Hawaii Health Systems Corporation

Financial Report
with Other Supplemental Information
June 30, 2011

Hawaii Health Systems Corporation

Contents

plante moran

Plante & Moran, PLLC
Suite 400
634 Front Avenue N.W.
Grand Rapids, MI 49504
Tel: 616.774.8221
Fax: 616.774.0702
plantemoran.com

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 years ended June 30, 2011 and 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 audits.

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

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, 2011 and 2010, the changes in its financial position, or its cash flows for the years 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, 2011 and 2010 and the changes in financial position and its cash flows for the years then ended, in conformity with accounting principles generally accepted in the United States of America.

As discussed in Note 1, in fiscal year 1997, the administration of the facilities that comprise HHSC was transferred from the State Department of Health - Division of Community Hospitals (the "State") to HHSC. At June 30, 2011, 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, 2011 and 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 audits were 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 the purpose 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 audits 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 February 1, 2012 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

February 1, 2012

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, 2011, 2010, and 2009. Please read it in conjunction with the Corporation's financial statements, which begin on page 16.

Using this Annual Report

The Corporation's financial statements consist of three statements: (a) a balance sheet; (b) a statement of revenue, 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 Revenue, 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 revenue, 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 revenue 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 operating, 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 16. The Corporation's net assets increased by $207,829 (.16 percent) in 2011, $36,452,169 (39.4 percent) in 2010, and decreased by $61,826,893 (40.1 percent) in 2009, 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, 2011, 2010, and 2009 is as follows:

	2011	2010	2009
Assets			
Current assets	$ 216,565,876	$ 195,301,745	$ 145,404,076
Capital assets - Net	291,103,090	285,585,332	276,695,726
Other assets	4,579,301	3,242,628	4,231,924
Total assets	**$ 512,248,267**	**$ 484,129,705**	**$ 426,331,726**
Liabilities			
Current liabilities	$ 112,587,993	$ 115,208,849	$ 113,407,307
Other postemployment liability	143,024,739	105,204,848	65,782,538
Due to the State of Hawaii	41,622,507	44,122,507	44,122,507
Other liabilities	85,949,731	90,738,033	110,616,075
Total liabilities	383,184,970	355,274,237	333,928,427
Net Assets (Deficit)			
Invested in capital assets - Net of related debt	238,189,336	222,054,782	206,007,708
Restricted	902,579	1,107,015	847,048
Unrestricted	(110,028,618)	(94,306,329)	(114,451,457)
Total net assets (deficit)	129,063,297	128,855,468	92,403,299
Total liabilities and net assets (deficit)	**$ 512,248,267**	**$ 484,129,705**	**$ 426,331,726**

At June 30, 2011, 2010 and 2009, HHSC's current assets approximated 42 percent, 40 percent, and 34 percent of total assets, respectively. Current assets increased approximately $21.3 million in 2011 due to increases in the due from the State of Hawaii of $15.1 million, and cash and cash equivalents of $10.7 million, which were partially offset by the decrease in estimated settlements from Medicare and Medicaid of $5.9 million. The increase in the amounts due from the State of Hawaii is due to allotments to HHSC for State-funded capital improvement projects in excess of amounts expended. 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. The increase in cash and cash equivalents of $10.7 million is primarily due to various factors, as reflected in the statement of cash flows. The reasons for this change are discussed in the "Operating Results and Changes in Net Assets" section below. The decrease in settlements expected from Medicare and Medicaid of $5.9 million is primarily due to the timing of payments received in 2011 related to the DHS supplemental payments. The primary reason for the increase in current assets in 2010 was due to the increase in cash and cash equivalents and amounts due from the State of Hawaii. The reasons for the increases in 2010 are consistent with the reasons in 2011.

At June 30, 2011, 2010, and 2009, HHSC's current liabilities were approximately 29 percent, 32 percent, and 34 percent of total liabilities, respectively. The primary reason for the decrease in current liabilities in 2011 of $2.6 million is due to the decrease in the current portion of long-term debt of $4.6 million, and the decrease in the capital lease obligation of $1.6 million, which were both due to repayments in 2011. The decrease was partially offset by increases in the current portion due to the State of Hawaii of $2.5 million, and accounts payable and accrued expenses of $1.5 million. The increase in the current portion due to the State of Hawaii is the result of impending maturity of the advance from the State of Hawaii. The increase in accounts payable and other accrued expenses is due to increases in operating expenses in 2011, coupled with the decrease in funding from the State of Hawaii. The increase in current liabilities in 2010 of $1.8 million was primarily due to the increase in the current portion of long-term debt due to the impending maturities related to the revolving line of credit loan facility for Maui Memorial Medical Center and the credit facility from the Yukio Okutsu Veterans Care Home. The relatively small decrease in current liabilities, coupled with the increase in HHSC's allocation of the other postemployment benefit liability from the State of Hawaii of $37.8 million, caused total liabilities to increase by $27.9 million.

At June 30, 2011, 2010, and 2009, HHSC's net assets are reflected as its investment in capital assets, net of related debt of approximately $238 million, $222 million, and $206 million, respectively. Total net assets were $129 million in 2011 and 2010, and $92 million in 2009.

Capital Assets

At June 30, 2011, 2010, and 2009, HHSC's capital assets, net of accumulated depreciation, comprised approximately 57 percent, 59 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 $5.5 million and $8.9 million in 2011 and 2010, respectively, is due primarily to ongoing construction projects.

A summary of HHSC's capital assets as of June 30, 2011, 2010, and 2009 is as follows:

	2011	2010	2009
Land and land improvements	$ 6,483,834	$ 6,483,834	$ 6,483,834
Building and improvements	376,906,867	353,427,467	352,802,119
Equipment	160,299,322	148,669,328	144,824,647
Construction in progress	21,485,947	31,223,642	12,675,132
Total capital assets	565,175,970	539,804,271	516,785,732
Less accumulated depreciation and amortization	(274,072,880)	(254,218,939)	(240,090,006)
Capital assets - Net	**$ 291,103,090**	**$ 285,585,332**	**$ 276,695,726**

Long-term Debt and Capital Lease Obligations

At June 30, 2011, HHSC had long-term debt and capital lease obligations totaling approximately $61.1 million. This amount is down approximately $13.4 million compared to fiscal year ended June 30, 2010.

HHSC repaid approximately $14.1 million and $11.1 million on outstanding long-term debt and capital lease obligation arrangements for the years ended June 30, 2011 and 2010, respectively. More detailed information about HHSC'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, 2011, 2010, and 2009 is as follows:

	2011	2010	2009
Operating revenue	$ 488,382,320	$ 471,177,026	$ 420,118,416
Operating expenses:			
Salaries and benefits	377,762,380	369,281,680	372,229,444
Purchased services and professional fees	69,056,744	59,169,765	55,858,767
Medical supplies and drugs	64,202,837	60,578,206	58,280,089
Depreciation and amortization	24,118,505	22,916,734	22,000,124
Insurance	6,316,661	7,695,836	5,470,601
Other	58,734,535	52,668,466	51,471,282
Total operating expenses	600,191,662	572,310,687	565,310,307
Operating loss	(111,809,342)	(101,133,661)	(145,191,891)
Nonoperating revenue (expenses):			
General appropriations from the State of Hawaii	81,967,200	98,260,994	66,918,042
Collective bargaining pay raise appropriation from the State of Hawaii	-	-	25,122,302
Other nonoperating income (expenses) - Net	421,319	1,380,735	(13,384,643)
Total nonoperating revenue	82,388,519	99,641,729	78,655,701
Excess of expenses over revenue before capital contributions	(29,420,823)	(1,491,932)	(66,536,190)
Capital contributions	29,628,652	37,944,101	4,709,297
Increase (decrease) in net assets	**$ 207,829**	**$ 36,452,169**	**$ (61,826,893)**

For the years ended June 30, 2011, 2010, and 2009, HHSC's operating expenses exceeded its operating revenue by $111.8 million, $101.1 million, and $145.2 million, respectively. General appropriations from the State of Hawaii totaled $82.0 million, $98.3 million, and $66.9 million, respectively. In addition, the appropriations from the State of Hawaii for capital contributions totaled $29.6 million, $37.9 million and $4.7 million, respectively. These items, along with the other nonoperating revenue, contributed to an increase in net assets of $208,000 and $36.5 million in 2011 and 2010, respectively, and to a decrease in net assets in 2009 of $61.8 million.

