets - Net	285,585,332	276,695,726	284,755,797
Other assets	3,242,628	4,231,924	6,751,133
Total assets	**$ 484,129,705**	**$ 426,331,726**	**$ 436,337,310**
Liabilities			
Current liabilities	$ 115,208,849	$ 113,407,307	$ 137,018,943
Other postemployment liability	105,204,848	65,782,538	30,249,692
Due to the State of Hawaii	44,122,507	44,122,507	34,122,507
Other liabilities	90,738,033	110,616,075	80,715,976
Total liabilities	355,274,237	333,928,427	282,107,118
Net Assets (Deficit)			
Invested in capital assets - Net of related debt	222,054,782	206,007,708	198,283,269
Restricted	1,107,015	847,048	2,116,477
Unrestricted	(94,306,329)	(114,451,457)	(46,169,554)
Total net assets (deficit)	128,855,468	92,403,299	154,230,192
Total liabilities and net assets (deficit)	**$ 484,129,705**	**$ 426,331,726**	**$ 436,337,310**

At June 30, 2010, 2009, and 2008, HHSC's current assets approximated 41 percent, 34 percent, and 33 percent of total assets, respectively. Current assets increased approximately $49.9 million in 2010 due to increases in cash and cash equivalents of $20.4 million, increases in amounts due from the State of Hawaii of $20.7 million, and increases in settlements expected from Medicare and Medicaid of $8.6 million. The increase in cash and cash equivalents of $20.4 million is due primarily to the positive change in the net cash flows from operating activities during fiscal year 2010. The reasons for this change are discussed in the "Operating Results and Changes in Net Assets" section below. It should be noted that HHSC's cash and cash equivalents balance of $52.3 million represents approximately 37 days' cash on hand, which is well below the 2010 Fitch Ratings "Nonprofit Hospital and Healthcare System Medians" benchmark of 166.8 days' cash on hand. The increase in amounts due from the State of Hawaii of $20.7 million is due to allotments to HHSC for State-funded capital improvement projects in excess of amounts expended. The increase in settlements expected from Medicare and Medicaid of $8.6 million is due primarily to the outstanding amounts of DHS Supplemental Payments of approximately $5 million as of June 30, 2010. Current assets were consistent in 2009 compared to 2008. All amounts due from the State of Hawaii represent the outstanding balance of allotments, claims, and encumbrances relating to HHSC's State-funded construction projects.

At June 30, 2010, 2009, and 2008, HHSC's current liabilities were approximately 32 percent, 34 percent, and 49 percent of total liabilities, respectively. The primary reason for the increase in current liabilities in 2010 of $1.1 million is due to an increase in the current portion of long-term debt of $12.9 million as a result of the impending maturities on the $11 million Maui Memorial Medical Center revolving line of credit loan facility and the $1.7 million Yukio Okutsu Veterans Care Home line of credit facility, which was offset by a decrease of $10.7 million in accounts payable and accrued expenses due primarily to the reduction in accounts payable as a result of the increased funding from the State of Hawaii. The small increase in current liabilities was offset by an increase of $39.4 million in the allocated other postemployment benefit liability from the State of Hawaii. The primary reason for the decrease in 2009 is primarily due to an increase in total liabilities coupled with a decrease in current liabilities.

At June 30, 2010, 2009, and 2008, HHSC's net assets are reflected as its investment in capital assets, net of related debt of approximately $222 million, $206 million, and $198 million, respectively. Total net assets were $129 million, $92 million, and $154 million for the years ended June 30, 2010, 2009, and 2008, respectively.

Capital Assets

At June 30, 2010, 2009, and 2008, HHSC's capital assets, net of accumulated depreciation, comprised approximately 59 percent, 65 percent, and 65 percent of its total assets, respectively. These assets consist mainly of land, hospital buildings, and equipment that are used in HHSC's operations. The increase of approximately $8.9 million in 2010 is due primarily to ongoing construction projects in 2010. In 2009, capital assets decreased by $7.5 million, due primarily to property and equipment losses totaling $10.6 million.

A summary of HHSC's capital assets as of June 30, 2010, 2009, and 2008 is as follows:

	2010	2009	2008
Land and land improvements	$ 6,483,834	$ 6,483,834	$ 6,483,834
Building and improvements	353,427,467	352,802,119	333,967,476
Equipment	148,669,328	144,824,647	136,918,212
Construction in progress	31,223,642	12,675,132	28,445,951
Total capital assets	539,804,271	516,785,732	505,815,473
Less accumulated depreciation and amortization	(254,218,939)	(240,090,006)	(221,059,676)
Capital assets - Net	**$ 285,585,332**	**$ 276,695,726**	**$ 284,755,797**

Long-term Debt and Capital Lease Obligations

At June 30, 2010, the Corporation had long-term debt and capital lease obligations totaling approximately $74.5 million. This amount is down approximately $4.3 million compared to fiscal year ended June 30, 2009.

The Corporation repaid approximately $11.1 million and $16.5 million on outstanding long-term debt and capital lease obligation arrangements for the years ended June 30, 2010 and 2009, respectively. More detailed information about the Corporation's long-term debt and capital lease obligations is presented in the notes to the financial statements.

Operating Results and Changes in Net Assets

Summarized financial information of HHSC's statement of revenues, expenses, and changes in net assets for the years ended June 30, 2010, 2009, and 2008 is as follows:

	2010	2009	2008
Operating revenues	$ 471,177,026	$ 420,118,416	$ 392,901,641
Operating expenses:			
Salaries and benefits	369,214,205	372,229,444	334,660,708
Purchased services and professional fees	59,318,851	55,858,767	57,413,345
Medical supplies and drugs	60,577,309	58,280,089	54,651,116
Depreciation and amortization	22,916,734	22,000,124	20,297,151
Insurance	7,695,836	5,470,601	4,923,601
Other	52,587,752	51,471,282	51,612,945
Total operating expenses	572,310,687	565,310,307	523,558,866
Operating loss	(101,133,661)	(145,191,891)	(130,657,225)
Nonoperating revenues (expenses):			
General appropriations from the State of Hawaii	98,260,994	66,918,042	68,701,083
Collective bargaining pay raise appropriation from the State of Hawaii	-	25,122,302	11,194,016
Other nonoperating income (expenses) - Net	1,380,308	(13,384,643)	3,500,224
Total nonoperating revenues	99,641,302	78,655,701	83,395,323
Excess of expenses over revenues before capital contributions	(1,492,359)	(66,536,190)	(47,261,902)
Capital contributions	37,944,528	4,709,297	11,393,465
Increase (decrease) in net assets before change in accounting principle	36,452,169	(61,826,893)	(35,868,437)
Change in accounting for State appropriations	-	-	30,814,737
Increase (decrease) in net assets	**$ 36,452,169**	**$ (61,826,893)**	**$ (5,053,700)**

For the years ended June 30, 2010, 2009, and 2008, HHSC's operating expenses exceeded its operating revenues by $101.1 million, $145.2 million, and $130.6 million, respectively. General appropriations from the State of Hawaii totaled $98.3 million, $66.9 million, and $68.7 million, respectively. The appropriations from the State of Hawaii and for collective bargaining pay totaled $0, $25.1 million, and $11.2 million, respectively. In addition, the appropriations from the State of Hawaii for capital contributions totaled $37.9 million, $4.7 million, and $11.4 million, respectively. These items, along with the other nonoperating revenues, contributed to an increase in net assets in 2010 of $36.5 million and decreases in net assets of $61.8 million and $5.1 million in 2009 and 2008, respectively.

Operating expenses for the fiscal year ended June 30, 2010 were approximately 1.2 percent more than the previous year. Operating expenses for the fiscal year ended June 30, 2010 increased $7 million or 1.2 percent from fiscal year 2009 due primarily to increases in nonpayroll expenses of $10 million offset by a decrease in salaries and benefits expense of $3 million. The increase in nonpayroll expenses was due primarily to a $5.5 million increase at Maui Memorial Medical Center due to the expansion of its cardiovascular program services during fiscal year 2010 and a $2 million increase at Yukio Okutsu Veterans Care Home due to increased patient volume. The decrease in salaries and benefits expense was due primarily to approximately $14 million in expense reductions from negotiated pay cuts and furloughs for HHSC's employees offset by an increase of approximately $4 million in other postretirement benefits expense allocated to HHSC by the State of Hawaii and increased payroll expenses for the expansion of the cardiovascular program at Maui Memorial Medical Center and the increased patient volume at Yukio Okutsu Veterans Care Home. Operating expenses for the fiscal year ended June 30, 2009 were approximately 8.0 percent higher than the previous year. Operating revenues increased by approximately $51.1 million in 2010 and $27.2 million in 2009. The increase in operating revenues of $51.1 million or 12 percent from fiscal year 2009 is due primarily to: (1) an increase in sole community hospital reimbursements from Medicare for HHSC's three acute hospitals of approximately $18.4 million, (2) the receipt of Supplemental Payments from the Department of Human Services of $14.7 million, and (3) various contract rate increases from third-party payors. Increases in 2009 were due to additional improved volumes and favorable settlements received during the year.

HHSC's management believes that the significant excess of operating expenses over operating revenues in both fiscal years 2010 and 2009, as well as the cumulative net losses, is due to several factors which are outlined below.

When the State of Hawaii implemented the QUEST program in 1994, the federal funds provided to the State of Hawaii for Medicaid Disproportionate Share Hospital (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' "Research Brief" for February 2011 states that "…the state and local payments NAPH members received in 2009 financed 32 percent of the unreimbursed care they provided. In addition, sources such as Medicaid DSH payments and supplemental Medicaid payments (also referred to as "upper payment limit," or UPL, payments), which are intended to reduce the shortfalls accrued by treating Medicaid patients and to partially subsidize care for the uninsured, covered 22 and 15 percent of unreimbursed care, respectively." The State Department of Human Services (DHS), in partnership with HHSC management, the governor, the State of Hawaii Legislature, and the Healthcare Association of Hawaii (HAH), was able to use HHSC's fiscal years 2010 and 2009 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 2010 and 2009. 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 2010 and 2009. In the 2009 Legislative Session, the State of Hawaii Legislature appropriated $4.8 million in fiscal year 2010 and $5.7 million in fiscal year 2011 to DHS in order to provide state matching funds to be used to draw down additional federal funds to be paid specifically to HHSC through the QUEST and QUEST Expanded Access plans. This payment mechanism provided $14.7 million to HHSC in fiscal year 2010 and is expected to provide $14.5 million to HHSC in fiscal year 2011. 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 implemented by the Centers for Medicare & Medicaid Services (CMS) is expected to have a significant impact on all healthcare providers in the near future. CMS has awarded contracts to four Recovery Audit Contractors (RACs) to identify improper payments made on claims of healthcare 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 required 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. RACs have already begun investigating Hawaii healthcare providers sometime after August 1, 2009. Management has developed an estimate of potential RAC take-backs 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 RACs 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 take-back for such possible exposure areas. Similar reimbursement recovery programs have been established for the Medicaid program.