Operating expenses for the fiscal year ended June 30, 2011 were approximately 4.9 percent higher than the previous year. Operating expenses for the fiscal year ended June 30, 2011 increased $27.9 million or 4.9 percent from fiscal year 2010 due primarily to increases in non-payroll expenses of $19.4 million, and to salaries and benefits of $8.5 million. The increase in operating expenses was due primarily to the increases of $14.7 million at Maui Memorial Medical Center (MMMC) and $10.9 million at Hilo Medical Center (HMC). At MMMC, non-payroll and payroll expenses increased by $7.8 million and $6.9 million, respectively, and were primarily due to the continued expansion of its cardiovascular program services. At HMC, non-payroll and payroll expenses increased by $7.1 million and $3.8 million, and was due primarily to the increase in volume in all areas, most notably the increase in emergency room visits of 3.9 percent. 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 non-payroll expenses of $10 million offset by a decrease in salaries and benefits expense of $3 million. The increase in non-payroll expenses was due primarily to a $5.5 million increase at MMMC 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 MMMC and the increased patient volume at Yukio Okutsu Veterans Care home.

HHSC's management believes that the significant excess of operating expenses over operating revenue in both fiscal years 2011 and 2010, 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 2011 and 2010 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 2011 and 2010. 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 2011 and 2010. 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 $14.5 million to HHSC in fiscal year 2011 and is expected to provide $11.6 million to HHSC in fiscal year 2012. 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 and 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 takebacks based on management's auditing of specific risk areas that have been the focus of the RAC contractors in the demonstration program. However, there is a risk that the 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 takeback 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 2011, HHSC's long-term care occupancy percentage was 88 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 "waitlist" 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 20-30 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 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 63 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 nationwide 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 years 2011 and 2010 were $9.1 million and $5.8 million, respectively. 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 2011, 54 percent of East Hawaii residents and 61 percent of West Hawaii residents requiring orthopedic surgeries were discharged from Oahu hospitals. In keeping with HHSC's mission of providing and enhancing accessible, comprehensive healthcare services that are quality-driven, customer-focused, and cost-effective, management began to contract or employ physicians to ensure that neighbor island residents would be able to receive quality healthcare in a timely manner in the community in which they reside. HHSC's costs of contracting with or employing physicians increased from $7.8 million in fiscal year 2006 to $17.8 million in fiscal year 2011. These costs not only include the salary or contract payments to the physicians, but also the cost of establishing the clinics and physician offices for those physicians. Management believes that without significant medical tort reform and an increase in physician reimbursement rates, there will be continuing pressure put on HHSC's facilities to recruit and employ the physician specialists that are needed to ensure that neighbor island residents receive the quality healthcare that they deserve.

Related to the physician shortage issue is the issue of on-call coverage. In the past, physicians provided on-call coverage for hospital emergency rooms as part of their duties as a medical staff member. However, due to the financial pressures listed in the paragraph above, physicians have started to demand payment for providing on-call coverage for hospital emergency rooms in order to make up for the financial shortfalls they experience from their private practices. Management has attempted to mitigate the need to pay physicians for on-call coverage by contracting with or employing hospitalists. Hospitalists are doctors whose primary professional focus is the practice of hospital medicine. They help manage patients throughout the continuum of hospital care, often seeing patients in the emergency room, and admitting them to inpatient wards. However, the lack of specialty physician availability on the neighbor islands described above has caused HHSC to pay certain of its physicians to provide on-call coverage for the emergency room. HHSC's cost for hospitalist/on-call coverage was $11.5 million in fiscal year 2010 and $11.1 million in fiscal year 2011.

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 years 2011 and 2010 was 11.7 years and 12.0 years, respectively, 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 healthcare for the state of Hawaii. For fiscal year 2011, HHSC's facilities accounted for 17.6 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, 80.3 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 64.8 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. The PPACA originally called for only a temporary allotment of DSH funds to Hawaii. In March 2010, the Health Care and Education Reconciliation Act changed the allotment of DSH funds to Hawaii to permanent status.

- Reduces Medicare DSH payments by $22 billion over 10 years

- Establishes and authorizes funding for community-based collaborative care networks, which are defined as a 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 payers.

- 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 FY 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 marketbasket 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' rule on accountable care organizations or the formation of state health insurance exchanges will have on HHSC.

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, 2011	June 30, 2010
Assets		
Current Assets		
Cash and cash equivalents - State of Hawaii (Note 2)	$ 14,189,042	$ 13,404,568
Cash and cash equivalents	48,837,196	38,872,844
Patient accounts receivable - Less allowances for doubtful accounts of $33,957,798 and $36,834,856 for the years ended June 30, 2011 and 2010, respectively (Note 2)	70,893,930	71,485,009
Supplies and other current assets	17,848,231	15,923,684
Due from the State of Hawaii (Note 3)	57,542,000	42,425,088
Estimated third-party payor settlements	7,255,477	13,190,552
Total current assets	216,565,876	195,301,745
Capital Assets - Net (Note 4)	291,103,090	285,585,332
Assets Limited as to Use (Note 2)	1,870,627	2,071,018
Other Assets	2,708,674	1,171,610
Total assets	**$ 512,248,267**	**$ 484,129,705**
Liabilities and Net Assets (Deficit)		
Current Liabilities		
Current portion of long-term debt (Note 7)	$ 9,246,099	$ 13,830,397
Current portion of capital lease obligations (Note 7)	7,811,490	9,450,164
Accounts payable and accrued expenses	72,071,249	70,586,299
Current portion of accrued workers' compensation (Note 8)	3,311,000	3,100,000
Current portion of accrued vacation (Note 5)	15,603,762	15,893,840
Current portion due to the State of Hawaii (Note 3)	2,500,000	-
Other current liabilities	2,044,393	2,348,149
Total current liabilities	112,587,993	115,208,849
Long-term Debt - Less current portion (Note 7)	26,523,205	26,378,782
Capital Lease Obligation - Less current portion (Note 7)	17,432,960	24,871,207
Other Liabilities		
Accrued vacation - Less current portion (Note 5)	26,524,413	22,176,971
Accrued workers' compensation - Less current portion (Note 8)	11,898,000	12,632,000
Other postemployment benefit liability (Note 6)	143,024,739	105,204,848
Due to the State of Hawaii (Note 3)	41,622,507	44,122,507
Patients' safekeeping deposits	468,048	481,977
Other liabilities	3,103,105	4,197,096
Total liabilities	383,184,970	355,274,237
Net Assets (Deficit)		
Invested in capital assets - Net of related debt	238,189,336	222,054,782
Restricted for capital purchases (Note 2)	902,579	1,107,015
Unrestricted	(110,028,618)	(94,306,329)
Total net assets (deficit)	129,063,297	128,855,468
Total liabilities and net assets (deficit)	**$ 512,248,267**	**$ 484,129,705**

See Notes to Financial Statements.

Hawaii Health Systems Corporation

Statement of Revenue, Expenses, and Changes in Net Assets

	Year Ended	
	June 30, 2011	June 30, 2010
Operating Revenue		
Net patient service revenue (net of provision for doubtful accounts of $34,293,871 and $34,075,589 for the years ended June 30, 2011 and 2010, respectively)	$ 479,377,019	$ 463,201,655
Other revenue	9,005,301	7,975,371
Total operating revenue	488,382,320	471,177,026
Operating Expenses		
Salaries and benefits	377,762,380	369,281,680
Purchased services	54,653,979	48,716,616
Medical supplies and drugs	64,202,837	60,578,206
Depreciation and amortization	24,118,505	22,916,734
Utilities	14,514,132	12,380,600
Repairs and maintenance	10,858,978	9,972,976
Other supplies	17,198,328	14,505,072
Professional fees	14,402,765	10,453,149
Insurance	6,316,661	7,695,836
Rent and lease	7,488,707	6,737,264
Other	8,674,390	9,072,554
Total operating expenses	600,191,662	572,310,687
Operating Loss	(111,809,342)	(101,133,661)
Nonoperating Revenue (Expenses)		
General appropriations from the State of Hawaii	81,967,200	98,260,994
Loss on disposal of capital assets	(464,715)	(503,262)
Restricted contributions	1,666,716	3,228,140
Interest expense	(4,164,772)	(5,081,405)
Interest and dividend income	449,707	942,604
Other nonoperating revenue - Net	2,934,383	2,794,658
Total nonoperating revenue	82,388,519	99,641,729
Excess of Expenses Over Revenue Before Capital Contributions	(29,420,823)	(1,491,932)
Capital Contributions	29,628,652	37,944,101
Increase in Net Assets	207,829	36,452,169
Net Assets - Beginning of year	128,855,468	92,403,299
Net Assets - End of year	**$ 129,063,297**	**$ 128,855,468**

See Notes to Financial Statements.

Hawaii Health Systems Corporation

Statement of Cash Flows

	Year Ended June 30, 2011	Year Ended June 30, 2010
Cash Flows from Operating Activities		
Cash received from government, patients, and third-party payors	$ 485,903,172	$ 455,385,079
Cash payments to employees for services	(334,939,053)	(330,231,955)
Cash payments to suppliers for services and goods	(204,894,256)	(192,756,071)
Other receipts from operations	9,005,301	7,975,371
Net cash used in operating activities	(44,924,836)	(59,627,576)
Cash Flows from Noncapital Financing Activities		
Appropriations from the State of Hawaii	81,967,200	98,260,994
Other nonoperating revenue - Net	5,903,252	7,341,108
Repayment of advance from the State of Hawaii	-	(3,000,000)
Net cash provided by noncapital financing activities	87,870,452	102,602,102
Cash Flows from Capital and Related Financing Activities		
Purchase of capital assets	(14,657,602)	(12,888,089)
Interest paid	(4,164,772)	(5,081,405)
Issuance of long-term debt	100,000	5,506,286
Repayments on long-term debt	(4,539,875)	(1,138,870)
Repayments on capital lease obligations	(9,584,639)	(10,004,401)
Proceeds from sale of assets	-	83,000
Net cash used in capital and related financing activities	(32,846,888)	(23,523,479)
Cash Flows from Investing Activities		
Interest income	449,707	942,604
Decrease (increase) in assets limited as to use	200,391	(289,191)
Net cash provided by investing activities	650,098	653,413
Net Increase in Cash and Cash Equivalents	10,748,826	20,104,460
Cash and Cash Equivalents - Beginning of year	52,277,412	32,172,952
Cash and Cash Equivalents - End of year	**$ 63,026,238**	**$ 52,277,412**
Balance Sheet Classification of Cash		
Cash and cash equivalents - State of Hawaii	$ 14,189,042	$ 13,404,568
Cash and cash equivalents	48,837,196	38,872,844
Total cash and cash equivalents	**$ 63,026,238**	**$ 52,277,412**

Hawaii Health Systems Corporation

Statement of Cash Flows (Continued)

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

	Year Ended June 30, 2011	Year Ended June 30, 2010
Cash Flows from Operating Activities		
Operating loss	$ (111,809,342)	$ (101,133,661)
Adjustments to reconcile operating loss to net cash from operating activities:		
Provision for doubtful accounts	34,293,871	34,075,589
Depreciation and amortization	24,118,505	22,916,734
Changes in assets and liabilities:		
Patient accounts receivable	(33,702,792)	(33,256,278)
Supplies and other assets	(3,488,244)	28,946
Accounts payable, accrued expenses, and other liabilities	(1,626,163)	(13,315,365)
Accrued workers' compensation liability	(523,000)	(413,000)
Postemployment benefit liability	37,819,891	39,422,310
Estimated third-party payor settlements	5,935,074	(8,635,887)
Accrued vacation	4,057,364	683,036
Net cash used in operating activities	**$ (44,924,836)**	**$ (59,627,576)**
Noncash Financing and Investing Activities		
Assets acquired under capital leases and debt	$ 507,718	$ 1,344,062
Capital assets contributed by the State of Hawaii and others	13,209,588	15,898,699
Capital assets included in accounts payable	1,699,437	2,261,752
Loss on disposal of capital assets	464,715	503,262
Change in due from the State of Hawaii	15,116,912	20,727,092

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, 2011. Accordingly, the assets, liabilities, and net assets of HHSC reflected in the accompanying statement of revenue, 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 a 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.

Liquidity - During the year ended June 30, 2011, HHSC incurred losses from operations of approximately $111.8 million and had negative cash flows from operations of $44.9 million. Overall, days in accounts payable have decreased as compared to June 30, 2010. However, days in accounts receivable have remained consistent with the prior year and days cash on hand remain at levels far below national medians. Downward pressures on reimbursements were due to federal healthcare reform and budget cuts to the State of Hawaii MedQUEST program. Although improvements continue to be seen by HHSC, management believes maintaining the current levels of service provided by HHSC will require continued funding by the State of Hawaii.

Reclassifications - Certain 2010 amounts in the Corporation's financial statements have been reclassified to conform with the 2011 presentation in the Corporation's financial statements. Approximately $3.8 million of estimated third-party payor settlements were reclassified from patient accounts receivable to estimated third-party payor settlements.

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.

Note 2 – Summary of Significant Accounting Policies (Continued)

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 revenue 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, 2011 and 2010 is indicated in the accompanying balance sheet 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 $48,516,000 and $38,338,000 at June 30, 2011 and 2010, respectively. Accordingly, these deposits were exposed to custodial credit risk. Custodial credit risk is the risk that in the event of a financial institution failure, HHSC's deposits might not be returned to it. HHSC believes that due to the dollar amounts of cash deposits and the limits of FDIC insurance, it is impractical to ensure all deposits. As a result, HHSC evaluates each financial institution; only those institutions with an acceptable estimated risk level are used as depositories.

Supplies - Supplies consist principally of medical and other supplies and are recorded at the lower of first-in, first-out cost or market.

Capital Assets - Capital assets assumed from the State at inception are recorded at cost less accumulated depreciation. Other capital assets are recorded at cost or estimated fair market value at the date of donation. Donated buildings, equipment, and land are recognized as revenue when all eligibility requirements have been met, generally at the date of donation. Equipment under capital leases 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

Note 2 - Summary of Significant Accounting Policies (Continued)

Gains or losses on the sale of capital assets are reflected in other nonoperating revenue. 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 revenue category in the statement of revenue, expenses, and changes in net assets.

Assets Limited as to Use - Assets limited as to use are restricted net assets, patients' safekeeping deposits, restricted deferred contributions, and restricted cash. Such restrictions have been externally imposed by contributors or by collateral agreements. 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, 2011 and 2010, assets limited as to use consisted of restricted cash of $1,870,627 and $2,071,018, 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.

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.

Note 2 – Summary of Significant Accounting Policies (Continued)

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

Net Patient Service Revenue - Net patient service revenue is 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, 2011 and 2010 was approximately $4,800,000 and $3,400,000, 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 revenue is 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 years 2011 and 2010 financial statements.

The estimated third-party payor settlements are based on estimates because complete information is not currently available to determine the final settlement amounts for certain cost report years. Management has used its best effort, judgment, and certain methodologies to estimate the anticipated final outcome.

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

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

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

Note 2 – Summary of Significant Accounting Policies (Continued)

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

All Medicare-certified hospitals and skilled nursing facilities are required to file annual Medicare cost reports. HHSC facilities required to file Medicare cost reports have been audited by the Medicare fiscal intermediary through fiscal year 2007.