HHSC's facilities on the neighbor islands suffer from an insufficient supply of long-term care beds. For fiscal year 2010, HHSC's long-term care occupancy percentage was 91 percent, 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 while the patient waits for a long-term care placement. Medicaid pays approximately 20 to 30 percent 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 30 to 45 waitlist patients per day. Management expects the waitlist 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.

HHSC's salaries and benefits expenses represent approximately 65 percent 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 healthcare 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 2010 were $5.8 million. 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 2010, 57 percent of East Hawaii residents and 66 percent 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 health care 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 $16.4 million in fiscal year 2010. 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 health care 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 $10.8 million in fiscal year 2009 and $11.5 million in fiscal year 2010.

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 healthcare 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 healthcare 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 2010 was 12.0 years, whereas the median average age of plant for all U.S. nonprofit 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 10 years in order to have HHSC's facilities continue to deliver quality care to its patients.

Finally, HHSC is a significant provider of health care for the state of Hawaii. For fiscal year 2010, HHSC's facilities accounted for 18.6 percent 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., Ka'u, Kohala, Lanai, etc.). Further, MMMC is the primary acute-care facility on the island of Maui, and HMC and Kona Community Hospital are the only acute-care facilities with more than 50 acute beds on the island of Hawaii. In large part because of HHSC's facilities in Maui, 80.9 percent 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 64.4 percent 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.

HHSC believes that there are two significant challenges facing HHSC in the near future: (1) the impact of federal healthcare reform on HHSC's facilities, and (2) the implementation of an electronic medical record/health information system. The Patient Protection and Affordable Health Care Act (PPACA) was signed into law on March 23, 2010. On March 30, 2010, the president enacted the Health Care and Education Reconciliation Act, which made a number of changes to the PPACA. Significant provisions of the PPACA include the following:

- Reduces Medicaid DSH spending by $14 billion over 10 years (2010-2019), and reduces Medicaid DSH spending by $4 billion in 2020. Provides Hawaii with a permanent Medicaid DSH allotment.
- Reduces Medicare DSH payments by $22 billion over 10 years
- Establishes and authorizes funding for Community-based Collaborative Care Networks, which are defined as consortia of providers with a joint governance structure that provide a comprehensive range of coordinated and integrated healthcare services for low-income patient populations. Each network must include a safety net hospital that serves a high volume of low-income patients and all FQHCs within the network's geographic area, unless such providers do not exist, refuse to participate, or place unreasonable demands on such participation.
- Provides grants to establish community health teams to support a medical home model. States or state-designated entities will be eligible to receive grants to establish community-based multi-disciplinary, interprofessional teams that will establish contractual relationships with primary care providers to provide support services, support medical homes, and improve quality and coordination of care.
- By January 1, 2012, requires the secretary to establish a shared savings program, under which qualifying groups of providers, including hospitals, would be recognized as Medicare Accountable Care Organizations (ACOs) and would share in Medicare cost savings above a certain threshold. The secretary may pay ACOs using a partial capitation model or other payment models that improve quality and efficiency and may give preference to ACOs participating in similar payment arrangements with other payors.
- Beginning October 1, 2012, reduces hospital payments to account for preventable readmissions for a limited number of high-volume or high-expenditure conditions to be selected by the secretary of HHS. Payment reductions will apply to all admissions. Hospitals' readmission rates will be publicly available on the CMS Hospital Compare website.
- Implements a budget-neutral value-based purchasing program for hospitals, under which Medicare IPPS payments will be reduced by 1 percent in fiscal year 2013, 1.25 percent in FY 2014, 1.5 percent in FY 2015, 1.75 percent in FY 2016, and 2 percent in FY 2017 and thereafter to fund incentive payments to hospitals achieving certain quality-based performance scores.

- Adjusts downward the annual market basket increase for inpatient and outpatient hospital services to account for economy-wide productivity gains, beginning in 2012. Productivity adjustments may result in negative market basket changes and a reduction in payment rates from the preceding fiscal year.

- Expands 340B program eligibility (for outpatient drugs) to children's hospitals, critical access hospitals, and rural referral centers with DSH adjustments greater than 8 percent

- Limits the amount that can be charged by a charitable hospital for emergency or medically necessary care to "the amount generally billed" to individuals who have insurance

Management estimates that the total impact of the provisions of the PPACA on HHSC's facilities will be a $56,002,000 decrease in reimbursements over a 10-year period (federal fiscal years 2010-2019).

This calculation does not include the impact of potential adjustments for low-volume hospitals, value-based purchasing, healthcare-acquired conditions payment penalties, and a cap on outlier payments for home health services. It also does not include the impact on cost-based Medicare plans, such as HMSA 65C+. The largest impact will be on HHSC's acute-care facilities (Hilo, Maui, and Kona), primarily due to the PPACA market basket reductions. HHSC's acute-care facilities are not affected by the Medicare DSH reductions because they receive a higher facility-specific Medicare reimbursement rate due to their designation as sole community hospitals. HHSC's critical access hospitals are not significantly affected by the PPACA because those facilities' Medicare reimbursements are cost-based. Management is in the process of evaluating what the impact the Centers for Medicare and Medicaid Services' proposed rule on accountable care organizations or the formation of state health insurance exchanges will have on HHSC. The expansion of 340B program eligibility for outpatient drugs will be something that HHSC's critical access hospitals will pursue.

In July 2011, HHSC entered into a $28.7 million contract with Siemens Healthcare to implement its Soarian Electronic Medical Records (EMR) and Health Information Systems. The system will be implemented in a phased approach, with the first facility going live in November 2012, with subsequent facilities going live through the end of September 2013. Management believes that the installation of an EMR system is a key step in the creation of an integrated health network with real-time access to patient information across the system. Unleashing new efficiencies and capturing quality improvement are examples of the many opportunities that will be enabled through the utilization of contemporary information technology. Driving out manual intervention, modernizing workflow across the HHSC continuum of care, hard-wiring change, and proactively monitoring performance through near real-time analytics are just a few of the essential elements sought by HHSC in pursuit of Meaningful Use as designated by the Centers for Medicare and Medicaid Services.

Contacting the Corporation's Financial Management

This financial report is designed to provide our patients, suppliers, taxpayers, and creditors with a general overview of the Corporation's finances and to show the Corporation's accountability for the money it receives. If you have questions about this report or need additional financial information, contact the Corporation's Corporate Office at Hawaii Health Systems Corporation, 3675 Kilauea Avenue, Honolulu, HI 96816.

Hawaii Health Systems Corporation

Balance Sheet

	June 30, 2010	June 30, 2009
Assets		
Current Assets		
Cash and cash equivalents - State of Hawaii (Note 2)	$ 13,404,568	$ 13,688,436
Cash and cash equivalents	38,872,844	18,484,516
Patient accounts receivable - Less allowances for contractual adjustments and doubtful accounts of $158,897,677 and $163,298,604 for the years ended June 30, 2010 and 2009, respectively (Note 2)	75,318,018	74,960,004
Due from Medicaid for Act 294	-	1,177,325
Supplies and other current assets	15,923,610	14,674,069
Estimated third-party payor settlements	9,357,617	721,730
Due from the State of Hawaii (Note 3)	42,425,088	21,697,996
Total current assets	195,301,745	145,404,076
Capital Assets - Net (Note 4)	285,585,332	276,695,726
Assets Limited as to Use (Note 2)	2,071,018	1,781,827
Other Assets	1,171,610	2,450,097
Total assets	**$ 484,129,705**	**$ 426,331,726**
Liabilities and Net Assets (Deficit)		
Current Liabilities		
Current portion of long-term debt (Note 7)	$ 13,771,350	$ 905,146
Current portion of capital lease obligations (Note 7)	9,509,211	8,962,476
Accounts payable and accrued expenses	70,586,299	80,580,341
Current portion of accrued workers' compensation (Note 8)	3,100,000	1,500,000
Current portion of accrued vacation (Note 5)	15,893,840	15,279,758
Current portion due to the State of Hawaii (Note 3)	-	3,000,000
Other current liabilities	2,348,149	3,179,586
Total current liabilities	115,208,849	113,407,307
Long-term Debt - Less current portion (Note 7)	26,378,782	39,576,344
Capital Lease Obligation - Less current portion (Note 7)	24,871,207	29,379,507
Other Liabilities		
Accrued vacation - Less current portion (Note 5)	22,176,971	22,108,017
Accrued workers' compensation - Less current portion (Note 8)	12,632,000	14,645,000
Other postemployment benefit liability (Note 6)	105,204,848	65,782,538
Due to State of Hawaii (Note 3)	44,122,507	44,122,507
Patients' safekeeping deposits	481,977	434,779
Other liabilities	4,197,096	4,472,428
Total liabilities	355,274,237	333,928,427
Net Assets (Deficit)		
Invested in capital assets - Net of related debt	222,054,782	206,007,708
Restricted for capital purchases (Note 2)	1,107,015	847,048
Unrestricted	(94,306,329)	(114,451,457)
Total net assets (deficit)	128,855,468	92,403,299
Total liabilities and net assets (deficit)	**$ 484,129,705**	**$ 426,331,726**

Statement of Revenues, Expenses, and Changes in Net Assets

	Year Ended June 30, 2010	Year Ended June 30, 2009
Operating Revenues		
Net patient service revenue (net of contractual adjustments and provision for doubtful accounts of $489,691,780 and $476,626,004 for the years ended June 30, 2010 and 2009, respectively)	$ 463,201,655	$ 412,550,881
Other revenues	7,975,371	7,567,535
Total operating revenues	471,177,026	420,118,416
Operating Expenses		
Salaries and benefits	369,214,205	372,229,444
Purchased services	48,844,368	47,666,430
Medical supplies and drugs	60,577,846	58,280,089
Depreciation and amortization	22,916,734	22,000,124
Utilities	12,380,600	12,561,963
Repairs and maintenance	9,890,324	9,963,517
Other supplies	14,505,992	14,619,102
Professional fees	10,474,483	8,192,337
Insurance	7,695,836	5,470,601
Rent and lease	6,737,264	7,009,387
Other	9,073,035	7,317,313
Total operating expenses	572,310,687	565,310,307
Operating Loss	(101,133,661)	(145,191,891)
Nonoperating Revenues (Expenses)		
General appropriations from the State of Hawaii	98,260,994	66,918,042
Collective bargaining pay raise appropriation from the State of Hawaii	-	25,122,302
Loss on disposal of capital assets	(503,262)	(10,647,810)
Restricted contributions	3,228,140	1,487,334
Interest expense	(5,081,405)	(5,857,475)
Interest and dividend income	942,604	559,316
Other nonoperating revenues - Net	2,794,231	1,073,992
Total nonoperating revenues	99,641,302	78,655,701
Excess of Expenses Over Revenue Before Capital Contributions	(1,492,359)	(66,536,190)
Capital Contributions	37,944,528	4,709,297
Increase (Decrease) in Net Assets	36,452,169	(61,826,893)
Net Assets - Beginning of year	92,403,299	154,230,192
Net Assets - End of year	**$ 128,855,468**	**$ 92,403,299**

See Notes to Financial Statements.