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

- *Critical Access 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 may be reviewed by contractors for validity, accuracy, and proper documentation. 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 revenue and capital appropriations are included in capital grants and contributions after the nonoperating revenue (expenses) subtotal in the statement of revenue, 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 is allocated an amount for interest paid by the State of general obligation bonds whose proceeds were used for hospital construction. A corresponding contribution from the State is also allocated to HHSC. The bonds are obligations for 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, 2011 and 2010, interest expense totaled approximately $5,400,000 and $4,900,000, 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, 2011 and 2010 was as follows:

	Percentage	
	2011	2010
Medicare	27	21
Medicaid	21	25
HSMA	9	9
Other third-party payors	27	29
Patient and other	16	16
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, 2011 and 2010, 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 2012. Accordingly, the advance is classified as a noncurrent liability at June 30, 2011 and 2010. The amount due to the State of $44,122,507 at June 30, 2011 and 2010 includes the $14,000,000 previously described, plus $20,122,507 of cash advances to the Department of Health - Division of Community Hospitals, which was assumed by HHSC at the date of its formation, and $10 million in advances from the State, of which $2.5 million is due in 2012. The $10 million advance is due over four years beginning in fiscal 2012.

At June 30, 2011 and 2010, approximately $57,500,000 and $42,400,000 was due from the State for allotments made to HHSC before June 30, 2011 and 2010, respectively.

Note 4 - Capital Assets

Transactions in the capital asset accounts for the year ended June 30, 2011 were as follows:

	Beginning of Year	Additions	Retirements	Transfers and Adjustments	End of Year
Assets not subject to depreciation:					
Land and land improvements	$ 6,483,834	$ -	$ -	$ -	$ 6,483,834
Construction in progress	31,223,642	22,874,321	-	(32,612,016)	21,485,947
Assets subject to depreciation:					
Buildings and improvements	353,427,467	1,677,736	(15,081)	21,816,745	376,906,867
Equipment	148,669,328	5,522,288	(4,687,565)	10,795,271	160,299,322
Total	539,804,271	30,074,345	(4,702,646)	-	565,175,970
Less accumulated depreciation:					
Buildings and improvements	(142,805,679)	(11,563,950)	165,649	-	(154,203,980)
Equipment	(111,413,260)	(12,527,922)	4,072,282	-	(119,868,900)
Total	(254,218,939)	(24,091,872)	4,237,931	-	(274,072,880)
Capital assets - Net	$ 285,585,332	$ 5,982,473	$ (464,715)	$ -	$ 291,103,090

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

	Beginning of Year	Additions	Retirements	Transfers and Adjustments	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

The State Department of Accounting and General Services and others transferred capital assets, including construction in progress, aggregating approximately $13,120,000 and $16,611,000 to HHSC as a contribution of capital, for June 30, 2011 and 2010, respectively.

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, 2011 were as follows:

	Beginning of Year	Additions	Reductions	End of Year	Current Portion	Noncurrent Portion
Accrued vacation	$ 38,070,811	$ 20,069,504	$ (16,012,140)	$ 42,128,175	$ 15,603,762	$ 26,524,413

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	$ 15,810,025	$ (15,079,198)	$ 38,070,811	$ 15,893,840	$ 22,176,971

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, 2011, 2010, and 2009 was approximately $33.8 million, $33.6 million, and $33.8 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)

Postemployment 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 actual cash contributions for postretirement benefits approximated $16.3 million, $16.3 million, and $21.0 million for the years ended June 30, 2011, 2010, and 2009, respectively.

	2011	2010
Beginning of year	$ 105,204,848	$ 65,782,538
Required contributions	54,089,618	55,725,464
Actual contributions	(16,269,727)	(16,303,154)
End of year	$ 143,024,739	$ 105,204,848

Sick Leave - Accumulated sick leave as of June 30, 2011 and 2010 was approximately $67,724,000 and $63,333,000, 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, 2011 was as follows:

	2010	Current Year Additions	Current Year Reductions	2011	Amounts Due Within One Year
Long-term debt	$ 40,209,179	$ 100,000	$ (4,539,875)	$ 35,769,304	$ 9,246,099
Capital lease obligations	$ 34,321,371	$ 507,718	$ (9,584,639)	$ 25,244,450	$ 7,811,490

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	$ 922,292	$ (1,194,603)	$ 40,209,179	$ 13,830,397
Capital lease obligations	$ 38,341,983	$ 5,928,056	$ (9,948,668)	$ 34,321,371	$ 9,450,164

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, 2011 and 2010, the balance payable was $15,591,132 and $15,948,775, 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. On May 20, 2010, MMMC signed a revised agreement on the $11 million taxable revolving line of credit, removing financial covenants and restructuring repayment. 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 $6,500,000 to $8,000,000. In January 2012, the Bank of Montreal agreed to extend the maturity date to April 2012. At June 30, 2011 and 2010, the balance payable was $8,000,000 and $11,000,000, respectively.

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.

Note 7 - Long-term Liabilities (Continued)

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 (HMC). At June 30, 2011 and 2010, the balance payable was $9,300,073 and $9,513,320, respectively.

Yukio Okutsu Veterans' Home - In May 2008, the Yukio Okutsu Veterans' Home entered into a line of credit for $1.8 million, which calls for monthly interest-only payments at an interest rate of 5 percent. In November 2011, the Yukio Okutsu Veterans' Home signed an extension, which extended the balloon principal payment due date from December 2011 to December 2012. In addition, the line of credit limit was reduced to $1,500,000. At June 30, 2011 and 2010, the balance payable was $1,262,151 and $1,576,148, respectively.

KVMH's 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, 2011 and 2010, the balance payable was $919,881 and $1,030,885, 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, 2011 and 2010, the balance payable was $291,354 and $494,349, respectively.

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 $110,000, through May 2013. This note is collateralized by certain equipment. At June 30, 2011 and 2010, the balance payable was $230,286 and $359,045, respectively.

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, 2011 and 2010, the balance payable was $74,327 and $227,610, respectively.

Note 7 - Long-term Liabilities (Continued)

Kahuku Medical Center - During 2011, Kahuku Medical Center entered into an unsecured loan with a local bank in the amount of $100,000 at an annual interest rate of 7.75 percent. The loan is due on demand, or if no demand, then on or before 30 days from the original loan date. At June 30, 2011, the balance of the loan was $100,000.

The capital lease obligations are summarized as follows:

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, 2011 and 2010, capitalized interest was not material. Capital lease obligations recorded on Corporate's accounting records at June 30, 2011 and 2010 were $23,143,417 and $31,495,130, 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, 2011 and 2010, the balance payable on these leases was $852,226 and $1,140,034, respectively.

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, 2011 and 2010, the balance payable was $245,484 and $404,439, respectively.

Kahuku Medical Center - During fiscal year 2010, Kahuku Medical Center entered into various capital lease obligations. The leases require monthly payments and are collateralized by the equipment. At June 30, 2011 and 2010, the balance payable was $114,799 and $221,713, respectively.

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, 2011 and 2010, the balance payable on the leases was $888,524 and $1,119,102, respectively.

The following is a schedule by years of principal and interest as of June 30, 2011:

Years Ending June 30	Long-term Debt		Capital Lease Obligation	
	Principal	Interest	Principal	Interest
2012	$ 9,246,099	$ 1,786,337	$ 7,811,490	$ 1,307,286
2013	2,366,962	1,483,776	5,596,873	897,491
2014	1,068,184	1,412,444	4,199,985	598,528
2015	1,136,913	1,343,715	2,193,020	382,672
2016	1,210,161	1,270,467	1,130,217	295,341
2017-2021	6,428,536	5,211,589	2,719,092	759,408
2022-2026	8,360,840	3,069,879	1,426,973	257,269
2027-2031	5,027,344	839,884	166,800	3,232
2032-2036	924,265	36,770	-	-
Total payments	$ 35,769,304	$ 16,454,861	$ 25,244,450	$ 4,501,227

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 $15,209,000 and $15,732,000 for unpaid claims as of June 30, 2011 and 2010, respectively.

Note 8 - Commitments and Contingencies (Continued)

	2011	2010
Estimated liability - Beginning of year	$ 15,732,000	$ 16,145,000
Estimated claims incurred - Including changes in estimates	2,787,200	2,504,000
Claim payments	(3,310,200)	(2,917,000)
Estimated liability - End of year	$ 15,209,000	$ 15,732,000

Operating Leases - HMC, MMMC, and Kahuku entered into various operating leases and related sublease agreements. Future minimum lease payments and sublease receipts at June 30, 2011 are as follows:

Years Ending June 30	Lease Payments	Sublease Receipts
2012	$ 1,475,296	$ 126,266
2013	1,495,948	-
2014	1,517,224	-
2015	786,880	-
2016	786,880	-
2017-2021	826,880	-
Thereafter	260,000	-
Total	$ 7,149,108	$ 126,266

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 revenue 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 years ended June 30, 2011 and 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 May 2012. As a result, $4 million of the proceeds was deferred and is being amortized on a straight-line basis through May 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, 2011

	Appropriation Symbol	
Cash and cash equivalents - State of Hawaii		
Special funds		
	S-98-396-H	$ 280,438
	S-93-359-H	2,818
	S-96-359-H	2,007
	S-97-359-H	3,556
	S-11-359-H	1,109,581
	S-11-373-H	479,063
	S-11-355-H	4,771,672
	S-11-371-H	636,972
	S-11-358-H	98,404
	S-11-365-H	578,782
	S-11-312-H	753,330
	S-11-354-H	1,561,494
	S-11-353-H	187,745
	S-11-350-H	3,232,164
	S-11-351-H	308,072
	S-11-352-H	195,300
Trust funds	T-04-921-H	6,679
Total per State		14,208,077
Reconciling items		(19,035)
Total per HHSC		**$ 14,189,042**
Assets limited as to use - Patient trust funds		
	T-04-923-H	$ 4,242
	T-04-919-H	1,044
	T-04-911-H	22,912
	T-11-909-H	7,495
	T-11-925-H	110,374
	T-10-915-H	12,763
Total per State		158,830
Reconciling items:		
Patient's safekeeping deposits held by financial institutions		113,508
Restricted assets held by financial institutions		1,598,289
Total per HHSC		**$ 1,870,627**

Hawaii Health Systems Corporation

Balance Sheet of Facilities
June 30, 2011

	Facilities																					
	Hilo Medical Center	Hale Ho'ola Hamakua	Ka'u Hospital	Yukio Okutsu Veterans Care Home - Hilo	Kona Community Hospital	Kohala Hospital	Maui Memorial Medical Center	Kula Hospital	Lanai Community Hospital	Leahi Hospital	Maluhia	Kahuku	Kauai Veterans Memorial Hospital	Samuel Mahelona Memorial Hospital	Total Facilities	Corporate	Reclassifications and Eliminations	HHSC Combined	Hawaii Health Systems Foundation	Alii Community Care - Maui	Alii Community Care - Kona	Reclassifications and Eliminations	HHSC Consolidated
Assets																							
Current Assets																							
Cash and cash equivalents - State of Hawaii	$ 3,232,164	$ 309,345	$ 190,052	$ -	$ 1,561,494	$ 187,745	$ 4,771,672	$ 636,972	$ 98,404	$ 753,330	$ 578,782	$ -	$ 1,109,581	$ 479,063	$ 13,908,604	$ 280,438	$ -	$ 14,189,042	$ -	$ -	$ -	$ -	$ 14,189,042
Cash and cash equivalents	12,733,881	11,349	26,647	700	1,145,242	1,013,083	14,231,632	2,997,702	41,922	1,238,382	2,567,287	188,612	2,649,194	69,399	38,915,032	9,525,160	-	48,440,192	36,905	158,581	201,518	-	48,837,196
Patient accounts receivable - Less allowances for doubtful accounts	21,023,178	2,965,363	596,107	1,701,568	7,909,752	418,215	21,253,327	3,408,790	405,506	1,856,478	1,903,622	1,360,483	3,351,870	2,245,234	70,399,493	-	-	70,399,493	-	10,466	483,971	-	70,893,930
Supplies and other current assets	3,321,153	151,104	42,978	5,540	2,109,594	52,983	8,307,741	254,967	94,863	655,035	1,528,048	115,340	776,673	137,993	17,554,012	176,874	-	17,730,886	-	37,059	80,286	-	17,848,231
Due from the State of Hawaii	3,382,000	489,000	5,061,000	-	2,781,000	437,000	33,896,000	3,102,000	1,669,000	403,000	3,162,000	-	1,062,000	1,979,000	57,423,000	119,000	-	57,542,000	-	-	-	-	57,542,000
Estimated third-party payor settlements	1,163,203	66,624	204,378	-	1,480,162	104,197	1,568,502	242,375	98,251	508,150	325,925	751,982	584,955	156,773	7,255,477	-	-	7,255,477	-	-	-	-	7,255,477
Total current assets	44,855,579	3,992,785	6,121,162	1,707,808	16,987,244	2,213,223	84,028,874	10,642,806	2,407,946	5,414,375	10,065,664	2,416,417	9,534,273	5,067,462	205,455,618	10,101,472	-	215,557,090	36,905	206,106	765,775	-	216,565,876
Due from Affiliates - Net	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	321,254,259	(308,392,543)	12,861,716	-	-	-	(12,861,716)	-
Capital Assets - Net	51,606,510	20,270,159	3,149,954	26,401,196	20,367,758	1,549,195	112,331,647	6,448,719	880,619	4,978,950	5,322,570	3,550,192	13,537,830	5,366,329	275,761,628	1,764,615	-	277,526,243	-	13,200,099	376,748	-	291,103,090
Assets Limited as to Use	38,452	48,749	4,579	-	415,012	-	111,998	113,027	51,436	128,877	81,381	240	346,609	30,267	1,370,627	500,000	-	1,870,627	-	-	-	-	1,870,627
Other Assets	393,769	-	-	1,667	356,030	-	1,856,895	-	-	-	-	-	85,050	-	2,693,411	-	-	2,693,411	-	-	15,263	-	2,708,674
Total assets	**$ 96,894,310**	**$ 24,311,693**	**$ 9,275,695**	**$ 28,110,671**	**$ 38,126,044**	**$ 3,762,418**	**$ 198,329,414**	**$ 17,204,552**	**$ 3,340,001**	**$ 10,522,202**	**$ 15,469,615**	**$ 5,966,849**	**$ 23,503,762**	**$ 10,464,058**	**$ 485,281,284**	**$ 333,620,346**	**$ (308,392,543)**	**$ 510,509,087**	**$ 36,905**	**$ 13,406,205**	**$ 1,157,786**	**$ (12,861,716)**	**$ 512,248,267**