Statement of Cash Flows

	Year Ended June 30, 2010	Year Ended June 30, 2009
Cash Flows from Operating Activities		
Cash received from government, patients, and third-party payors	$ 455,385,079	$ 405,949,126
Cash payments to employees for services	(330,231,955)	(333,368,297)
Cash payments to suppliers for services and goods	(192,756,071)	(162,989,813)
Other receipts from operations	7,975,371	7,567,535
Net cash used in operating activities	(59,627,576)	(82,841,449)
Cash Flows from Noncapital Financing Activities		
Appropriations from the State of Hawaii	98,260,994	92,040,344
Advances from the State of Hawaii	-	13,000,000
Other nonoperating revenues - Net	7,341,108	556,506
Repayment of advance from the State of Hawaii	(3,000,000)	-
Net cash provided by noncapital financing activities	102,602,102	105,596,850
Cash Flows from Capital and Related Financing Activities		
Purchase of capital assets	(12,888,089)	(8,796,140)
Interest paid	(5,081,405)	(4,539,261)
Issuance of long-term debt	5,506,286	3,374,230
Repayments on long-term debt	(1,138,870)	(7,287,312)
Repayments on capital lease obligations	(10,004,401)	(9,261,556)
Proceeds from sale of assets	83,000	31,862
Proceeds from federal grants	-	836,045
Net cash used in capital and related financing activities	(23,523,479)	(25,642,132)
Cash Flows from Investing Activities		
Interest income	942,604	559,316
Redemption of funds held in escrow	-	1,000,000
Purchase of investments	(289,191)	(338,064)
Net cash provided by investing activities	653,413	1,221,252
Net Increase (Decrease) in Cash and Cash Equivalents	20,104,460	(1,665,479)
Cash and Cash Equivalents - Beginning of year	32,172,952	33,838,431
Cash and Cash Equivalents - End of year	**$ 52,277,412**	**$ 32,172,952**
Balance Sheet Classification of Cash		
Cash and cash equivalents - State of Hawaii	$ 13,404,568	$ 13,688,436
Cash and cash equivalents	38,872,844	18,484,516
Total cash and cash equivalents	**$ 52,277,412**	**$ 32,172,952**

See Notes to Financial Statements.

A reconciliation of operating loss to net cash used in operating activities is as follows:

	Year Ended June 30, 2010	Year Ended June 30, 2009
Cash Flows from Operating Activities		
Operating loss	$ (101,133,661)	$ (145,191,891)
Adjustments to reconcile operating loss to net cash from operating activities:		
Provision for doubtful accounts	34,075,589	27,980,497
Depreciation and amortization	22,916,734	22,000,124
Changes in assets and liabilities:		
Patient accounts receivable and amounts due from Medicaid for Act 294	(33,256,278)	(42,852,507)
Supplies and other assets	28,946	(558,998)
Accounts payable, accrued expenses, and other liabilities	(13,315,365)	10,759,660
Accrued workers' compensation liability	(413,000)	(2,154,000)
Postemployment benefit liability	39,422,310	35,532,846
Estimated third-party payor settlements	(8,635,887)	8,270,255
Accrued vacation	683,036	3,372,565
Net cash used in operating activities	**$ (59,627,576)**	**$ (82,841,449)**
Noncash Financing and Investing Activities		
Assets acquired under capital leases and debt	$ 1,344,062	$ 7,640,742
Capital assets contributed by the State of Hawaii and others	15,898,699	8,367,969
Capital assets included in accounts payable	2,261,752	4,076,447
Rental income contributed to and equity in earnings of the Clinical Laboratories of Hawaii partnership due to sale of investment	-	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	503,262	10,626,171
Change in allotment from State of Hawaii	20,727,092	4,178,771

Note 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 (the "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 Ho'ola Hamakua
- Ka'u Hospital
- Yukio Okutsu Veterans Care Home (Yukio is not included in the East Hawaii Region audited financial statements)

West Hawaii Region:
- Kona Community Hospital
- Kohala Hospital

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

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

Oahu Region:
- Leahi Hospital
- Maluhia
- Kahuku Medical Center

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 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 statement of revenues, expenses, and changes in net assets may be significantly different from those eventually included in the final settlement.

The 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 healthcare facilities in the state.

Note 1 - Organization (Continued)

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 7- 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 nonprofit 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 12-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.

In June 2011, the Legislature passed Act 126, S.B. 1300, effective July 1, 2011, which reconstituted the HHSC board of directors to a 13-member board of directors by adding an at-large voting member appointed by the governor of the State of Hawaii and changing the voting status of the Director of the Department of Health from non-voting to voting member.

Note 1 - Organization (Continued)

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.

Liquidity - During the year ended June 30, 2010, HHSC incurred losses from operations of approximately $97.9 million and had negative cash flows from operations of $60.2 million. Overall, days in accounts payable and days in accounts receivable are both down significantly compared to June 30, 2010. These improvements in operations are primarily due to a combination of substantial increases in Medicare reimbursement for HHSC's sole community hospitals, increased funding from the State of Hawaii, and pay cuts and furloughs imposed on HHSC employees. Although improvements have been seen by HHSC, management believes maintaining the current levels of service provided by HHSC would require continued funding by the State of Hawaii.

Subsequent Events - The financial statements and related disclosures include evaluation of events up through and including August 24, 2011, which is the date the financial statements were available to be issued.

Reclassification - Certain prior year amounts have been reclassified for consistency with the current period presentation. These reclassifications had no effect on the reported results of operations.

Note 2 - Summary of Significant Accounting Policies

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

HHSC's financial statements are presented in accordance with the pronouncements of the Governmental Accounting Standards Board (GASB) and the American Institute of Certified Public Accountants' Audit and Accounting Guide, *Health Care Organizations*. Pursuant to GASB Statement No. 20, *Accounting and Financial Reporting for Proprietary Funds and Other Governmental Entities That Use Proprietary Fund Accounting*, HHSC has elected not to apply the provisions of relevant pronouncements of the Financial Accounting Standards Board issued after November 30, 1989.

Use of Estimates - The preparation of 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 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, 2010 and 2009 is indicated in the accompanying statement of revenues, expenses, and changes in net assets as "cash and cash equivalents on deposit with the State of Hawaii." The Hawaii Revised Statutes authorize the Director of Finance to invest in obligations of, or guaranteed by, the U.S. government, obligations of the State, federally insured savings and checking accounts, time certificates of deposit, and repurchase agreements with federally insured financial institutions. Cash and deposits with financial institutions are collateralized in accordance with State statutes. All securities pledged as collateral are held either by the State Treasury or by the State's fiscal agents in the name of the State.

HHSC has cash in financial institutions that is in excess of available depository insurance coverage. The amount of uninsured and uncollateralized deposits totaled approximately $38,338,000 at June 30, 2010. 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 might 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.

Note 2 - Summary of Significant Accounting Policies (Continued)

Capital Assets - Capital assets assumed from the State at inception are recorded at cost less accumulated depreciation. Other capital assets are recorded at cost or estimated fair market value at the date of donation. Donated buildings, equipment, and land are recognized as revenue when all eligibility requirements have been met, generally at the date of donation. Equipment under capital leases is recorded at the present value of future payments. Buildings, equipment, and improvements are depreciated by the straight-line method using these asset lives:

Building 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 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, 2010 and 2009, assets limited as to use consisted of restricted cash of $2,071,018 and $1,781,827, respectively.

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.

Note 2 - Summary of Significant Accounting Policies (Continued)

Net Assets - Net assets are classified in three components. Net assets invested in capital assets - net of related debt consist of capital assets net of accumulated depreciation and are reduced by the current balances of any outstanding borrowings used to finance the purchase or construction of those assets. Restricted expendable net assets are noncapital net assets that must be used for a particular purpose, as specified by creditors, grantors, or contributors external to the Corporation. Unrestricted net assets are the remaining net assets that do not meet the definition of invested in capital assets - net of related debt or restricted.

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

Net Patient Service Revenues - Net patient service revenues are recorded on an accrual basis in the period in which the related services are provided at established rates, less contractual adjustments and provision for doubtful accounts. HHSC, as a safety net provider, provides charity care to certain patients; the specific cost of such care for the years ended June 30, 2010 and 2009 was approximately $3,400,000 and $4,200,000, respectively.

HHSC has agreements with third-party payors that provide for payments at amounts different from their established rates. Payment arrangements include prospectively determined rates per discharge, reimbursed costs, discounted charges, and per diem payments. Net patient service revenues are reported at the estimated net realizable amounts from patients, third-party payors, and others for services rendered, including estimated retroactive adjustments under reimbursement agreements with third-party payors. Retroactive adjustments are recorded on an estimated basis in the period the related services are rendered and adjusted in future periods as final settlements are determined. The adjustments to the final settlements did not have a significant impact on the fiscal year 2010 and 2009 financial statements.

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.

Note 2 - Summary of Significant Accounting Policies (Continued)

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.

- *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 Hospital (CAH)* - HHSC has eight facilities (Hale Ho'ola Hamakua, Kauai Veterans Memorial Hospital, Kahuku Medical Center, Ka'u Hospital, Kohala Hospital, Kula Hospital, Lanai Community Hospital, and Samuel Mahelona Memorial Hospital) that are designated as critical access hospitals (CAH) by the Centers 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 healthcare facility, or (3) be certified by the State as being a necessary provider of healthcare 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.

Note 2 - Summary of Significant Accounting Policies (Continued)

- *Sole Community Hospital* - 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.

The Medicare program has initiated a recovery audit contractor (RAC) initiative, whereby claims subsequent to October 1, 2007 will be reviewed by contractors for validity, accuracy, and proper documentation. A demonstration project completed in several other states resulted in the identification of potential significant overpayments. HHSC has been contacted by the RAC auditors, and is currently unable to determine the extent of liability for overpayments, if any.

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.

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 years ended June 30, 2010 and 2009, the amount of bond interest allocated to HHSC was approximately $5,600,000 and $5,800,000, respectively.

Note 2 - Summary of Significant Accounting Policies (Continued)

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 8.

Concentration of Credit Risk - Patient accounts receivable consist 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, 2010 and 2009 was as follows:

	Percentage	
	2010	2009
Medicare	22	21
Medicaid	23	23
HSMA	15	16
Other third-party payors	25	23
Patient and other	15	17
Total	100	100

Note 3 - State of Hawaii Advances and Receivable

In fiscal year 2003, HHSC received a $14,000,000 advance from the State to relieve its cash flow shortfall. At June 30, 2010 and 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 2011. Accordingly, the advance is classified as a noncurrent liability at June 30, 2010 and 2009. The amounts due to the State of $44,122,507 and $47,122,507 at June 30, 2010 and 2009, respectively include 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. 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, 2010, $42.4 million was due from the State for allotments made to HHSC before June 30, 2010.

Note 4 - Capital Assets

Transactions in the capital asset accounts for the year ended June 30, 2010 were as follows:

	Beginning of Year	Additions	Retirements	Transfers	End of Year
Assets not subject to depreciation:					
Land and land improvements	$ 6,483,834	$ -	$ -	$ -	$ 6,483,834
Construction in progress	12,675,132	26,253,873	(296,944)	(7,408,419)	31,223,642
Assets subject to depreciation:					
Buildings and improvements	352,802,119	432,964	(933,280)	1,125,664	353,427,467
Equipment	144,824,647	5,750,467	(8,144,527)	6,238,741	148,669,328
Total	516,785,732	32,437,304	(9,374,751)	(44,014)	539,804,271
Less accumulated depreciation:					
Buildings and improvements	(132,423,416)	(11,606,672)	1,180,395	44,014	(142,805,679)
Equipment	(107,666,590)	(11,308,206)	7,561,536	-	(111,413,260)
Total	(240,090,006)	(22,914,878)	8,741,931	44,014	(254,218,939)
Capital assets - Net	$ 276,695,726	$ 9,522,426	$ (632,820)	$ -	$ 285,585,332

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	$ 6,483,834	$ -	$ -	$ -	$ 6,483,834
Construction in progress	28,457,491	22,009,328	(10,820,126)	(26,971,561)	12,675,132
Assets subject to depreciation:					
Buildings and improvements	334,264,125	312,766	(626,299)	18,851,527	352,802,119
Equipment	136,610,023	8,115,515	(2,719,555)	2,818,664	144,824,647
Total	505,815,473	30,437,609	(14,165,980)	(5,301,370)	516,785,732
Less accumulated depreciation:					
Buildings and improvements	(120,420,028)	(12,136,545)	133,157	-	(132,423,416)
Equipment	(100,639,648)	(9,873,922)	2,509,074	337,906	(107,666,590)
Total	(221,059,676)	(22,010,467)	2,642,231	337,906	(240,090,006)
Capital assets - Net	$ 284,755,797	$ 8,427,142	$ (11,523,749)	$ (4,963,464)	$ 276,695,726

The State Department of Accounting and General Services and others transferred capital assets, including construction in progress, aggregating approximately $16,611,000 and $6,900,000, respectively, to HHSC as a contribution of capital. During 2009, HHSC wrote off approximately $10,600,000 in fixed assets relating to abandoned projects at KVMH, MMSC, and Corporate.

Note 4 - Capital Assets (Continued)

HHSC may enter into capital leases on behalf of the facilities. In that situation, the capital lease obligation is recorded in Corporate's 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.

The facilities may also enter into capital leases individually. In that situation, the capital lease obligation is recorded in the facility's accounting records. While the assets are being constructed, the amounts are recorded as construction in progress in the accounting records of the facility. The facility makes the capital lease payments and incurs the interest expense, as well as the depreciation on the capital asset.

In July 2011, HHSC entered into a $28.7 million contract with Siemens Healthcare to implement its Soarian Electronic Medical Records and Health Information Systems. The system will be implemented in a phased approach, with the first facility going live in November 2012, with subsequent facilities going live through the end of September 2013.

Note 5 - Accrued Vacation

Transactions in this account during the year ended June 30, 2010 were as follows:

	Beginning of Year	Additions	Reductions	End of Year	Current Portion	Noncurrent Portion
Accrued vacation	$ 37,339,984	$ 15,759,973	$ (15,079,198)	$ 38,020,759	$ 15,893,840	$ 22,126,919

Transactions in this account during the year ended June 30, 2009 were as follows:

	Beginning of Year	Additions	Reductions	End of Year	Current Portion	Noncurrent Portion
Accrued vacation	$ 33,988,135	$ 19,060,460	$ (15,708,611)	$ 37,339,984	$ 15,279,758	$ 22,060,226

Note 6 - 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.

Note 6 - Employee Benefits (Continued)

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 five years of credited service or elect early retirement at any age with 25 years of credited service. Such employees are entitled to retirement benefits, payable monthly for life, of 2 percent 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 percent 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 age at 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 percent of their average final salary, as defined, for each year of credited service. Benefits fully vest on reaching 10 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 after July 1, 2006 are required to join the hybrid plan. Participants will contribute 6 percent 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 percent 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, 2010, 2009, and 2008 was approximately $33.6 million, $33.8 million, and $34.7 million, respectively, equal to the required contribution.

The ERS issues a publicly available financial report that includes financial statements and required supplemental 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.

Note 6 - Employee Benefits (Continued)

Postretirement Health Care and Life Insurance Benefits - In addition to providing pension benefits, the State provides certain postretirement healthcare benefits (medical, prescription drug, vision, and dental) to all qualified employees and their dependents. Pursuant to Act 88 SLH of 2001, the State contributes to the Hawaii Employer-Union Health Benefits Trust Fund, an agent multiple employer defined benefit plan. This plan is sponsored by and administered by the State of Hawaii.

For employees hired before July 1, 1996, the State pays the entire monthly healthcare premium for employees retiring with 10 or more years of credited service, and 50 percent of the monthly premium for employees retiring with fewer than 10 years of credited service. Retirees in this category can elect a 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 percent of the retired employees' monthly Medicare or non-Medicare premium. For those retiring with at least 15 years but fewer than 25 years of service, the State pays 75 percent of the base monthly contribution. For those employees retiring with at least 25 years of service, the State pays 100 percent of the base monthly contribution. Only single plan coverage is provided for retirees in this category. 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 percent of the base monthly contribution. For those retiring with at least 15 years but fewer than 25 years of service, the State pays 75 percent of the base monthly contribution. For those employees retiring with at least 25 years of service, the State pays 100 percent 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.

The State of Hawaii receives an annual actuarial valuation to compute the annual required contribution (ARC) necessary to fund the postretirement obligation for all state employees, including those employed by HHSC. The ARC represents a level of funding that, if paid on an ongoing basis, is projected to cover the current normal cost of benefits provided this year and to amortize any unfunded actuarial liabilities over a period not to exceed 30 years. Currently, the State contributes to the plan on a "pay-as-you-go basis," only contributing the amounts necessary to pay for current year benefits.

Note 6 - Employee Benefits (Continued)

For cost allocation purposes, the State allocates the full accrual ARC expense among its component units, including HHSC, based on respective percentages of covered payroll. The State requires HHSC to contribute to the plan at a rate of covered payroll necessary to fund its share of the annual “pay-as-you-go contributions,” which is significantly less than the actuarially determined contribution rate. HHSC then allocates its full accrual ARC expense among its various regions based on their respective percentages of covered payroll. The cumulative difference between the amounts the State requires HHSC to contribute and HHSC’s allocation of the total plan ARC expense is recorded as other postretirement benefit liability on the balance sheet of each region. HHSC's contributions for postretirement benefits approximated $16.3 million, $21.0 million, and $17.9 million for the years ended June 30, 2010, 2009, and 2008, respectively.

	2010	2009
Beginning of year	$ 65,782,538	$ 30,249,691
Required contributions	55,725,464	56,363,593
Actual contributions	(16,303,154)	(20,830,746)
End of year	$ 105,204,848	$ 65,782,538

Sick Leave - Accumulated sick leave as of June 30, 2010 and 2009 was approximately $63,333,000 and $64,170,000, respectively. Sick leave accumulates at the rate of 14 hours for each month of service, as defined without limit. Sick pay can be taken only in the event of illness and is not convertible to pay upon termination of employment. Accordingly, no liability for sick pay is recorded in the accompanying financial statements.

Note 7 - Long-term Liabilities

Long-term liability activity for the year ended June 30, 2010 was as follows:

	2009	Current Year Additions	Current Year Reductions	2010	Amounts Due Within One Year
Long-term debt	$ 40,481,490	$ 807,512	$ (1,138,870)	$ 40,150,132	$ 13,771,350
Capital lease obligations	$ 38,341,983	$ 6,042,836	$ (10,004,401)	$ 34,380,418	$ 9,509,211

Long-term liability activity for the year ended June 30, 2009 was as follows:

	2008	Current Year Additions	Current Year Reductions	2009	Amounts Due Within One Year
Long-term debt	$ 44,432,281	$ 9,031,310	$ (12,982,101)	$ 40,481,490	$ 905,146
Capital lease obligations	$ 39,964,272	$ 7,640,742	$ (9,263,031)	$ 38,341,983	$ 8,962,476

Note 7 - Long-term Liabilities (Continued)

The long-term debt obligations are summarized as follows:

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.

The note payable requires monthly payments, including interest at 5.9 percent, ranging from $107,241 to $126,433 through October 2027. The note is collateralized by certain property and equipment. At June 30, 2010 and 2009, the balance payable was $15,948,775 and $16,285,976, respectively.

MMMC Working Capital Financing - In April 2008, MMMC obtained an $11 million taxable revolving line of credit loan facility from JPMorgan Chase Bank, N.A. for working capital purposes. The loan required quarterly interest payments at the London Inter-Bank Offered Rate (LIBOR) plus 175 basis points, with any unpaid principal amounts due in April 2011. The loan was 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 contained 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 JPMorgan Chase Bank. On May 20, 2010, MMMC signed a revised agreement on the $11 million taxable revolving line of credit, removing financial covenants and restructuring repayment. The loan payable will be paid off in four quarterly payments beginning in July 2010 and ending in April 2011. Interest requirements and security for the revised agreement remained unchanged from the original agreement. In January 2011, JPMorgan Chase Bank, N.A. assigned its interest in the taxable revolving line of credit loan facility to Bank of Montreal. Concurrently, MMMC and Bank of Montreal agreed to amend the terms and conditions of the loan to extend the maturity date to January 2012 and increase the draws under the revolving credit facility from $6.5 million to $8.0 million. At June 30, 2010 and 2009, the balance payable was $11 million.

Note 7 - Long-term Liabilities (Continued)

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.

The note payable requires monthly payments, including interest, totaling $64,069 through September 2032. The note payable is secured by certain assets of Hilo Medical Center. At June 30, 2010 and 2009, the balance payable was $9,513,320 and $9,714,379, respectively.

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, 2010 and 2009, the balance payable was $1,576,148 and $1,554,688, respectively.

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. At June 30, 2010 and 2009, the balance payable was $1,030,885 and $1,178,300, respectively.

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 percent, 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, 2010 and 2009, the balance payable was $494,349 and $684,908, respectively.

Note 7 - Long-term Liabilities (Continued)

Alii Health Center - During fiscal year 2010, Alii Health Center entered into two notes payable. The first note payable was used to finance the purchase of billing software. This note requires monthly payments, including interest at 8 percent, ranging from $3,290 to $180,000, through May 2013. This note is collateralized by certain equipment. At June 30, 2010, the balance payable was $359,045.

The second note relates to outstanding amounts due to an accounts receivable management service provider. The note requires monthly installments of $15,000 through October 2011. The note is unsecured. At June 30, 2010, the balance payable was $227,610.

Corporate - HHSC entered into capital leases on behalf of the facilities. The capital lease obligation is recorded in HHSC Corporate's accounting records. While the assets are being constructed, the amounts are recorded as construction in progress in the accounting records of either Corporate or the facilities. Corporate makes the capital lease payments and incurs the interest expense, while the facilities record depreciation on the capital asset. Corporate also computes capitalized interest on construction in progress and transfers the capitalized interest asset to the facilities. The facilities reimburse Corporate through the due from affiliates account. For the years ended June 30, 2010 and 2009, capitalized interest was not material. Capital lease obligations recorded on Corporate's accounting records at June 30, 2010 and 2009 were $31,495,130 and $38,341,983, respectively.