Liabilities and Net Assets (Deficit)																							
Current Liabilities																							
Current portion of long-term debt	$ 226,175	$ -	$ -	$ -	$ -	$ -	$ 8,000,000	$ -	$ -	$ -	$ -	$ 100,000	$ 120,820	$ -	$ 8,446,995	$ 216,158	$ -	$ 8,663,153	$ -	$ 379,324	$ 203,622	$ -	$ 9,246,099
Current portion of capital lease obligations	180,210	-	-	-	-	-	285,860	-	-	-	-	30,644	251,248	-	747,962	7,063,528	-	7,811,490	-	-	-	-	7,811,490
Accounts payable and accrued expenses	20,161,720	892,413	731,222	801,484	10,171,597	541,730	22,160,105	1,820,133	395,646	1,611,631	1,177,179	1,308,481	3,892,045	1,084,462	66,749,848	4,853,634	-	71,603,482	-	98,671	369,096	-	72,071,249
Current portion of accrued workers' compensation liability	648,000	93,000	-	-	564,000	127,000	787,000	153,000	1,000	438,000	138,000	-	131,000	231,000	3,311,000	-	-	3,311,000	-	-	-	-	3,311,000
Current portion of accrued vacation	3,558,405	262,385	210,970	29,000	2,109,354	186,659	4,632,486	843,022	97,594	915,000	672,000	197,311	1,093,445	522,471	15,330,102	273,660	-	15,603,762	-	-	-	-	15,603,762
Current portion of due to State of Hawaii	-	-	-	-	-	-	2,500,000	-	-	-	-	-	-	-	2,500,000	-	-	2,500,000	-	-	-	-	2,500,000
Other current liabilities	555,162	17,288	(9,687)	4,424	157,528	16,984	575,086	700	-	-	-	-	243,840	50,000	1,611,325	-	-	1,611,325	-	431,862	1,206	-	2,044,393
Total current liabilities	25,329,672	1,265,086	932,505	834,908	13,002,479	872,373	38,940,537	2,816,855	494,240	2,964,631	1,987,179	1,636,436	5,732,398	1,887,933	98,697,232	12,406,980	-	111,104,212	-	909,857	573,924	-	112,587,993
Long-term Debt - Less current portion	9,073,898	-	-	1,262,151	-	-	-	-	-	-	-	-	799,061	-	11,135,110	75,196	-	11,210,306	-	15,211,808	101,091	-	26,523,205
Capital Lease Obligations - Less current portion	65,274	-	-	-	-	-	566,366	-	-	-	-	84,155	637,276	-	1,353,071	16,079,889	-	17,432,960	-	-	-	-	17,432,960
Other Liabilities																							
Accrued vacation - Less current portion	5,657,627	519,505	201,080	-	2,122,846	322,941	7,728,142	1,419,091	164,284	2,063,040	1,581,330	-	2,664,099	1,272,960	25,716,945	765,666	-	26,482,611	-	-	41,802	-	26,524,413
Accrued workers' compensation - Less current portion	2,688,000	214,000	151,000	-	1,151,000	126,000	3,891,000	1,076,000	82,000	462,000	431,000	-	961,000	465,000	11,698,000	200,000	-	11,898,000	-	-	-	-	11,898,000
Other postemployment benefit liability	33,852,569	3,055,186	1,871,776	-	15,411,875	1,684,581	47,395,651	6,661,757	939,002	7,396,201	5,885,240	-	11,837,655	4,456,510	140,448,003	2,576,736	-	143,024,739	-	-	-	-	143,024,739
Due to affiliates - Net	79,657,067	739,761	9,955,296	512,248	44,697,090	7,936,304	6,997,685	21,610,331	14,114,250	17,677,696	28,291,442	1,398,786	57,311,869	17,492,718	308,392,543	-	(308,392,543)	-	-	12,891,626	(29,910)	(12,861,716)	-
Due to the State of Hawaii	-	506,153	-	-	7,605,205	528,149	7,500,000	1,114,264	-	6,416,791	491,450	-	1,043,345	2,417,150	27,622,507	14,000,000	-	41,622,507	-	-	-	-	41,622,507
Patients' safekeeping deposits	38,452	48,749	4,579	-	-	-	-	113,027	51,436	121,254	56,846	240	4,242	29,223	468,048	-	-	468,048	-	-	-	-	468,048
Other liabilities	423,167	-	14,461	2,278,254	144,693	-	204,623	12,065	-	-	-	-	20,229	5,613	3,103,105	-	-	3,103,105	-	-	-	-	3,103,105
Total liabilities	156,785,726	6,348,440	13,130,697	4,887,561	84,135,188	11,470,348	113,224,004	34,823,390	15,845,212	37,101,613	38,724,487	3,119,617	81,011,174	28,027,107	628,634,564	46,104,467	(308,392,543)	366,346,488	-	29,013,291	686,907	(12,861,716)	383,184,970
Net Assets (Deficit)																							
Invested in capital assets - Net of related debt	42,060,953	20,270,159	3,149,954	25,139,045	20,367,758	1,549,195	111,479,421	6,448,719	880,619	4,978,950	5,322,570	3,435,393	11,729,425	5,366,329	262,178,490	(21,670,156)	-	240,508,334	-	(2,391,033)	72,035	-	238,189,336
Restricted for capital purchases	-	-	-	-	415,012	-	111,998	-	-	7,623	24,535	-	342,367	1,044	902,579	-	-	902,579	-	-	-	-	902,579
Unrestricted	(101,952,369)	(2,306,906)	(7,004,956)	(1,915,935)	(66,791,914)	(9,257,125)	(26,486,009)	(24,067,557)	(13,385,830)	(31,565,984)	(28,601,977)	(588,161)	(69,579,204)	(22,930,422)	(406,434,349)	309,186,035	-	(97,248,314)	36,905	(13,216,053)	398,844	-	(110,028,618)
Total net assets (deficit)	(59,891,416)	17,963,253	(3,855,002)	23,223,110	(46,009,144)	(7,707,930)	85,105,410	(17,618,838)	(12,505,211)	(26,579,411)	(23,254,872)	2,847,232	(57,507,412)	(17,563,049)	(143,353,280)	287,515,879	-	144,162,599	36,905	(15,607,086)	470,879	-	129,063,297
Total liabilities and net assets (deficit)	**$ 96,894,310**	**$ 24,311,693**	**$ 9,275,695**	**$ 28,110,671**	**$ 38,126,044**	**$ 3,762,418**	**$ 198,329,414**	**$ 17,204,552**	**$ 3,340,001**	**$ 10,522,202**	**$ 15,469,615**	**$ 5,966,849**	**$ 23,503,762**	**$ 10,464,058**	**$ 485,281,284**	**$ 333,620,346**	**$ (308,392,543)**	**$ 510,509,087**	**$ 36,905**	**$ 13,406,205**	**$ 1,157,786**	**$ (12,861,716)**	**$ 512,248,267**

Hawaii Health Systems Corporation

Supplemental Statement of Revenue, Expenses, and Changes in Net Asset (Deficit) of Facilities
Year Ended June 30, 2011

	Facilities																					
	Hilo Medical Center	Hale Ho'ola Hamakua	Ka'u Hospital	Yukio Okutsu Veterans Care Home - Hilo	Kona Community Hospital	Kohala Hospital	Maui Memorial Medical Center	Kula Hospital	Lanai Community Hospital	Leahi Hospital	Maluhia	Kahuku	Kauai Veterans Memorial Hospital	Samuel Mahelona Memorial Hospital	Total Facilities	Corporate	Reclassifications and Eliminations	HHSC Combined	Hawaii Health Systems Foundation	Alii Community Care - Maui	Alii Community Care - Kona	Reclassifications and Eliminations	HHSC Consolidated
Operating Revenue																							
Net patient service revenue (net of provision for doubtful accounts)	$ 116,923,245	$ 10,074,834	$ 4,760,434	$ 12,389,526	$ 54,995,149	$ 5,141,762	$ 172,622,616	$ 16,518,251	$ 2,692,140	$ 15,166,626	$ 14,405,262	$ 6,750,329	$ 29,650,149	$ 14,734,672	$ 476,824,995	$ -	$ -	$ 476,824,995	$ -	$ -	$ 2,552,024	$ -	$ 479,377,019
Other revenue	1,430,917	20,179	21,670	-	422,111	12,440	1,471,866	76,779	7,286	283,786	54,744	505,523	292,388	39,426	4,639,115	-	(172,024)	4,467,091	-	3,817,676	720,534	-	9,005,301
Total operating revenues	118,354,162	10,095,013	4,782,104	12,389,526	55,417,260	5,154,202	174,094,482	16,595,030	2,699,426	15,450,412	14,460,006	7,255,852	29,942,537	14,774,098	481,464,110	-	(172,024)	481,292,086	-	3,817,676	3,272,558	-	488,382,320
Operating Expenses																							
Salaries and benefits	83,918,949	8,161,283	4,561,071	5,548,120	41,769,831	4,624,095	121,234,182	16,691,169	2,639,989	18,391,236	15,663,398	5,324,019	26,702,407	13,386,067	368,615,816	6,400,577	-	375,016,393	-	-	2,745,987	-	377,762,380
Purchased services	18,179,404	1,114,026	1,016,834	232,511	5,667,567	950,134	18,173,387	1,080,685	1,026,098	543,583	576,197	549,441	3,980,395	1,108,155	54,198,417	134,742	(172,024)	54,161,135	-	7,784	485,060	-	54,653,979
Medical supplies and drugs	15,066,050	449,244	106,159	550,377	7,919,366	110,134	35,151,751	561,134	355,075	469,992	296,418	599,310	2,121,909	293,019	64,049,938	-	-	64,049,938	-	-	152,899	-	64,202,837
Depreciation and amortization	4,618,934	799,995	223,740	1,030,061	2,752,377	330,064	8,204,045	436,335	79,925	772,098	457,352	479,228	1,386,554	432,929	22,003,637	1,128,012	-	23,131,649	-	857,275	129,581	-	24,118,505
Utilities	2,510,236	583,551	160,371	942,734	1,486,368	169,176	4,071,737	322,532	120,183	1,010,823	619,682	342,006	1,061,541	537,240	13,938,180	148,228	-	14,086,408	-	360,477	67,247	-	14,514,132
Repairs and maintenance	3,441,477	353,638	63,785	87,845	1,722,363	195,109	2,835,909	144,734	41,529	185,111	293,265	249,771	906,755	174,463	10,695,754	91,802	-	10,787,556	-	44,711	26,711	-	10,858,978
Other supplies	4,320,452	406,903	171,547	534,404	1,192,756	201,418	5,390,543	994,871	129,915	883,785	729,893	203,993	962,575	633,166	16,756,221	105,220	-	16,861,441	-	317,007	19,880	-	17,198,328
Professional fees	4,468,642	22,339	87,136	(10,452)	629,614	117,725	4,448,785	89,493	(16,666)	51,356	122,633	976,932	554,712	322,864	11,865,113	427,552	-	12,292,665	-	2,110,100	-	-	14,402,765
Insurance	1,412,241	75,023	111,766	1,168,512	637,147	49,892	1,017,986	145,046	18,135	288,786	136,779	223,782	545,216	168,860	5,999,171	3,292	-	6,002,463	-	82,559	231,639	-	6,316,661
Rent and lease	2,013,663	18,616	29,023	40,745	615,871	41,190	3,151,295	51,783	12,854	29,615	1,219	195,767	739,532	58,181	6,999,354	49,766	-	7,049,120	-	248,680	190,907	-	7,488,707
Other	1,582,859	122,956	70,476	2,588,066	850,660	85,361	1,623,927	63,864	66,142	114,488	44,784	123,407	671,967	117,104	8,126,061	268,787	-	8,394,848	235	102,094	177,213	-	8,674,390
Total operating expenses	141,532,907	12,107,574	6,601,908	12,712,923	65,243,920	6,874,298	205,303,547	20,581,646	4,473,179	22,740,873	18,941,620	9,267,656	39,633,563	17,232,048	583,247,662	8,757,978	(172,024)	591,833,616	235	4,130,687	4,227,124	-	600,191,662
Operating Loss	(23,178,745)	(2,012,561)	(1,819,804)	(323,397)	(9,826,660)	(1,720,096)	(31,209,065)	(3,986,616)	(1,773,753)	(7,290,461)	(4,481,614)	(2,011,804)	(9,691,026)	(2,457,950)	(101,783,552)	(8,757,978)	-	(110,541,530)	(235)	(313,011)	(954,566)	-	(111,809,342)
Nonoperating Revenue (Expenses)																							
General appropriations from the State of Hawaii	17,797,088	1,521,920	1,370,440	-	11,788,752	730,052	27,981,668	2,210,240	855,768	4,810,196	3,106,876	1,470,000	6,551,100	1,773,100	81,967,200	-	-	81,967,200	-	-	-	-	81,967,200
Loss on disposal of capital assets	(422,675)	-	-	-	-	-	(34,365)	-	-	(4,659)	(3,016)	-	-	-	(464,715)	-	-	(464,715)	-	-	-	-	(464,715)
Restricted contributions	949,303	-	111,971	-	17,501	-	587,941	-	-	-	-	-	-	-	1,666,716	-	-	1,666,716	-	-	-	-	1,666,716
Interest expense	(597,628)	(5,620)	(28)	(67,031)	(118,712)	(43)	(407,406)	(394)	-	(55)	(182)	(54,154)	(178,494)	-	(1,429,747)	(1,750,953)	-	(3,180,700)	-	(931,409)	(52,663)	-	(4,164,772)
Interest and dividend income	189,829	-	3,118	-	40,243	-	28,825	13,653	96	30,487	34,925	-	36,619	49,898	427,693	16,473	-	444,166	-	5,541	-	-	449,707
Corporate allocation expense	(2,289,546)	(179,049)	(103,198)	-	(1,055,033)	(103,947)	(3,300,943)	(334,339)	(74,786)	(365,255)	(304,823)	-	(616,567)	(279,940)	(9,007,426)	9,007,426	-	-	-	-	-	-	-
Other nonoperating revenue (expenses) - Net	852,123	267,150	1,531	(98,439)	(399,068)	61,923	321,305	150,219	13,198	22,001	1,535	170,921	317,744	280,710	1,962,853	(356,380)	-	1,606,473	-	-	2,798,705	(1,470,795)	2,934,383
Total nonoperating revenue (expenses)	16,478,494	1,604,401	1,383,834	(165,470)	10,273,683	687,985	25,177,025	2,039,379	794,276	4,492,715	2,835,315	1,586,767	6,110,402	1,823,768	75,122,574	6,916,566	-	82,039,140	-	(925,868)	2,746,042	(1,470,795)	82,388,519
Excess of Revenue (Under) Over Expenses Before Capital Contributions	(6,700,251)	(408,160)	(435,970)	(488,867)	447,023	(1,032,111)	(6,032,040)	(1,947,237)	(979,477)	(2,797,746)	(1,646,299)	(425,037)	(3,580,624)	(634,182)	(26,660,978)	(1,841,412)	-	(28,502,390)	(235)	(1,238,879)	1,791,476	(1,470,795)	(29,420,823)
Capital Contributions	(218,103)	652,081	320,277	-	1,134,174	(35,120)	22,154,529	1,864,884	(47,854)	(623,010)	2,025,147	-	780,744	1,620,903	29,628,652	-	-	29,628,652	-	-	-	-	29,628,652
(Decrease) Increase in Net Assets	**$ (6,918,354)**	**$ 243,921**	**$ (115,693)**	**$ (488,867)**	**$ 1,581,197**	**$ (1,067,231)**	**$ 16,122,489**	**$ (82,353)**	**$ (1,027,331)**	**$ (3,420,756)**	**$ 378,848**	**$ (425,037)**	**$ (2,799,880)**	**$ 986,721**	**$ 2,967,674**	**$ (1,841,412)**	**$ -**	**$ 1,126,262**	**$ (235)**	**$ (1,238,879)**	**$ 1,791,476**	**$ (1,470,795)**	**$ 207,829**

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*

plante moran

Plante & Moran, PLLC
Suite 400
634 Front Avenue N.W.
Grand Rapids, MI 49504
Tel: 616.774.8221
Fax: 616.774.0702
plantemoran.com

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*

Independent Auditor's Report

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 years ended June 30, 2011 and 2010 and have issued our report thereon dated February 1, 2012. We conducted our audits in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

Internal Control Over Financial Reporting

In planning and performing our audits, 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, 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 2011-01 through 2011-04 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 2011-05 through 2011-12 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

February 1, 2012

Finding - 2011-01

Organization - Kauai Region

Finding Type - Material weakness

Criteria - The status of construction in progress should be reviewed on a regular basis to ensure projects are capitalized and depreciation begins timely.

Condition - Invoices related to construction projects received in June were not capitalized appropriately. In addition, projects of approximately $1,400,000 were transferred to capital assets from construction in progress during the audit.

Context - Lack of review of construction invoices subsequent to year end and untimely approval of projects for capitalization

Cause - Management was tracking the projects, but did not put them into service timely.

Effect - Interim financial statements did not properly reflect depreciable assets throughout the year.

Recommendation - On a regular basis, construction in progress accounts should be reviewed on a project basis. Management should communicate with the appropriate personnel to determine when projects have been completed and should be transferred to in-service.