Maui Memorial Medical Center - In September 2009, MMMC entered into a capital lease for the acquisition of equipment for $780,000. The lease requires monthly payments over 48 months with a bargain purchase option at the end of the term. On November 30, 2009, MMMC entered into a capital lease for the acquisition of equipment for $830,000. The lease requires monthly payments over 60 months and is collateralized by the equipment. At June 30, 2010, the balance payable on these leases was $1,140,034.

Hilo Medical Center - In September 2009, Hilo Medical Center entered into a capital lease for wireless communication and related equipment for $499,850. The lease term is 36 months, with a monthly payment of $16,750, including interest at a rate of 12.62 percent. The lease is collateralized by the equipment. At June 30, 2010, the balance payable was $404,439.

Kahuku Medical Center - During fiscal year 2010, Kahuku entered into various capital lease obligations. The leases require monthly payments and are collateralized by the equipment. At June 30, 2010, the balance payable was $221,713.

Note 7 - Long-term Liabilities (Continued)

Kauai Veterans Memorial Hospital - In August 2009, KVMH entered into a capital lease for the acquisition of a mammography machine. The lease term is 60 months, with a monthly payment of $12,748, including interest at a rate of 8.5 percent. The lease is collateralized by the equipment. In October 2009, KVMH entered into a capital lease for the acquisition of an MRI machine. The lease term is 60 months, with a monthly payment of $13,676, including interest at a rate of 8.5 percent. The lease is collateralized by the equipment. At June 30, 2010, the balance payable on the leases was $1,119,102.

The following is a schedule by years of bond principal and interest as of June 30, 2010:

Years Ending June 30	Long-term Debt Principal	Long-term Debt Interest	Capital Lease Obligation Principal	Capital Lease Obligation Interest
2011	$ 13,771,350	$ 1,875,686	$ 9,509,211	$ 1,814,348
2012	1,119,383	1,556,439	7,776,491	1,291,669
2013	1,103,159	1,483,777	5,581,194	887,403
2014	1,068,184	1,412,444	4,124,569	590,229
2015	1,136,914	1,443,714	2,139,253	377,616
2016-2020	6,242,019	5,592,585	3,543,390	947,139
2021-2025	7,881,961	3,164,071	1,458,141	343,910
2026-2030	6,210,914	1,333,631	248,169	22,306
2031-2035	1,616,248	113,615	-	-
Total payments	$ 40,150,132	$ 17,975,962	$ 34,380,418	$ 6,274,620

Note 8 - 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 a $29 million aggregate. HHSC has also purchased additional excess insurance with a $10 million per claim and aggregate limit. 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 also directly provides treatment for injured workers. The estimated liability is based on actuarial projections of costs using historical claims-paid data. Estimates are continually monitored and reviewed and, as settlements are made or estimates adjusted, differences are reflected in current operations. HHSC has accrued a liability of $15,732,000 and $16,145,000 for unpaid claims as of June 30, 2010 and 2009, respectively.

Note 8 - Commitments and Contingencies (Continued)

	2010	2009
Estimated liability - Beginning of year	$ 16,145,000	$ 18,299,000
Estimated claims incurred, including changes in estimates	2,504,000	901,700
Claim payments	(2,917,000)	(3,055,700)
Estimated liability - End of year	$ 15,732,000	$ 16,145,000

Operating Leases - HMC and MMMC entered into various operating leases and related sublease agreements. Future minimum lease payments and sublease receipts at June 30, 2010 are as follows:

Years Ending June 30	Lease Payments	Sublease Receipts
2011	$ 1,488,460	$ 123,202
2012	1,475,296	126,266
2013	1,495,948	-
2014	1,517,224	-
2015	786,880	-
2016-2020	1,603,760	-
Total	$ 8,637,568	$ 249,468

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 was 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.

Note 8 - Commitments and Contingencies (Continued)

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 percent. 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, 2010, there were no payments made to OHA.

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

Note 9 - 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 (the "Partnership"). The primary purpose of the Partnership was to provide clinical laboratory services within the state of Hawaii. On June 1, 2002, HHSC contributed the use of the laboratory space and related ancillary services in seven of its facilities (Hilo Medical Center, Kona Community Hospital, MMMC, Hale Ho'ola Hamakua, Ka'u Hospital, Kohala Hospital, and Kula Hospital) in exchange for a less than controlling interest in the Partnership.

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 was 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 require 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.

Other Supplemental Information

Hawaii Health Systems Corporation

Supplemental Schedule of Reconciliation of Cash on Deposit and Assets Limited as to Use with the State of Hawaii
Year Ended June 30, 2010

	Appropriation Symbol	
Cash and cash equivalents - State of Hawaii		
Special funds:		
	S-98-396-H	$ 221,507
	S-93-359-H	2,818
	S-96-359-H	2,007
	S-97-359-H	3,556
	S-09-359-H	1,208,736
	S-09-373-H	537,294
	S-10-355-H	4,359,897
	S-10-371-H	611,224
	S-10-358-H	99,451
	S-09-365-H	545,847
	S-09-312-H	743,058
	S-10-354-H	1,401,479
	S-93-353-H	6,563
	S-10-353-H	156,072
	S-10-350-H	3,069,798
	S-10-351-H	269,059
	S-10-352-H	170,177
Trust funds	T-04-921-H	6,679
Total per State		13,415,222
Reconciling items		(10,654)
Total per HHSC		**$ 13,404,568**
Assets limited as to use -		
Patient trust funds:		
	T-04-923-H	$ 4,129
	T-04-919-H	1,044
	T-04-911-H	22,912
	T-09-909-H	15,264
	T-09-925-H	107,402
	T-10-915-H	12,763
Total per State		163,514
Reconciling items:		
Patient's safekeeping deposits held by financial institutions		208,928
Restricted assets held by financial institutions		1,536,413
Other		162,163
Total per HHSC		**$ 2,071,018**

Hawaii Health Systems Corporation

Balance Sheet of Facilities
June 30, 2010

	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
	Facilities									
Assets										
Current Assets										
Cash and cash equivalents - State of Hawaii	$ 3,069,798	$ 270,332	$ 164,929	$ -	$ 1,401,479	$ 162,635	$ 4,359,897	$ 611,224	$ 99,451	$ 743,058
Cash and cash equivalents	8,861,886	11,349	30,816	700	(17,413)	797,694	10,657,448	4,092,199	383,775	862,499
Patient accounts receivable - Less allowances for contractual adjustments and doubtful accounts	21,242,084	1,955,388	523,086	1,544,446	7,903,162	681,526	26,025,591	2,582,936	338,025	1,889,206
Supplies and other current assets	3,069,951	299,149	75,340	3,118	1,872,806	47,961	6,924,032	212,581	143,210	662,466
Estimated third-party payor settlements	2,559,846	63,607	338,344	-	4,061,852	129,403	(157,120)	(18,606)	100,227	527,545
Due from State of Hawaii	5,321,376	901,293	5,716,926	-	2,070,845	780,399	18,778,898	2,739,939	1,735,732	1,376,589
Total current assets	44,124,941	3,501,118	6,849,441	1,548,264	17,292,731	2,599,618	66,588,746	10,220,273	2,800,420	6,061,363
Capital Assets - Net	47,951,963	19,837,332	1,499,133	27,391,500	22,039,442	1,580,809	109,477,084	4,998,686	876,187	4,950,234
Assets Limited as to Use	48,209	115,626	4,639	-	427,767	1,853	278,451	122,338	845	133,832
Other Assets	488,934	-	-	-	485,230	-	72,833	-	-	-
Total assets	**$ 92,614,047**	**$ 23,454,076**	**$ 8,353,213**	**$ 28,939,764**	**$ 40,245,170**	**$ 4,182,280**	**$ 176,417,114**	**$ 15,341,297**	**$ 3,677,452**	**$ 11,145,429**
Liabilities and Net Assets (Deficit)										
Current Liabilities										
Current portion of long-term debt	$ 213,247	$ -	$ -	$ 1,576,148	$ -	$ -	$ 11,000,000	$ -	$ -	$ -
Current portion of capital lease obligations	158,955	-	-	-	-	-	287,808	-	-	-
Accounts payable and accrued expenses	17,732,711	693,201	503,200	683,554	11,811,312	429,161	22,692,509	1,518,564	343,317	1,654,703
Current portion of accrued workers' compensation liability	760,000	145,000	-	-	455,000	85,000	640,000	260,000	-	290,000
Current portion of accrued vacation	3,245,079	281,529	185,528	6,034	2,323,731	340,936	4,518,118	909,323	106,132	930,000
Other current liabilities	442,512	26,492	(9,642)	-	157,524	25,816	995,086	700	-	-
Total current liabilities	22,552,504	1,146,222	679,086	2,265,736	14,747,567	880,913	40,133,521	2,688,587	449,449	2,874,703
Long-term Debt - Less current portion	9,300,073	-	-	-	-	-	-	-	-	-
Capital Lease Obligations - Less current portion	245,484	-	-	-	-	-	852,226	-	-	-
Other Liabilities										
Accrued vacation - Less current portion	4,954,805	386,427	157,850	-	1,795,070	110,805	6,505,638	1,309,335	152,820	1,669,640
Accrued workers' compensation - Less current portion	2,694,000	164,000	161,000	-	1,513,000	149,000	3,714,000	1,248,000	82,000	562,000
Other postemployment benefit liability	24,735,936	1,949,040	1,373,410	-	11,402,817	1,267,031	33,945,831	4,918,611	697,315	5,902,616
Due to affiliates - Net	80,179,614	1,467,276	9,694,384	544,378	50,469,631	7,885,228	11,849,838	21,458,162	13,772,903	16,759,726
Due to the State of Hawaii	-	506,153	-	-	7,605,205	528,149	10,000,000	1,114,264	-	6,416,791
Patients' safekeeping deposits	48,209	115,626	4,639	-	-	1,853	-	122,338	845	118,608
Other liabilities	876,484	-	22,153	2,417,673	302,221	-	433,139	18,485	-	-
Total liabilities	145,587,109	5,734,744	12,092,522	5,227,787	87,835,511	10,822,979	107,434,193	32,877,782	15,155,332	34,304,084
Net Assets (Deficit)										
Invested in capital assets - Net of related debt	38,034,204	19,837,332	1,499,133	25,815,352	22,039,442	1,580,809	108,337,050	4,998,686	876,187	4,950,234
Restricted for capital purchases	-	-	-	-	428,360	-	295,789	-	-	15,264
Unrestricted	(91,007,266)	(2,118,000)	(5,238,442)	(2,103,375)	(70,058,143)	(8,221,508)	(39,649,918)	(22,535,171)	(12,354,067)	(28,124,153)
Total net assets (deficit)	(52,973,062)	17,719,332	(3,739,309)	23,711,977	(47,590,341)	(6,640,699)	68,982,921	(17,536,485)	(11,477,880)	(23,158,655)
Total liabilities and net assets (deficit)	**$ 92,614,047**	**$ 23,454,076**	**$ 8,353,213**	**$ 28,939,764**	**$ 40,245,170**	**$ 4,182,280**	**$ 176,417,114**	**$ 15,341,297**	**$ 3,677,452**	**$ 11,145,429**