Finding - 2011-02

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

Finding Type - Material weakness

Criteria - Reconciliation of the accounts receivable subsidiary ledgers to the general ledger is essential to ensure amounts presented in the financial statements are accurate. Review of the reconciliations and detailed subsidiary ledgers is essential to ensure that amounts recorded in the financial statements are accurate and properly valued. In addition, payments received for patient receivable balances, which cannot be applied immediately to a patient account, should be posted to an accounts receivable general ledger account (generally a suspense account).

Condition - Accounts receivable reconciliations are not prepared or formally reviewed in all circumstances. The result of the lack of controls resulted in an overstatement of $1,285,949 in the accounts receivable as compared to the detailed subsidiary ledger. Additionally, certain payments for patient receivables that could not be applied to patient accounts were inappropriately posted to a third-party payor settlement account instead of an accounts receivable account. This led to an overstatement of estimated third-party payor settlement liabilities and accounts receivable of $1,053,649.

Context - Accounts receivable reconciliations are not being completed or reviewed. In addition, journal entries posted to estimated third-party payor settlement accounts are not being reviewed for appropriateness.

Cause - Procedures are not in place to complete and review accounts receivable reconciliations or to review journal entries posted to estimated third-party payor settlement accounts.

Effect - Accounts receivable was overstated by $2,339,598, net patient service revenue was overstated by $1,285,949, and estimated third-party payor settlement liabilities were overstated by $1,053,649.

Recommendation - We recommend management implement a formal reconciliation process related to accounts receivable. The region should reconcile detailed aging schedules to the general ledger on a monthly basis. All variances should be researched and resolved. Someone separate from the preparation process should review the reconciliation and accounts receivable subsidiary ledgers to determine if amounts are properly valued. Additionally, all journal entries made during the year to estimated third-party payor settlement accounts should be analyzed to ensure they are appropriate.

Finding - 2011-03

Organization - East Hawaii Region (Hilo Medical Center)

Finding Type - Material weakness

Criteria - Unbilled accounts receivable should be reviewed periodically to ensure accounts are being billed timely as well as to evaluate if adequate allowances are in place on those accounts.

Condition - Detailed unbilled accounts receivable reports were available, but were not analyzed in detail to determine if accounts were adjusted to net realizable value.

Context - Lack of detail review of the net realizable value of unbilled accounts receivable

Cause - Procedures are not in place to review and evaluate unbilled accounts receivable to net realizable value.

Effect - Interim financial statements were overstated by approximately $2,000,000 within patient accounts receivable and net patient service revenue.

Recommendation - We recommend management review the detailed unbilled accounts receivable reports on a periodic basis and determine the net realizable value of these accounts. Recorded allowances should be adjusted to reflect the determinations made during the review process.

Finding - 2011-04

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 - Depreciation expense recorded in fiscal year 2011 was identical to depreciation expense recorded in fiscal year 2010.

Context - Property and equipment amounts recorded in the general ledger did not have adequate supporting documentation. Depreciation expense had been recorded based on what had been recorded in fiscal year 2010, instead of calculating current year depreciation based on cost and estimated useful lives.

Cause - Depreciation expense of approximately $104,000 needed to be recorded in fiscal year 2011.

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 - 2011-05

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

Finding Type - Significant deficiency

Criteria - Debt balances should reflect outstanding obligations of the organization.

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

Context - We identified an outstanding obligation at June 30, 2011 of Alii that had been written off in the general ledger.

Cause - The loan was being paid down by a related party in 2011. It is expected this will continue in 2012 when the loan should be fully repaid. The loan obligation was not shifted to the related party; therefore, the obligation remains with Alii at June 30, 2011.

Effect - Interim financial statements were misstated by $74,327 within short-term debt and nonoperating revenue. An adjusting journal entry was posted to correct this misstatement.

Recommendation - We recommend management and the board review general ledger accounts related to debt to ensure outstanding obligations are properly reflected in the general ledger.

Finding - 2011-06

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

Finding Type - Significant deficiency

Criteria - The controls in place, including the client's IT controls and other controls, are not sufficient to reliably prevent or detect inappropriate access and ability to change the accounting data (e.g., database information) and transaction information.

Condition - It was noticed during the audit that a password is not required for access to the accounting system (Quickbooks).

Context - All users to the accounting system should be required to enter a password to enter the system.

Cause - Not requiring users of the accounting system to enter a password before gaining access to the system

Effect - Unauthorized access could be gained into the accounting system and unsupported entries could be made.

Recommendation - We recommend that access to Quickbooks be limited by a password. In addition, a process for restricting access to terminated employees should be implemented.

Finding - 2011-07

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

Finding Type - Significant deficiency

Criteria - General journal entries are not required to be reviewed before being posted.

Condition - It was noticed during year-end audit procedures that any individual who has access to the accounting system (Quickbooks) can post an entry into the system.

Context - Errors could be made when entries are made and their effect could go unnoticed/uncorrected.

Cause - A restriction on the posting of journal entries is not in place. The accounting system should be modified so that an individual who creates a journal entry cannot post the entry to the system. Alternatively, a formal policy should be adopted and followed whereby all manual entries are signed off on as being reviewed before being posted.

Effect - Unsupported or incorrect journal entries could be made to the system.

Recommendation - We recommend a policy be put in place whereby all manual journal entries that are posted to the system be approved by the individual not posting the entry. Alternatively, the accounting system should be modified to not allow the creator of an entry to post that entry.

Finding - 2011-08

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 - Review of bank reconciliations by someone independent of the bank reconciliation preparation process could not be verified during the audit. Additionally, those preparing bank reconciliations also have the ability to initiate wire transfers and post journal entries to the general ledger.

Context - Review of bank reconciliations for various cash accounts by someone independent of the process could not be verified.

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

Effect - Lack of internal controls surrounding the bank reconciliation process.

Recommendation - We recommend management review the policies and procedures in place regarding the cash cycle. We recommend management require the preparer and reviewer of bank reconciliations to formally sign and date the reconciliation, which will help to ensure proper controls are in place around the cash cycle. Additionally, we recommend the preparer of bank reconciliations not have access to posting journal entries or initiating wire transfers.

Finding - 2011-09

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

Finding Type - Significant deficiency

Criteria - Formal review of the accounts payable and construction in progress reconciliations are essential to ensure activity is properly recorded. Additionally, employees determining what payables should be recorded as of June 30, 2011 should have the proper training to ensure amounts are recorded properly.

Condition - Accounts payable and construction in progress reconciliations are not formally reviewed by someone independent of the reconciliation preparation process. Also, invoices were improperly excluded from accounts payable at year end. The apparent primary cause is employees responsible for approving the invoices were not forwarding them to the finance department to be accrued prior to the year-end close.

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

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

Effect - Accounts payable accounts were understated by $847,268, capital asset accounts were understated by $261,678, and operating expenses were understated by $585,590 at year end.

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

Finding - 2011-10

Organization - Kauai Region

Finding Type - Significant deficiency

Criteria - Accounts receivable and revenue should be reviewed for proper cutoff at year end.

Condition - Accounts receivable and revenue were not properly stated at June 30, 2011.

Context - Lack of proper review of 2011 revenue posted subsequent to June 30, 2011

Cause - Management was tracking the amounts billed subsequent to year end, but included several rebilled accounts and credits posted.

Effect - Revenue and accounts receivable at June 30, 2011 were understated by approximately $90,000.

Recommendation - Management should review the detail of the charges used to determine the late charge accrual. Amounts that have been rebilled or are credit balances should not be included in the analysis.

Finding - 2011-11

Organization - Kauai Region

Finding Type - Significant deficiency

Criteria - Liabilities related to accrued vacation should be based on system reports.

Condition - The liability for accrued vacation was not properly adjusted as of June 30, 2011.

Context - Lack of review of liability in comparison to system reports

Cause - A manual report was used to determine the liability associated with accrued vacation rather than system reports, which are updated to reflect amounts earned and used by employees at the time of payroll.

Effect - Interim financial statements were understated by approximately $15,000 within liabilities and payroll expenses.

Recommendation - The vacation accrual should be updated on a regular basis based on reports provided by the payroll database.

Finding - 2011-12

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 Medical Center implement a formal policy which will include a monthly review of all adjusting journal entries, including supporting documentation.