	Maluhia	Kahuku	Kauai Veterans Memorial Hospital	Samuel Mahelona Memorial Hospital	Total Facilities	Corporate	Reclassifications and Eliminations	HHSC Combined	Hawaii Health Systems Foundation	Alii - Maui Community Care	Alii - Kona Community Care	Reclassifications and Eliminations	HHSC Consolidated
	Facilities												
Assets													
Current Assets													
Cash and cash equivalents - State of Hawaii	$ 545,847	$ -	$ 1,217,117	$ 537,294	$ 13,183,061	$ 221,507	$ -	$ 13,404,568	$ -	$ -	$ -	$ -	$ 13,404,568
Cash and cash equivalents	1,899,023	425,548	734,071	55,735	28,795,330	9,853,300	-	38,648,630	37,140	125,087	61,987	-	38,872,844
Patient accounts receivable - Less allowances for contractual adjustments and doubtful accounts	1,904,899	1,494,182	4,111,222	2,685,427	74,881,180	-	-	74,881,180	-	19,715	417,123	-	75,318,018
Supplies and other current assets	1,515,964	128,502	676,396	174,700	15,806,176	7,579	-	15,813,755	-	33,832	76,023	-	15,923,610
Estimated third-party payor settlements	353,000	346,858	937,661	115,000	9,357,617	-	-	9,357,617	-	-	-	-	9,357,617
Due from State of Hawaii	1,403,960	-	527,280	569,183	41,922,420	502,668		42,425,088	-	-	-		42,425,088
Total current assets	7,622,693	2,395,090	8,203,747	4,137,339	183,945,784	10,585,054	-	194,530,838	37,140	178,634	555,133	-	195,301,745
Capital Assets - Net	5,324,272	3,467,850	14,161,919	5,552,259	269,108,670	2,003,750	-	271,112,420	-	13,972,283	500,629	-	285,585,332
Assets Limited as to Use	65,292	240	346,516	25,410	1,571,018	500,000	-	2,071,018	-	-	-	-	2,071,018
Other Assets	-	-	109,350	-	1,156,347	-	-	1,156,347	-	-	15,263		1,171,610
Total assets	**$ 13,012,257**	**$ 5,863,180**	**$ 22,821,532**	**$ 9,715,008**	**$ 455,781,819**	**$ 343,815,058**	**$ (318,826,299)**	**$ 480,770,578**	**$ 37,140**	**$ 14,150,917**	**$ 1,071,025**	**$ (11,899,955)**	**$ 484,129,705**
Liabilities and Net Assets (Deficit)													
Current Liabilities													
Current portion of long-term debt	$ -	$ -	$ 111,008	$ -	$ 12,900,403	$ 202,994	$ -	$ 13,103,397	$ -	$ 357,643	$ 310,310	$ -	$ 13,771,350
Current portion of capital lease obligations	-	105,602	230,843	-	783,208	8,726,003	-	9,509,211	-	-	-	-	9,509,211
Accounts payable and accrued expenses	1,021,686	780,308	3,937,591	1,103,097	64,904,914	5,132,930	-	70,037,844	-	190,293	358,162		70,586,299
Current portion of accrued workers' compensation liability	80,000	-	160,000	225,000	3,100,000	-	-	3,100,000	-	-	-	-	3,100,000
Current portion of accrued vacation	684,000	158,596	1,682,097	293,493	15,664,596	229,244	-	15,893,840	-	-	-	-	15,893,840
Other current liabilities	-	-	253,602	50,000	1,942,090	-	-	1,942,090	-	405,910	149	-	2,348,149
Total current liabilities	1,785,686	1,044,506	6,375,141	1,671,590	99,295,211	14,291,171	-	113,586,382	-	953,846	668,621	-	115,208,849
Long-term Debt - Less current portion	-	-	919,877	-	10,219,950	291,355	-	10,511,305	-	15,591,132	276,345	-	26,378,782
Capital Lease Obligations - Less current portion	-	116,111	888,259	-	2,102,080	22,769,127	-	24,871,207	-	-	-	-	24,871,207
Other Liabilities													
Accrued vacation - Less current portion	1,349,973	-	1,556,564	1,423,653	21,372,580	754,339	-	22,126,919	-	-	50,052	-	22,176,971
Accrued workers' compensation - Less current portion	489,000	-	914,000	699,000	12,389,000	243,000		12,632,000	-	-	-		12,632,000
Other postemployment benefit liability	4,607,949	-	8,969,427	3,426,090	103,196,073	2,008,775	-	105,204,848	-	-	-	-	105,204,848
Due to affiliates - Net	27,881,162	1,430,054	56,837,472	18,596,471	318,826,299	-	(318,826,299)	-	-	11,974,146	1,396,604	(13,370,750)	-
Due to the State of Hawaii	491,450	-	1,043,345	2,417,150	30,122,507	14,000,000	-	44,122,507	-	-	-	-	44,122,507
Patients' safekeeping deposits	40,757	240	4,496	24,366	481,977	-	-	481,977	-	-	-	-	481,977
Other liabilities	-	-	20,483	6,458	4,097,096	100,000	-	4,197,096	-	-	-	-	4,197,096
Total liabilities	36,645,977	2,590,911	77,529,064	28,264,778	602,102,773	54,457,767	(318,826,299)	337,734,241	-	28,519,124	2,391,622	(13,370,750)	355,274,237
Net Assets (Deficit)													
Invested in capital assets - Net of related debt	5,324,272	3,246,137	12,011,932	5,552,259	254,103,029	(29,985,729)	-	224,117,300	-	(1,976,492)	(86,026)	-	222,054,782
Restricted for capital purchases	24,535	-	342,020	1,047	1,107,015	-	-	1,107,015	-	-	-	-	1,107,015
Unrestricted	(28,982,527)	26,132	(67,061,484)	(24,103,076)	(401,530,998)	319,343,020	-	(82,187,978)	37,140	(12,391,715)	(1,234,571)	1,470,795	(94,306,329)
Total net assets (deficit)	(23,633,720)	3,272,269	(54,707,532)	(18,549,770)	(146,320,954)	289,357,291	-	143,036,337	37,140	(14,368,207)	(1,320,597)	1,470,795	128,855,468
Total liabilities and net assets (deficit)	**$ 13,012,257**	**$ 5,863,180**	**$ 22,821,532**	**$ 9,715,008**	**$ 455,781,819**	**$ 343,815,058**	**$ (318,826,299)**	**$ 480,770,578**	**$ 37,140**	**$ 14,150,917**	**$ 1,071,025**	**$ (11,899,955)**	**$ 484,129,705**

Hawaii Health Systems Corporation

Supplemental Statement of Revenues, Expenses, and Changes in Net Asset (Deficit) of Facilities
Year Ended June 30, 2010

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
Operating Revenues								
Net patient service revenue	$ 113,736,733	$ 7,892,242	$ 4,725,537	$ 10,909,894	$ 53,893,232	$ 5,405,871	$ 167,116,350	$ 15,930,677
Other revenues	1,203,985	21,290	16,661	-	338,180	8,294	1,006,271	76,129
Total operating revenues	114,940,718	7,913,532	4,742,198	10,909,894	54,231,412	5,414,165	168,122,621	16,006,806
Operating Expenses								
Salaries and benefits	80,157,072	6,736,312	4,660,142	4,953,779	40,804,739	4,479,104	114,342,808	17,172,019
Purchased services	14,572,182	986,264	894,833	230,790	5,496,461	1,000,306	16,525,564	1,211,894
Medical supplies and drugs	14,590,918	366,063	103,883	411,288	6,562,496	127,816	33,331,515	573,448
Depreciation and amortization	4,161,518	496,878	126,530	1,019,203	2,849,994	278,351	7,624,385	386,788
Utilities	1,974,853	573,119	119,759	1,028,490	1,357,832	142,301	3,384,677	250,314
Repairs and maintenance	3,225,685	205,297	75,907	47,246	1,548,692	140,099	2,862,754	152,151
Other supplies	3,671,597	342,797	147,839	517,025	1,083,772	164,401	4,051,209	1,049,447
Professional fees	2,820,906	10,303	17,183	128,006	797,789	143,671	2,019,820	86,048
Insurance	2,016,961	66,397	96,067	759,413	886,116	22,739	1,963,159	159,667
Rent and lease	1,694,642	18,195	28,624	21,942	412,842	33,736	3,045,423	48,667
Other	1,747,958	60,936	63,352	2,350,876	1,640,468	211,958	1,436,434	81,867
Total operating expenses	130,634,292	9,862,561	6,334,119	11,468,058	63,441,201	6,744,482	190,587,748	21,172,310
Operating (Loss) Gain	(15,693,574)	(1,949,029)	(1,591,921)	(558,164)	(9,209,789)	(1,330,317)	(22,465,127)	(5,165,504)
Nonoperating Revenues (Expenses)								
General appropriations from State of Hawaii	23,224,000	2,256,000	1,424,000	-	10,848,000	1,350,000	28,827,000	4,551,000
Loss on disposal of capital assets	(24,704)	-	-	-	(291,024)	(7,219)	(167,311)	(1,982)
Restricted contributions	869,435	-	83,686	-	2,630	163,029	2,109,360	-
Interest expense	(606,354)	(6,248)	(69)	(81,631)	(376,246)	(261)	(514,020)	(4,147)
Interest and dividend income	145,932	-	2,620	-	83,630	-	415,166	15,668
Corporate allocation expense	(2,718,579)	(202,654)	(133,420)	-	(1,300,584)	(134,485)	(3,952,668)	(435,346)
Other nonoperating revenues (expenses) - Net	522,167	579,120	1,347	(238)	(1,827,627)	16,093	300,609	96,697
Total nonoperating revenues (expenses) - Net	21,411,897	2,626,218	1,378,164	(81,869)	7,138,779	1,387,157	27,018,136	4,221,890
Excess of Revenue Over (Under) Expenses Before Capital Contributions	5,718,323	677,189	(213,757)	(640,033)	(2,071,010)	56,840	4,553,009	(943,614)
Capital Contributions	5,056,423	429,184	5,579,091	427	2,768,352	410,463	16,963,176	2,024,450
Increase (Decrease) in Net Assets	**$ 10,774,746**	**$ 1,106,373**	**$ 5,365,334**	**$ (639,606)**	**$ 697,342**	**$ 467,303**	**$ 21,516,185**	**$ 1,080,836**

	Lanai Community Hospital	Leahi Hospital	Maluhia	Kahuku	Kauai Veterans Memorial Hospital	Samuel Mahelona Memorial Hospital	Total Facilities
Operating Revenues							
Net patient service revenue	$ 2,488,069	$ 15,710,798	$ 14,334,382	$ 6,764,377	$ 27,797,439	$ 13,768,363	$ 460,473,964
Other revenues	7,801	246,857	41,072	357,906	99,160	40,531	3,464,137
Total operating revenues	2,495,870	15,957,655	14,375,454	7,122,283	27,896,599	13,808,894	463,938,101
Operating Expenses							
Salaries and benefits	2,638,303	19,351,707	15,867,163	4,964,463	28,294,793	14,501,171	358,923,575
Purchased services	802,638	497,203	473,365	516,339	3,553,998	749,695	47,511,532
Medical supplies and drugs	305,739	458,448	281,501	584,024	2,449,833	298,167	60,445,139
Depreciation and amortization	72,775	680,748	426,741	297,477	1,477,624	446,359	20,345,371
Utilities	105,391	880,920	544,106	287,385	853,285	414,385	11,916,817
Repairs and maintenance	45,089	203,107	212,086	272,344	651,302	93,777	9,735,536
Other supplies	117,487	946,892	712,067	203,044	652,215	470,369	14,130,161
Professional fees	28,704	139,827	57,277	1,042,618	527,834	375,066	8,195,052
Insurance	18,593	261,805	140,710	194,579	534,566	230,764	7,351,536
Rent and lease	11,657	30,722	4,519	154,275	726,033	60,176	6,291,453
Other	62,309	61,374	25,496	121,442	481,505	81,041	8,427,016
Total operating expenses	4,208,685	23,512,753	18,745,031	8,637,990	40,202,988	17,720,970	553,273,188
Operating (Loss) Gain	(1,712,815)	(7,555,098)	(4,369,577)	(1,515,707)	(12,306,389)	(3,912,076)	(89,335,087)
Nonoperating Revenues (Expenses)							
General appropriations from State of Hawaii	1,496,000	5,925,000	4,632,000	1,500,000	8,509,000	2,898,000	97,440,000
Loss on disposal of capital assets	(3,370)	(3,694)	(3,373)	-	(585)	-	(503,262)
Restricted contributions	-	-	-	-	-	-	3,228,140
Interest expense	-	(1,245)	-	(47,433)	(172,333)	(185)	(1,810,172)
Interest and dividend income	1,197	37,248	110,784	-	69,480	19,849	901,574
Corporate allocation expense	(90,089)	(480,809)	(392,775)	-	(777,661)	(355,152)	(10,974,222)
Other nonoperating revenues (expenses) - Net	9,596	79,169	-	-	764,635	341,376	882,944
Total nonoperating revenues (expenses) - Net	1,413,334	5,555,669	4,346,636	1,452,567	8,392,536	2,903,888	89,165,002
Excess of Revenue Over (Under) Expenses Before Capital Contributions	(299,481)	(1,999,429)	(22,941)	(63,140)	(3,913,853)	(1,008,188)	(170,085)
Capital Contributions	1,598,159	1,340,317	1,129,908	-	300,663	343,915	37,944,528
Increase (Decrease) in Net Assets	**$ 1,298,678**	**$ (659,112)**	**$ 1,106,967**	**$ (63,140)**	**$ (3,613,190)**	**$ (664,273)**	**$ 37,774,443**

	Corporate	Reclassifications and Eliminations	HHSC Combined	Hawaii Health Systems Foundation	Alii Community Care - Maui	Alii Community Care - Kona	Reclassifications and Eliminations	HHSC Consolidated
Operating Revenues								
Net patient service revenue	$ -	$ -	$ 460,473,964	$ -	$ -	$ 2,727,691	$ -	$ 463,201,655
Other revenues	-	-	3,464,137	-	3,657,437	853,797	-	7,975,371
Total operating revenues	-	-	463,938,101	-	3,657,437	3,581,488	-	471,177,026
Operating Expenses								
Salaries and benefits	7,273,573	-	366,197,148	-	-	3,017,057	-	369,214,205
Purchased services	599,038	51,303	48,161,873	-	8,883	673,612	-	48,844,368
Medical supplies and drugs	-	-	60,445,139	-	-	132,707	-	60,577,846
Depreciation and amortization	1,706,064	-	22,051,435	-	753,356	111,943	-	22,916,734
Utilities	108,607	-	12,025,424	-	293,999	61,177	-	12,380,600
Repairs and maintenance	92,196	-	9,827,732	-	44,248	18,344	-	9,890,324
Other supplies	46,968	-	14,177,129	-	304,325	24,538	-	14,505,992
Professional fees	392,667	-	8,587,719	-	1,886,764	-	-	10,474,483
Insurance	114	-	7,351,650	-	81,016	263,170	-	7,695,836
Rent and lease	85,155	-	6,376,608	-	101,724	258,932	-	6,737,264
Other	234,546	-	8,661,562	1,385	86,329	323,759	-	9,073,035
Total operating expenses	10,538,928	51,303	563,863,419	1,385	3,560,644	4,885,239	-	572,310,687
Operating (Loss) Gain	(10,538,928)	(51,303)	(99,925,318)	(1,385)	96,793	(1,303,751)	-	(101,133,661)
Nonoperating Revenues (Expenses)								
General appropriations from State of Hawaii	820,894	-	98,260,894	100	-	-	-	98,260,994
Loss on disposal of capital assets	-	-	(503,262)	-	-	-	-	(503,262)
Restricted contributions	-	-	3,228,140	-	-	-	-	3,228,140
Interest expense	(2,251,239)	-	(4,061,411)	-	(951,851)	(68,143)	-	(5,081,405)
Interest and dividend income	40,491	-	942,065	-	539	-	-	942,604
Corporate allocation expense	10,974,222	-	-	-	-	-	-	-
Other nonoperating revenues (expenses) - Net	37,419	51,303	971,666	(9,797)	-	382,525	1,449,837	2,794,231
Total nonoperating revenues (expenses) - Net	9,621,787	51,303	98,838,092	(9,697)	(951,312)	314,382	1,449,837	99,641,302
Excess of Revenue Over (Under) Expenses Before Capital Contributions	(917,141)	-	(1,087,226)	(11,082)	(854,519)	(989,369)	1,449,837	(1,492,359)
Capital Contributions	-	-	37,944,528	-	-	-	-	37,944,528
Increase (Decrease) in Net Assets	**$ (917,141)**	**$ -**	**$ 36,857,302**	**$ (11,082)**	**$ (854,519)**	**$ (989,369)**	**$ 1,449,837**	**$ 36,452,169**

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*

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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
Hawaii Health Systems Corporation

We have audited the financial statements of Hawaii Health Systems Corporation (a component unit of the State of Hawaii) as of and for the year ended June 30, 2010 and have issued our report thereon dated August 24, 2011. 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 Hawaii Health Systems Corporation's internal control over financial reporting as a basis for designing our auditing procedures for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of the entity's internal control over financial reporting.

Our consideration of internal control over financial reporting was for the limited purpose described in the preceding paragraph and was not designed to identify all deficiencies in internal control over financial reporting that might be significant deficiencies or material weaknesses and therefore, there can be no assurance that all deficiencies, significant deficiencies, or material weaknesses have been identified. However, as described in the accompanying schedule of findings and questioned costs, we identified certain deficiencies in internal control over financial reporting that we consider to be material weaknesses and other deficiencies that we consider to be significant deficiencies.

A deficiency in internal control 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 and correct misstatements on a timely basis. A material weakness is a deficiency, or a combination of deficiencies, in internal control such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented or detected and corrected on a timely basis. We consider the deficiencies described in the accompanying schedule of findings as Findings 2010-1 through 2010-6 to be material weaknesses.

To the Board of Directors
Hawaii Health Systems Corporation

A significant deficiency is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance. We consider the deficiencies described in the accompanying schedule of findings as Findings 2010-7 through 2010-17 to be significant deficiencies.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether Hawaii Health Systems Corporation's 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 financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit and, accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards.*

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 management, the board of directors, others within the entity, and regulatory bodies and is not intended to be and should not be used by anyone other than these specified parties.

Plante & Moran, PLLC

August 24, 2011

Finding - 2010-1

Organization - HHSC - Corporate

Finding Type - Material weakness

Criteria - Accrued liability balances should reflect actual liabilities of the organization. Detailed information should be reviewed to ensure accrued liability amounts are recorded in accordance with generally accepted accounting principles.

Condition - The Corporation had designed controls over the review of accrued liabilities; however, the review process was not effective.

Context - We identified two accrued liability accounts that were overstated due to inclusion of amounts that were not actual liabilities of the Corporation.

Cause - Management did not review the accrued liability accounts for validity of balances recorded.

Effect - Accrued liabilities were not properly reflected in year-end balances, resulting in total audit adjustments of $134,232 to remove amounts that were not actual liabilities.

Recommendation - Review accrued liability accounts to ensure balances reflect actual liabilities of the Corporation.

Finding - 2010-2

Organizations - East Hawaii Region, West Hawaii Region, Maui Region, Kauai Region, Oahu Region, and Kahuku Medical Center

Finding Type - Material weakness

Criteria - Professional liability detailed information should be reviewed periodically to ensure adequate liabilities are recorded related to any professional liability exposure in accordance with generally accepted accounting principles.

Condition - Detailed professional liability reports were provided, but the information was not used to determine if the facilities had professional liability exposure. The facilities noted below were determined to have exposure related to professional liability claims of approximately:

- Hilo Medical Center $300,000
- Kauai Veterans Memorial Hospital $230,000
- Samuel Mahelona Memorial Hospital $50,000
- Kona Community Hospital $190,000
- Maui Memorial Medical Center $760,000
- Leahi Hospital $90,000
- Kahuku Medical Center $40,000

In total, the exposure related to professional liability claims is approximately $1,650,000. No accruals for professional liability exposure were recorded prior to the start of the audit.

Context - Lack of consideration of professional liability exposure

Cause - Management was aware of the potential claims, but the obligations had not been reflected in the general ledger.

Effect - Interim financial statements were understated by approximately $1,650,000 within liabilities and operating expenses. An adjusting journal entry was posted to the facilities noted above, in the amounts noted above.

Recommendation - Members of the finance department and the risk manager should periodically review open professional liability claims to determine the exposure the facilities have at that point in time. Recorded accruals should be adjusted to reflect the determinations made at these meetings.

Finding - 2010-3

Organization - Kahuku Medical Center

Finding Type - Material weakness

Criteria - Capital assets schedules should be reviewed and agreed to the general ledger to ensure the balances presented on the financial statements are accurate.

Condition - A capital asset schedule, which is maintained in an Excel spreadsheet, was provided, but the information did not agree to the general ledger by approximately $183,000.

Context - Lack of detail review of the capital asset schedule and related formulas used to calculate depreciation

Cause - Management was unaware that the schedules did not agree to the general ledger.

Effect - Interim financial statements were misstated by approximately $183,000 within assets and operating expenses. An adjusting journal entry was posted to correct this misstatement.

Recommendation - The schedule should be reviewed and agreed to the general ledger on a regular basis.

Finding - 2010-4

Organization - West Hawaii Region (Kona Community Hospital)

Finding Type - Material weakness

Criteria - Loan receivable amounts should be evaluated for collectibility on a regular basis to ensure they are properly reflected in the financial statements.

Condition - No allowances were recorded in the general ledger for amounts not expected to be collected related to a loan made to another organization.

Context - A formal analysis had not been performed at year end to assess the collectibility of loan receivables.

Cause - Subsequent to year end, the outstanding balance of the loan receivable was deemed uncollectible and the entire loan amount written off.

Effect - The balance sheet was overstated by the full loan balance at year end. An adjusting journal entry was recorded to correct this misstatement.

Recommendation - We recommend management perform formal reviews of assets, such as loans receivable, in the future to ensure the financial statements properly reflect the collectibility of those assets.

Finding - 2010-5

Organization - Alii Community Care, Inc. (Alii - Maui Community Care)

Finding Type - Material weakness

Criteria - Property and equipment lapse schedules should be maintained. Reconciliation of the detailed lapse schedule to the general ledger is essential to ensure amounts presented in the financial statements are accurate.

Condition - A property and equipment lapse schedule did not exist. Also, depreciation expense had not been recorded in fiscal year 2010.

Context - Property and equipment amounts recorded in the general ledger did not have adequate supporting documentation. Depreciation was not considered throughout the year.

Cause - Property and equipment amounts in the general ledger were overstated by approximately $600,000. Also, depreciation expense of approximately $1,600,000 needed to be recorded in fiscal year 2010.

Effect - The balance sheet and statement of operations were misstated throughout the year.

Recommendation - We recommend management perform formal reviews of property and equipment accounts to ensure what is being reported is properly supported by lapse schedules or other detailed records. Additionally, management should record depreciation expense on a monthly basis to ensure net property and equipment amounts presented in internal financial statements are reasonably stated.

Finding - 2010-6

Organization - Alii Community Care, Inc. (Alii - Kona Community Care)

Finding Type - Material weakness

Criteria - Appropriate internal controls should be maintained to ensure the financial statements are free of material misstatement and assets are properly safeguarded.

Condition - Difficulties were experienced in obtaining supporting documentation for a number of general ledger accounts during the audit process. In addition, the turnover contributed to a general lack of controls - especially a lack of sufficient separation of duties.

Context - Supporting documentation for general ledger accounts had to be recreated during the audit process by management. Policies and procedures at the facility were updated and implemented as the audit continued based on findings noted during the audit process.

Cause - Overall, significant adjustments were not made to the facility's general ledger accounts; however, the lack of internal controls was evident.

Effect - Lack of internal controls at the facility exposes the facility to risk.

Recommendation - We recommend management and the board review the policies and procedures of the facility to ensure adequate internal controls are in place to mitigate the risk of fraud and financial statement manipulation.

Finding - 2010-7

Organization - West Hawaii Region

Finding Type - Significant deficiency

Criteria - Manual journal entries and supporting documentation should be reviewed on a regular basis to ensure these manual journal entries are being recorded properly.

Condition - Formal review of manual journal entries posted to the general ledger was not performed.

Context - Manual journal entries are not reviewed, resulting in a lack of internal control related to manual journal entries.

Cause - Manual journal entries are not reviewed.

Effect - No process exists to ensure the manual journal entries posted to the general ledger are properly supported and recorded properly.

Recommendation - We recommend management implement a formal policy to include a monthly review of all manual journal entries, including supporting documentation.

Finding - 2010-8

Organization - HHSC - Corporate

Finding Type - Significant deficiency

Criteria - Proper documentation for contracts obtained through procurement should be maintained to ensure compliance with internal policies.

Condition - The Corporation has procedures in place to ensure proper documentation for all contracts obtained through procurements is maintained; however, documentation maintained by the Corporation for three contracts was not adequate.

Context - Our review of 25 procurement files identified three files which lacked proper documentation.

Cause - Management did not follow procedures to ensure proper documentation is maintained.

Effect - Three procurement files do not have proper documentation of the procurement process.

Recommendation - Management should review their procedures in place to ensure proper documentation of the procurement contract files is maintained.

Finding - 2010-9

Organization - HHSC - Corporate

Finding Type - Significant deficiency

Criteria - Payroll accruals should properly reflect all payroll-related liabilities of the Corporation.

Condition - The Corporation did not review its payroll accrual to ensure the balance was properly recorded at year end.

Context - During audit procedures, we found several employee payroll liabilities were not recorded in the correct period.

Cause - Management did not review the payroll accrual calculations for validity of balances recorded.

Effect - Payroll accrued liabilities were not properly reflected in year-end balances, resulting in an audit adjustment of $200,048 to record amounts that should have been recorded at year end.

Recommendation - Review payroll accrual calculations to ensure balances accurately reflect liabilities of the Corporation.

Finding - 2010-10

Organization - HHSC - Corporate

Finding Type - Significant deficiency

Criteria - Earned vacation should be paid out to separated employees based on time earned.

Condition - The Corporation overpaid one separated employee.

Context - The schedule of accrued vacation as of June 30, 2010 had errors for the vacation hours for three employees. One of the employees left the Corporation in June 2010. Due to the error in accrued vacation hours, this employee was paid out more vacation time than was earned as of the separation date.

Cause - Management did not review the vacation activity.

Effect - The Corporation overpaid one separated employee $1,000 more than what the employee had earned prior to leaving. The actual errors noted above resulted in the accrued vacation balance to be overstated by $3,039.

Recommendation - Review vacation time accruals for all employees and payments to separated employees to ensure balances are proper.

Finding - 2010-11

Organization - East Hawaii Region (Hilo Medical Center)

Finding Type - Significant deficiency

Criteria - Review of bank reconciliations is essential to ensure activity in bank accounts is proper. Additionally, proper separation of duties in and around the cash cycle is vital to ensure proper controls are in place to mitigate the inherent risk of the cash cycle.

Condition - Bank reconciliations are not formally reviewed by someone independent from the bank reconciliation preparation process. Additionally, those preparing bank reconciliations also have the ability to initiate wire transfers and post journal entries to the general ledger.

Context - Bank reconciliations for various cash accounts are not reviewed.

Cause - Procedures are not in place to have adequate internal controls around the cash cycle.

Effect - One cash account was overstated by $50,813.

Recommendation - We recommend a formal review process be put in place of bank reconciliations. Additionally, we recommend the preparer of bank reconciliations not have access to posting journal entries or initiating wire transfers.

Finding - 2010-12

Organization - East Hawaii Region (Hilo Medical Center and Hale Ho'ola Hamakua)

Finding Type - Significant deficiency

Criteria - Reconciliation of the detailed lapse schedule to the general ledger is essential to ensure amounts presented in the financial statements are accurate.

Condition - Reconciliations are not performed related to property and equipment accounts. The result of the lack of reconciliations resulted in an understatement of $1,437,393 in the property and equipment accounts as compared to the detailed subsidiary ledger.

Context - Property and equipment reconciliations are not completed.

Cause - Procedures are not in place to complete property and equipment reconciliations.

Effect - Property and equipment accounts were understated by a total of $1,437,393, of which $585,393 relates to current projects and $852,000 for differences identified in previous years.

Recommendation - We recommend management implement a formal reconciliation process related to capital asset accounts. The Corporation should reconcile detailed lapse schedules to the general ledger on a monthly basis. All variances should be researched and resolved.

Finding - 2010-13

Organization - East Hawaii Region (Hilo Medical Center and Hale Ho'ola Hamakua)

Finding Type - Significant deficiency

Criteria - Formal review of the accounts payable reconciliation is essential to ensure activity is properly recorded. Additionally, employees determining what payables should be recorded as of June 30, 2010 should have the proper training to ensure amounts are recorded properly.

Condition - Accounts payable reconciliations are not formally reviewed by someone independent of the accounts payable process. Also, invoices were both improperly included in and improperly excluded from accounts payable at year end. The apparent cause is employees accruing invoices based on invoice date, instead of when the services were performed or when the goods were received.

Context - Lack of review of accounts payable reconciliations and lack of adequate training of those employees working with payables

Cause - Procedures are not in place to complete accounts payable reconciliations and lack of adequate training of those employees working with payables.

Effect - Accounts payable accounts were overstated by $474,682 at year end.

Recommendation - We recommend a formal process be implemented to ensure accounts payable reconciliations are formally reviewed. We also recommend additional training for those employees working with payables to ensure invoices are recorded in the proper period going forward.

Finding - 2010-14

Organization - Maui Region (Kula Hospital)

Finding Type - Significant deficiency

Criteria - Bad debt allowances should be reviewed periodically to ensure adequate accruals are recorded in accordance with generally accepted accounting principles.

Condition - Detailed collections on accounts receivable were provided. The results showed that for Kula Hospital, there was an approximate $1,500,000 shortfall between what was recorded in net accounts receivable as of June 30, 2009 and what was actually collected on those accounts subsequently.

Context - Lack of hindsight review of bad debt allowances

Cause - Management has access to the necessary information to perform the analysis, but did not use this data in the calculation of the allowances.

Effect - Interim financial statements were overstated by approximately $1,500,000 within assets and operating revenues.

Recommendation - On a regular basis, members of the finance department should review collections on accounts receivable to ensure the model used to calculate the allowance is reasonable.

Finding - 2010-15

Organization - Maui Region (Maui Memorial Medical Center)

Finding Type - Significant deficiency

Criteria - The underlying data used to calculate the vacation accrual should be reviewed periodically to ensure accurate amounts are used to calculate the accrual in accordance with generally accepted accounting principles.

Condition - Detailed testing of the vacation accrual showed that incorrect rates were used for certain employees to calculate the vacation accrual as of June 30, 2010.

Context - Lack of detailed review of the assumptions used in the calculation

Cause - Management used rates provided by human resources, but did not verify that proper amounts were used.

Effect - Interim financial statements were overstated by approximately $800,000 within liabilities and operating expenses

Recommendation - On a regular basis, members of the finance department should review these calculations to ensure accurate accruals for vacation are recorded.

Finding - 2010-16

Organization - Kauai Region (Samuel Mahelona Memorial Hospital)

Finding Type - Significant deficiency

Criteria - Expenses and liabilities for goods and services performed should be recorded when used or at the time the service is complete.

Condition - Goods and services were used or services were performed prior to June 30, 2010, but the liability was not recorded as of year end.

Context - Lack of review of services performed, but not invoiced

Cause - Open purchase orders are not reviewed at the end of each period. In addition, a lag may occur between when an invoice is received and when the liability is recorded.

Effect - Interim financial statements were understated by approximately $67,000 within liabilities and capital assets.

Recommendation - At the end of each reporting period, management should thoroughly review open purchase orders and invoices received to identify potential liabilities that should be recorded.

Finding - 2010-17

Organization - Kahuku Medical Center

Finding Type - Significant deficiency

Criteria - Adjusting journal entries recorded by the Kahuku controller should be independently reviewed on a regular basis to ensure these adjusting journal entries are recorded properly.

Condition - No formal review of adjusting journal entries posted to the general ledger is performed.

Context - Adjusting journal entries are not reviewed at this time. This has resulted in a lack of control related to adjusting journal entries.

Cause - Adjusting journal entries are not reviewed.

Effect - At this time, there is no process in place to ensure the adjusting journal entries posted to the general ledger are properly supported and if they are posted properly.

Recommendation - We recommend Kahuku implement a formal policy, which will include a monthly review of all adjusting journal entries, including supporting documentation.